

Fundamental Morals

Aware of the risks connected with stocks investing, Integrity Growth & Income Fund uses a blended strategy to balance its investments between growth and dividend-paying stocks, depending on where value is in the stock market. Portfolio manager Robert Loest looks within his ethical universe to identify well-managed companies that generate reliable cash flows and consistent returns on investment and that sell below their estimated fair market value.

Q: What is your investment philosophy?

A: We have two core beliefs. First, investing in stocks is risky. Second, we want to invest only in companies that meet out ethical criteria. We use several statistical risk management tools to measure risk and risk adjusted returns. This enables us to keep risk under control and helps us identify developing risky situations. Although we primarily invest in stocks with very low investment risk, it doesn't eliminate the volatility risk. If the market goes down we are going to go down with it to some significant degree. Our primary objective is to minimize the investment risk, and let the returns take care of themselves.

Q: What are the key criteria that you follow in stock selection?

A: The moral focus applies to the Growth and Income Fund. Every stock that meets our investment criteria is then put through our ethical screen. If management fails significantly to behave in what we consider an ethical way, for instance, we will normally stay away from the company. If it passes our ethical screens, we continue with our fundamental analysis. Our value investment methodology helps us identify companies that generate reliable cash flows

and consistent returns on investment. We generate an estimate of future free cash flows to determine fair value for the company. We are looking to buy at a discount to the fair value to keep our risk in the portfolio.

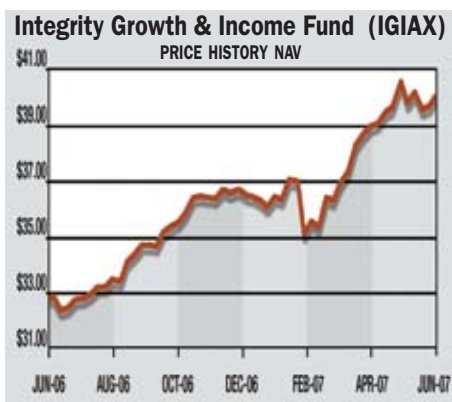
Q: What's the research process? Is it possible to buy stocks below fair value all the time?

A: We use the discounted cash flow method to calculate a company's ability to generate consistent free cash flows. The most recent 4 years plus the year we are in, and the last five quarters of cash flow enables us to build a set of operating and financial metrics that measure the performance and value of the business. Financial analysis of a 5-year period including the last five quarters provides a foundation to determine the long- and near-term direction of the business performance. Our research process compares the company's financial performance with its peers' and determines the fair value of the business. We prepare a 12-page report that helps us to summarize our findings on the company, business valuations and competitive landscape. We are always looking to purchase the stock at a discount to its intrinsic value but that is not always possible. For example, 3M



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Loest received his B.A. degree in 1966 from the University of Tennessee and his Ph.D. in biology from Florida State University. He graduated from the Navy's Officer Candidate School (OCS) in Newport, RI and served as a Naval officer from 1967-1972.



and Johnson & Johnson rarely trade at large discounts to fair value. There are a large number of investors who follow these companies, and they are always ready to buy them when they decline in value.

Q: How is your investment process organized?

A: Our investment process is designed to identify businesses that generate consistent, high returns in invested capital. Through our fundamental analysis we get a better insight into the investment merits of the company and its peers. We measure each company on a standardized set of measures and spend a lot of time in analyzing cash flows generated by various businesses. Our process looks at one company at a time and understands its customers, suppliers, competitors and barriers to entry. Our research process emphasizes returns on invested capital using free cash flow growth, removing the emotional component of investment selection.

“Our research process helps us identify well-run companies within our moral universe that are consistent free cash flow cows and have a high return on invested capital. After that, we just sit and wait for the prices to fall below our estimate of fair value for a buy.”

The research process basically comes up with companies that have a consistently high return on invested capital and that also lie within my moral universe. After that, we just sit and wait for the prices to fall into our buy range of a 30% or larger discount to estimated fair value.

Q: Can you illustrate your investment process with a couple of stock ideas?

A: The first example is John Wiley & Sons, a 200-year old publishing company. They publish scientific, medical and technical journals, and since I come from an academic background of science I know that research gets published no matter what the economy is doing. They have, in my view, little correlation with the economy. John Wiley provides a fundamental component of information that a technological society driven by knowledge cannot do without. Wiley is also a dominant leader in that marketplace. When I looked at Wiley they were selling at about half their fair value. This is a company that turns out free cash flow that is as predictable as the sunrise. The company is valued at \$2.5 billion and is largely ignored by investors. They have managed consistently to convert sales growth into high levels of free cash flow growth.

We bought Wiley for these reasons. During the last five years the company has managed to increase its operating cash flow from \$140 million to \$240 million. In our estimate, fair value of the company per share is north of \$90 with 7% growth, and \$57 if it never grows again. It trades at a huge discount near \$45 and company generates ROICs in excess of 21%, so we added the stock to our portfolio.

The second example is Johnson & Johnson. The company meets our criteria of steady free cash flows and rising sales and profits. The company also is one of the few pharmaceutical companies

that satisfy most of our ethical screens for animal rights. People for the Ethical Treatment of Animals (PETA) submitted a shareholder proxy to encourage them to reduce animal experimentation, and they were the most responsive of the drug companies. J&J generates a 30% ROIC and pays a steady dividend, yet the stock is undervalued by more than 40% by our estimate. The company is not polluting the world and is trying to minimize animal experimentation. This should give you a better picture of our research process and how I start to build a portfolio.

Q: How do you go about portfolio construction?

A: We run a diversified portfolio of between 20 and 30 stocks, which statistically eliminate virtually all of the stock specific risk of the S&P 500. Even with fewer stocks, our portfolio has less volatility in returns than most of our peers. It is easier to avoid bad sectors in the market with fewer stocks. When you have a large number of holdings you are more likely to be exposed to sectors that may significantly under-perform the market. Because of this discipline we were able to avoid residential construction and related areas because of this selective approach. It is also easy to overweight stocks or sectors that are likely to outperform the market.

This disciplined approach dictates that we only pick the one or two best companies in a particular sector. We may have a number of different industries with one or two stocks in each industry, but we tend to be concentrated where the value is, in areas such as non-housing related financials, healthcare, industrial, energy and business services which comprise about 50% of the portfolio.

We largely avoided primary gas and oil stocks for ethical reasons, and because most companies don't have any free cash flow due to huge capital expenditure requirements. About 6.5%

of our portfolio is energy. The financial stocks we have are credit card lender American Express and money market fund manager Federated Investors. We also have Portfolio Recovery Associates and Western Union.

Portfolio Recovery Associates buys up distressed credit card debt for the most part at about 2.5 cents on the dollar. They then collect the easy accounts over the next few years and sell the remainder to somebody else. In the process they make typically 300% or 400% on that portfolio of distressed credit card debt. It is a consistent free cash flow generator. It was selling at a significant discount to fair value when I first bought the stock because the economy was booming and the stock market was charging ahead. In this environment, nobody wanted a company that would benefit primarily in a weak economy. We bought the stock about 50% below fair value. We sold about half of our shares for large gains before the recent market drop, and it is now very undervalued again because they are growing so fast. And if the economy enters into a recession, the stock will benefit. We have about 4.25% of the fund in Portfolio Recovery.

Another 4% of the fund is in Epic Systems, with over 8% just in these two companies. Epic Systems essentially owns the bankruptcy software system in the U.S. They don't make their money by selling the software. When a company declares bankruptcy, its assets are put in receivership and held by a bank, and Epic is paid a percentage of the assets that are in bankruptcy resolution. The worse the economy gets, the more bankruptcies you have and the more money they make. Like PRAA, they are counter-cyclical. If a fund is not over-diversified in its holdings, a few counter-cyclicals like EPIQ and PRAA can make a big difference in its volatility and performance in recessions. If you are over-diversified, as


most large funds are, there are simply too few such companies to have much of a beneficial impact.

Q: Do you worry about economic recession? How is your portfolio likely to perform in case of economic downturn?

A: We look for companies that are not only undervalued and but also have superior returns on invested capital. Buying at a large discount to fair value means the stocks don't have as much downside risk as the overall stock market. We also look for stocks that will withstand a recession better due to major demographic, legislative or technological tail winds. This won't completely avoid risk, of course, but it does tend to reduce it to some degree.

Energy Conversion Devices (ENER) is another company and sector we believe is recession-proof. The demand for energy will keep rising, and solar energy will find a growing market in tough economic climates. The healthcare sector is another, because aging Baby Boomers and new medical technologies are expected to drive an increasing need in developed economies.

Q: How do you see the risk and what do you do to control it?

A: A widespread belief among individual investors and Wall Street is that risk and returns are correlated, although research shows that isn't strictly true. In a pure stock fund with ultra low investment risk, the risk is that you are not going to outrun the broad indexes in a strong market environment. We are normally fully invested in the market, and while our methodology won't protect us from normal market volatility, it should tend to minimize investment risk if investors don't allow themselves to be driven out by short term panics. We should do better in poor stock markets, which should reduce overall volatility throughout an entire market cycle. 

Integrity Growth & Income Fund

Symbol	IGIAX
Website	www.integrityfunds.com
Address	Integrity Mutual Funds, Inc. 1 Main Street North Minot, ND 58703
Tel. No.	800-276-1262
Inception	01/03/1995

PORTFOLIO

Total Net Assets*	\$44.07
Avg Mkt Cap (\$ Weighted)*	\$54,200
Average Price/Earnings Ratio	14.13
Average Price/Book Ratio	3.18
Turnover Ratio	37.89%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$50
Min Initial IRA Investment	\$1,000

RISK (AGAINST S&P 500 TR INDEX)

Alpha	2.64
Beta	0.86
R-Squared	0.66
Ann. Std Deviation	7.78
Sharpe Ratio	1.17

RETURNS VS. S&P 500 INDEX

	IGIAX	Index
1 Year (Cum.)	20.75%	20.59%
3 Year (Ann.)	13.42%	11.68%
5 Year (Ann.)	9.79%	10.71%

RETURNS VS. LIPPER MLT-CAP CORE INDEX

	IGIAX	Index
1 Year (Cum.)	20.75%	20.76%
3 Year (Ann.)	13.42%	13.25%
5 Year (Ann.)	9.79%	12.18%

FEES AND EXPENSES

Max Sales Charge - Front	5.75%
Max Sales Charge - Deferred	1.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.60%

PORTFOLIO MANAGER

Robert Loest	01/03/95
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*millions

Data through: 06/30/07

Source: Company Documents; Lipper

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