

## Adapt and Prosper

*Many investors try to follow market leadership but few have a long-term, unbiased, and quantitatively derived strategy to do it. Jason Browne, manager of the FundX Upgrader Fund, doesn't find any value in trying to predict future leadership. Instead, he relies on an internally developed ranking system to capture broad trends and to select the funds with the most appropriate strategy and risk level in the current environment.*

**Q: What is your investment philosophy and how does it differentiate you from other fund managers?**

**A:** Our investment philosophy is based on the belief that market leadership changes over time, while most fund managers don't recognize that fact. They usually follow a particular style or a strategy that works well in certain market environments although it may not work as well in others.

Contrary to that approach, we have an investment strategy that adapts to changing market environments without trying to predict future leadership. We don't believe that we are able to forecast the future, or that we would add any value by doing that. But we believe that by monitoring the performance of the funds and the components of the market, we can take advantage of changing market leadership.

We manage a total of seven funds with a common strategy that is applied in a variety of ways. The funds differ mainly in terms of allocation, portfolio construction, and risk profiles. Currently we manage over \$2 billion and the FundX Upgrader Fund has about \$830 million in asset.

**Q: What's the process that allows you to benefit from the changes in market leadership?**

**A:** Our strategy is based on relative performance and the approach is fairly straightfor-

ward. We classify the mutual funds by risk, which we measure by the level of concentration and by the historical downside record. To determine the different risk categories, we look at a combination of performance, volatility, portfolio construction, style, and management.

Once we classify the funds, we rank them based on the average performance over the last one, three, six, and twelve months, or the various results within a year. The system is not overly optimized, and I believe that this is one of the reasons for its success. Effectively, we take a snapshot of the current winners on a bi-weekly basis but we rely on the monthly rankings for major portfolio decisions.

Then we review the rankings to select the funds that are in the top 10% of their risk category for the portfolio. We have specific sell thresholds, and when they reach the threshold, we replace them with the current leaders. By consistently applying this approach, we incrementally move from style to style and from one area of the market to another in response to changing market leadership. Our goal is to capture the broad trends that last for years as opposed to every little shift that might take place in the marketplace.

**Q: Would you explain your risk categories in more detail?**

**A:** We want enough variety in each risk cat-

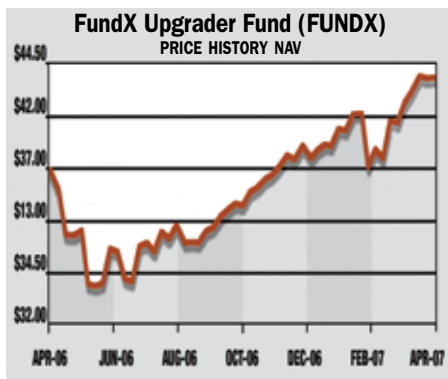


**JASON W. BROWNE** is a Principal, Portfolio Manager, and Department Head with DAL Investment Company, LLC in San Francisco, CA.

Browne oversees the daily trading, research and operations for the FundX Upgrader funds; a series of no-load mutual funds using both ETFs and mutual funds to execute DAL's active, relative strength based investment strategy.

Browne received his BA from San Francisco State University and his MBA from St. Mary's College.

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egory to potentially provide exposure to new areas as market leadership changes. In other words, in each risk category, we need value and growth orientations, different market capitalizations and both foreign and domestic funds represented. At the same time, we are cognizant of the fact that for each component of the portfolio, we have to understand and be comfortable with the level of risk. We only allocate money to funds with risk levels that are consistent with our objective.

Class I represents the most speculative fund category. It includes very concentrated funds, usually country-specific, or diversified funds that are very aggressive. Class II consists of speculative funds, which usually have regional focus such as developed countries or emerging markets. This category may also include broadly diversified funds that are more aggressive than the broad U.S. market.

Class III represents the core component of our portfolios. It consists of funds that are more diversified and with market-level risk. These can be international, domestic, large, mid, and small cap, value and growth funds. The idea is to have a diverse group that we can select from. Class IV represents total return funds, of funds that generate a significant portion of their gains through income. These could be REITs, balanced funds, or convertibles funds.

**Q: How do you approach the portfolio construction process?**

**A:** In the FundX Upgrader Fund, we typically hold anywhere between 50 and 70 different funds. About 70% of that portfolio is in the Class III category, or the more diversified funds. The other 30% is in the more specu-

lative risk categories. Typically, our smallest positions are in Class I, while the Class III holdings are two to three times the size of the holdings in the speculative funds.

We don't have any static allocations and our holdings change in response to changing market leadership. For example, in the late 1990s we had no international exposure; we held domestic growth-oriented funds. In 2000, we started a transition into value funds, still mostly domestic. When the FundX Upgrader was launched in November 2001, it was mostly in small and mid-cap value funds because that's where our rankings were leading us. By late 2002 and into 2003, we began to own a lot of international funds, which currently represent about 70% of the portfolio. Before we invested in mutual funds only; now we also use exchange traded funds.

Overall, we sidestep from the conventional wisdom that because you can't predict leadership changes, you have to ride through difficult periods with a diversified portfolio, including components that underperform over a sustained period of time with the hope that they will add value later. Instead, we hold the areas that do well and we get rid of all the others. But the portfolio is still diversified. Among the 60 different funds that we hold, we have hundreds of securities. For example, the 70% exposure to international funds is diversified broadly geographically and by market capitalization.

**Q: What are the major drivers of your sell decisions?**

**A:** Typically, if we own 60 funds in the portfolio, we would sell three or four of them each month. Although our turnover rate is about 100% to 150% per year, a lot of the turnover takes place on the fringes. We always have a series of funds that we hold for several years, and we have funds that we hold for three to six months.

It is a fully invested strategy, so we don't sell something unless we have something else that we find more attractive. Everything we own is a buy or hold; we don't sell just because it's going down. We are patient enough

to allow our system to guide us to future leadership as opposed to following the temptation of reacting to market events. Ultimately, if leadership changes, we'll change as well.

A side effect of our strategy is its tax effectiveness. First, we get distributions from the funds that we invest in and many of them end up being long-term capital gain distributions. And since we invest in funds based on performance, the funds that perform well tend to last awhile. The ones that we end up selling in less time usually have smaller gains or even losses.

**Q: What's your definition of long-term performance?**

**A:** Our goal is to outperform through the market cycle as opposed to generating a specific return over the near term. Upgrading is a long-term strategy that involves looking at short-term performance. Our experience shows that by monitoring our rankings and moving incrementally as leadership changes, we ultimately align ourselves with the leadership trends as they develop.

Overall, we try to capture 70% to 80% of a trend that lasts for months or even years. Because our system is less sensitive to short-term movements, implementation is easier. We focus on making sure that we have adequate diversity among the funds to select from and an approach that gets us into things reasonably quickly but doesn't constantly fluctuate. Fortunately, over the last 36 years that strategy has worked very well for us.

**Q: How do you handle the research process?**

**A:** We have a five-person investment committee and staff that is focused on research only. Since we take a quantitative look at the market, we hold the funds we buy accountable for their performance versus a peer group that we select. A great part of our research is geared towards the risk classes and involves looking at historical data and performance.

We use data from a variety of sources and we meet with fund managers to understand their

funds and to make sure that we place them in the right category. Most of the research is done through our proprietary software but we also use data from external sources to maintain our back tests and to monitor the actual performance versus our expectations. Then we monitor the performance of the funds to make sure that they're in line with our risk expectations.

We look for new funds and we evaluate the implications of the new funds to the various risk categories. Even if a fund is never selected, its presence in our rankings will affect the other funds. Adding a fund of a certain type can change our portfolio weighting more than our investment in it. We also continuously examine our risk classifications to make sure that the metrics we use are the best for the purpose. Overall, the monitoring is a constant process of matching historical experience and expectations with the actual practice.

Also, we always look at the number of funds that we need to own. When we evaluate the sell threshold, we have to factor in minimum holding times to avoid trading for the sake of trading. Having more activity not only generates potentially higher trading costs, but also increases the chance to cause problems for the underlying funds. So the optimal holding periods and the potential impact of the transaction costs are important pieces of the research process.

### Q: Could you give us specific examples that illustrate your process?

**A:** An example would be the emerging markets area. About a year ago, we had a lot of exposure there and we took a big hit when they sold off. The reason was that while some emerging markets funds fell in the rankings, others stayed highly ranked, and certain areas like China even moved higher. We don't feel compelled to react to a sell off; typically, we move incrementally. If the sell off is the beginning of a real inflection point, new leadership will emerge and we'll make a thorough change.


But not all the changes are as dramatic. Often funds start to move up and replace other

areas, even when they're still performing well. For example, the REIT funds have done well over the last several years but in some of our portfolios they have been replaced by utilities funds. REIT funds continue to do well and who knows whether utilities leadership will persist, but our system works through incremental moves into the one area and out of the other.

### Q: What's your view on risk control?

**A:** The portfolio construction in itself is related to risk control because, by design, we have to make sure that if we allocate money to a risk category, we would be comfortable buying any of the funds there. But once we have placed the funds in the risk categories, we continuously monitor for changes. The other important part is the liquidity. We recognize that sooner or later market leadership will change, and depending on the size of the fund that tops the ranks, we should be comfortable with the size of our position if we have to sell it.

Since we follow a quantitative strategy, we make sure that we don't take risk beyond our tolerance level for a specific piece of the portfolio. We measure the risk based on historical performance, mostly looking at Maximum Drawdown or the Ulcer Index. The standard deviation represents positive and negative deviations, the Ulcer Index measures only the downside. It is the average drawdown as opposed to the maximum drawdown.

Overall, I believe that most momentum strategies have a difficult time with implementation because they try to capture trends that don't last very long. Others try to predict future market leadership based on valuations or pure subjective judgement calls. We have found that it is best to stick to our unbiased process in a consistent way. Sometimes it may work against us, but we only do the things that have proved to add value on average, over time. By controlling risk through portfolio allocation, we are able to patiently follow our strategy in a disciplined way, which I believe is the principle driver of our long-term success. 

## FundX Upgrader Fund

Symbol	<b>FUNDX</b>
Website	<a href="http://www.fundxfund.com">www.fundxfund.com</a>
Address	DAL Investment Company LLC 235 Montgomery Street Suite 1049 San Francisco, CA 94104
Tel. No.	866-455-3863
Inception	11/01/2001

### PORTFOLIO

Total Net Assets*	\$806.2
Avg Mkt Cap (\$ Weighted) *	N/A
Average Price/Earnings Ratio	N/A
Average Price/Book Ratio	N/A
Turnover Ratio	112%

### INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$2,500
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$1,000

### RISK (AGAINST S&P 500 - 3-YR)

Alpha	0.20
Beta	1.25
R-Squared	0.65
Ann. Std Deviation	10.92
Sharpe Ratio	1.28

### RETURNS VS. S&P 500 INDEX

	FUNDX	Index
1 Year (Cum.)	13.56%	15.24%
3 Year (Ann.)	18.50%	12.25%
5 Year (Ann.)	12.22%	8.54%

### RETURNS VS. RUSSELL 1000 VALUE TR IX INDEX

	FUNDX	Index
1 Year (Cum.)	13.56%	18.15%
3 Year (Ann.)	18.50%	16.77%
5 Year (Ann.)	12.22%	11.83%

### FEES AND EXPENSES - A-SHARES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee**	2.00%
Total Expense Ratio	1.23%

### PORTFOLIO MANAGERS

Jason Browne	11/01/2001
Janet Brown	11/01/2001
Bernard Burke	11/01/2001
Martin DeVault	11/01/2001
Sean McKeon	11/01/2001

\* millions \*\*within one month of purchase

Data through: 04/30/07

Source: Company Documents; Lipper

Ticker staff searches for mutual funds for their consistency in performance and durability of investment style.

Our interview covers investment philosophy and strategy, research process, portfolio construction and risk control for funds. Through an interview we uncover long-term strategies and processes that help to generate long-term returns.

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