

Investing in Niche Creators

Instead of trying to predict when the market may rise or fall, Daniel F. Dent, portfolio manager at the DF Dent Premier Growth Fund, relies on selecting stocks with superior long-term growth characteristics, strong and sustainable earnings prospects, high quality management teams and reasonable stock prices. For him, the solid financial characteristics such as a high return on equity, good profit margins and a strong balance sheet are more important than the absolute size of the company.

Q: What is your investment philosophy?

A: We believe that stock performance is highly correlated with earnings growth. Sometimes, a stock may get ahead of the earnings and subsequently underperform while the earnings catch up, or there may be some macroeconomic or company-specific issues that could hold the stock back so that it is valued more attractively relative to its growth characteristics.

Q: What are the company characteristics that you look for?

A: We look for companies that can potentially sustain a high rate of earnings growth over an extended period of time. We look for companies that are the masters of their niche and that have established the strongest competitive market position within their niche. Ideally, we look for companies that were the creators of that niche. That niche may be defined by parameters such as product portfolio, distribution, marketing, geographic footprint or engineering expertise. The companies that have created, established and developed that niche are more likely to have the courage and the creativity to expand the niche, to adapt and to reinvent themselves more than the other companies.

It is very important for us to get comfortable with the management by seeing them both in public conferences, interviews and in our offices. We also go to their facilities to get

the feel of the management style, the corporate culture, whether the employees are supportive of management and happy with their jobs. We also look for managements that have modest salaries, significant equity ownership, and a passion for the business. We want them to have that unusual duality of being personally very humble and modest, yet at the same time very ambitious for the company and aggressive in managing the business. These are the qualities of Level 5 leaders that Jim Collins describes in his book, *Good to Great*.

Q: Could you give an example of a company that was not only the master of a particular niche, but also the creator of it?

A: Carmax, one of our largest holdings, was an experimental division of Circuit City. Circuit City decided to spin it off as a separate company. Carmax created a different experience for the purchaser of used cars which has been very successful.

One of the major aspects of their program is that a customer does not have to haggle over the price. The salesmen are commissioned with a fixed rate per car, which eliminates the temptation of the salesperson to try to push someone up to a higher-priced car to get a bigger commission.

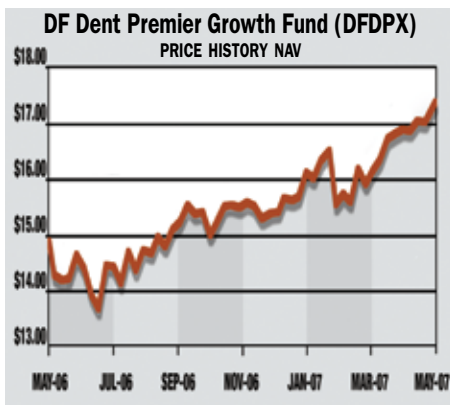
Carmax Superstores offer a much bigger selection. Their used-car lots annually turn over their inventory five times as fast as



DANIEL F. DENT CFA, graduated cum laude from Princeton University and later received an MBA in finance and investments from the Wharton School of Finance. He was a securities analyst before joining the investment counseling division of T. Rowe Price Associates in 1970 where he later became a vice president.

Dent is a Chartered Financial Analyst and a past president of the Baltimore Security Analysts Society, an organization of approximately 180 practicing investment professionals in Baltimore. He has served as a trustee and director of various non-profit organizations.

“We have found that stock performance is highly correlated with earnings growth. We look for companies that can potentially sustain a high rate of earnings growth over an extended period of time.”



the average within the industry, so they have a large supply of fresh cars. Through their website, customers can see the automobiles that are available, not just at the Superstore, where they are shopping, but in all the other stores within a reasonable distance. So if you find the car you like on the computer, and if it is within a reasonable distance, they will bring that one up for you. If you do not buy it, you pay a modest freight charge. But if you end up buying that car, the freight charge counts towards the price of the car. If you don't like the car at all and return it within five days, you will get a full refund with no hassle. Within the 30-day warranty, you can take that car to a mechanic of your choosing, and if there is anything that needs to be done that they have not already repaired before the car was offered for sale, Carmax will fix it at no charge.

Carmax has 80 stores nationally now, and they are growing that base at 15% to 20% per year. The efficiency and the margins should only get better as they cluster stores around cities. They have been able to adapt to change and to reinvent themselves periodically, and management has continuously refined the business model.

Q: What are the key elements of your investment strategy?

A: It is very much a bottom-up strategy. Being bottom-up, we do not have to be as concerned with an overall view of the world and the specific trends within the economy, although we do like there to be some kind of "mega-trend" or "wind at the back" of our companies. Really good growth companies

can often "power" through bad economies with strong earnings expansion.

Management integrity and passion, work ethic, corporate culture along with competitive drive and a good business model will more often reward shareholders no matter what the industry is. By using this process, we often discover companies that are not on everyone's radar screen.

Q: How do you reach your buy decisions?

A: First, we go through initial discussions to determine which companies we've seen recently that might merit further research. Once we come up with a company to be researched, we develop a detailed report on the company, which we call a Qualitative Research Template. We often make a Reasons-to-Buy list to distill the research down to some specific points that are important for the company. We also do a quantitative analysis on the company that analyzes various financial metrics and models earnings growth over the next several years.

Having done this work with a team of six research investment analysts here, there is usually a single person that has done the bulk of the research and knows the company best, and that person will become the sponsor of that company internally.

We don't have a highly structured approval process. Such flexibility allows us to look at any company which appears to fit our investment criteria. We all challenge the person that has developed the interest in the company and we review any of the possible reservations the other people might have. As we are not bound to a specific macro view of the world (which most likely would not be as accurate as assumed), we have the flexibility and the latitude to identify the companies that have the qualitative management characteristics and also the quantitative characteristics such as the growth rates, the return on equity, the profitability, the operating margins, the cash flow, the things that most growth investors will look at.

Q: How is your research team organized?

A: We have six investment/research people here. The investment work is divided between what we refer to as first and second generation. The three of us who all have in excess of 35 years investment management experience are the first generation. The second generation is three individuals that range in age from 33 to 41. Referring to them as the second generation implies that this firm is structured to remain independent and 100% management owned. This is in fact our commitment.

When we talk to prospective clients, we like to say that we have low turnover in three categories - a low percentage of lost accounts, low turnover of people within the firm, and low turnover within the portfolios.

Q: How do you go about building your portfolio?

A: We would like to be opportunistic buyers and we know what we want to buy. Since we have a very low portfolio turnover rate, there are a lot of companies that we have in the portfolio where we want to build position size, and we will try to use the weakness in stocks or the market to be opportunistic buyers.

The mutual fund has enjoyed a steady cash flow for its entire history of almost six years now. That means that at any point in time the percentage of our existing positions is diminishing to the extent that new cash keeps coming in.

About \$6.5 million of that cash flow goes towards buying existing positions within the portfolio. The portfolio in the first quarter, for instance, went from \$102 million to \$112 million, an increase of \$10 million. And about \$6.5 million of that was net shareholder purchases and the rest was appreciation. So basically 90% of that \$6.5 million went to maintaining the structure and the percentage allocation.

Q: What is the size of your biggest holdings? Do you look at any benchmark?

A: The top five holdings range in size from 2.57% to 2.87% of the total portfolio. The portfolio has a total of about 50 stocks in it. Within our peer group that's considered reasonably concentrated, although not concentrated enough for us. We'd like to have perhaps 10% fewer names in the portfolio.

We do not manage, weight, or allocate against any market benchmark. We are just looking for "best in class" companies as investments. However, almost by default, we use the S&P 500 Index as a benchmark for performance comparison, because it is a broad index that most managers use.

Q: What kind of risks do you monitor and what do you do to mitigate them?

A: We generally would not put more than 5% of the portfolio at cost into a security. In reality, we normally limit positions to 2.5%-3.0% at cost.

As a multi-cap growth fund, at the end of 2006 we had 39.4% of portfolio in large cap, 44.6% in mid cap, 8.6% in small cap and 7.4% was in cash reserves, which is a higher percentage in cash than we normally carry. Right at the end of the year, we had some purchases in the fund come in, so cash came in and built up the reserves right at the end of the quarter.

Over the last year or so, we have decreased the allocation in small cap from 16% percent to 8.6% and we have increased the large cap from 34% to 39%. With the new funds received late in the year, we increased large cap allocation by 5%. The shift over the course of the year was to build large cap at the expense of small cap. Over the history of the fund, the mid-cap area has had the highest allocation.

In our opinion, the greatest risk to our investments is loss of management credibility. We try to identify managements that tend to under-promise and over-deliver.


Q: How would you describe your sell discipline?

A: In situations where fundamentals change, we will eliminate the companies. Our research is intended to identify companies that have a sustainable high growth-rate over a long period of time so we are trying to buy companies where that's likely to happen.

When there's an issue and the company is light on revenues, margins or earnings, we try to figure out whether this is failure to execute on the part of management or something that is exogenous to the company that it had no control over. If management failed to execute in a significant way, we'll most likely sell the position. If the "miss" resulted from exogenous factors, we try to determine whether this is going to be a permanent change or not. If it's a permanent change, then we take the exogenous factors seriously, and we would consider getting out of the situation.

If we made an investment for reasons "A, B, and C", and subsequently find that we are holding the position for reasons "X, Y, and Z", then we are probably rationalizing a mistake and will consider the investment a sale candidate.

If we feel that the tide has turned for the companies we own, we will exit from our positions. But if we think that Wall Street concerns about the industry and the company are overblown or short-term focused and there are still solid long-term growth prospects in the technology, or business or marketplace, we will hold onto our positions.

For instance, there's been some concern with pricing and competition in the GPS space. But we feel that GPS technology is going to find more and more applications, many of which have not yet been discovered, and we believe that our three companies in this space will continue to be market leaders in their niches. Two of our top five performers in fiscal 2006 were the GPS stocks. 

DF Dent Premier Growth Fund

Symbol	DFDPX
Website	www.dfdent.com
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Tel. No.	866-233-3368
Inception	07/16/2001

PORTFOLIO

Total Net Assets*	\$127.9
Avg Mkt Cap (\$ Weighted)*	\$19,500
Average Price/Earnings Ratio	23.64
Average Price/Book Ratio	4.76
Turnover Ratio	25%

INVESTMENT INFORMATION

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

RISK (AGAINST S&P 500 DAILY REINV INDEX - 3 YEARS)

Alpha	0.09
Beta	1.04
R-Squared	0.76
Ann. Std Deviation	8.65
Sharpe Ratio	1.24

RETURNS VS. S&P 500 DAILY REINV INDEX

	DFDPX	Index
1 Year (Cum.)	16.69%	22.79%
3 Year (Ann.)	14.91%	13.03%
5 Year (Ann.)	12.15%	9.45%

RETURNS VS. RUSSELL MID CP TR INDEX

	DFDPX	Index
1 Year (Cum.)	16.69%	23.76%
3 Year (Ann.)	14.91%	19.14%
5 Year (Ann.)	12.15%	15.31%

FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio**	1.15%

PORTFOLIO MANAGER

Daniel F. Dent	07/16/2001
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*millions

Data through: 05/31/07

Source: Company Documents; Lipper

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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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