

## Margin of Safety

*In today's markets, forward-looking business analysis can reward an equity investor. The investment approach of Westport fund manager Edmund H. Nicklin, Jr. depends on the dynamics of an event-driven, earnings-focused strategy to identify companies that are selling at an attractive discount relative to their potential within a two-year investment horizon. The "event" is responsible for creating either the valuation discount or the catalyst to remove an existing discount.*

**Q: What is your investment philosophy?**

**A:** Market or company-based announcements sometimes offer investors an opportunity to profit from stock price movements. Stocks can sell-off dramatically when the market receives negative news and they can fail to fully reflect good news.

When either corporate information or a significant stock price change indicates a company has the potential to be an attractive investment, an analysis of the earnings capability of its assets is undertaken.

We do not believe in screening stocks on financial criteria to identify potentially attractive investments because these parameters are generally not forward looking.

**Q: What kind of earnings do you consider? Are you looking to buy companies trading at a discount to intrinsic value?**

**A:** From our perspective the key to valuation is forward earnings. Estimating forward earnings based on historical earnings is not advisable unless the

company's industry is stable. We try to identify events or catalysts that could affect the company's profitability and estimate the impact on the company's value in the short and long term. If the company's stock trades at a discount to this estimate of intrinsic value based on future earnings, we consider the company statistically acceptable. If the catalysts needed for closure of the discount are visible, the company shares are viewed as an investment. Furthermore, a discount to the intrinsic value provides a margin of safety for the investment.

**Q: How do you identify and evaluate events for your investment process?**

**A:** Our main sources are market, economic and company specific news that we classify broadly into negative and positive events.

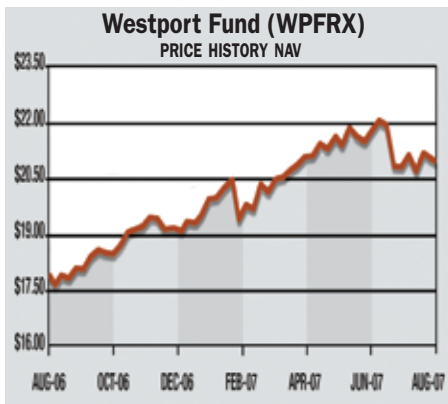
The occurrence of a negative event generally results in a significant price decline in the marketplace. However, a price decline, even a large one, may not signal a real opportunity but it should cause us to investigate. Industry or company-specific knowledge is an advantage in an analysis. An earnings miss is an important example of a negative event. If in our



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Nicklin is also portfolio manager for Westport Asset Management, Inc. Prior to joining Westport, he served as the portfolio manager of Evergreen Growth and Income Fund from its inception in October, 1986 to August 1997.

Nicklin holds a Bachelors of Science in Electrical Engineering, a Masters of Science in Management and Ph.D. in Operations Research and Statistics from the Rensselaer Polytechnic Institute. He is also a Chartered Financial Analyst.



perception, the underlying causes of a company's earnings miss were not long term or fundamental to its operations, we would be interested in the stock. If we believe the stock has significant upside, then we complete the analysis.

Positive events that trigger our interest include expansion of a company's current product line, a new management, or a business acquisition. A management change often improves company focus.

An acquisition will also attract us especially where it suggests that a company has improved its competitive position. In these cases, there is an opportunity for higher returns that may not be reflected in the company's stock price.

**Q: Can you give an example of a stock pick where you have benefited from a negative event?**

**A:** Federal Express or FedEx Corp. In 2005, this leader in express delivery service missed quarterly earnings with a higher fuel price an important contrib-

**“Ours is an event-driven, earnings-focused investment philosophy through which corporate value is assessed. Attractive opportunities should have the potential to provide a significant return in two years.”**

uting factor. Along with this negative, there were two positive long-term factors affecting the company. One, FedEx was revamping its business to carry more heavyweight freight and second, it was building out its international network. Our analysis suggested a company in transition to a higher level of profitability (in a stable economic environment) and an attractive investment.

**Q: Can you give an example of stock pick based on acquisition or on positive event?**

**A:** One unique example is a holding we acquired five years ago. There were actually three phases in the evolution of this portfolio holding, a small company - in pharmacy services – AdvancePCS.

At the start of this decade, we became interested in changes underway at drug distribution companies like McKesson Corp. and realized there was opportunity to profit as pharmacy benefit management services were granted to more corporate and government employees and retirees.

We noted with interest the sale by McKesson of its retail pharmacy benefit manager, PCS, to Rite Aid Corp., a drugstore chain. Next, PCS, the erstwhile McKesson subsidiary was sold to Advance Paradigm to form AdvancePCS which afforded the new company the advantage of PCS's network and technology, including software for administering retail pharmacy benefits. We liked the opportunity and established a position in AdvancePCS after the merger. The new company provided a better offering of healthcare services including a dramatic improvement in retail-pharmacy benefit management.

The next important event took place in 2004 when pharmacy services provider Caremark Rx, Inc., purchased AdvancePCS. Again, we felt there were significant benefits from the merger of these two companies including strengthened retail and mail and integrated retail and

mail pharmacy services allowing the combined company to compete effectively against Medco Health Services, heretofore the dominant mail pharmacy provider.

The third event was in May 2007, when Caremark merged with giant drug store chain CVS, promising profitability gains from economies of scale. Today that holding remains a significant position in the Fund. At each step in this chain of acquisitions, the outlook was reevaluated. Our analysis at each stage indicated that the acquisition would drive earnings and that there were substantial added gains possible for shareholders.

**Q: What is your research process? What metrics or screens do you apply when you look for stock ideas?**

**A:** We follow a two-step process, first, looking for negative and positive events, and second, gathering extensive information about the industry and the companies involved. Background knowledge of good companies and businesses is an advantage because it helps to avoid “value” traps – statistically attractive companies that remain that way. There are both subjective and analytical dimensions to the research process. The former often involves talking with industry competitors and people with industry knowledge.

Our aim is to try and gain sufficient insight to be confident in our judgment that the market is likely wrong in its assessment, and is unable to fully anticipate or wait for the positive outcome from the events we have reviewed. Consequently, we do not believe in screening companies on historical financial measures for research candidates. However, financial statistics are an important aspect in assessing corporate structure and forming a view of the business.

**Q: How do you go about portfolio construction?**

**A:** Ideally, we would like to have between 25 and 35 portfolio holdings - relatively

concentrated. The procedure is to add value through our research, and it is usually, one company at a time.

We allocate more portfolio assets to ideas where we have greater confidence in the anticipated results. Generally, we target an allocation of 3% to 4% for each position. We often initiate a position with less than 2% and then add to the holding over time.

However, twice in the past ten years, we had positions grow to more than 10%. Trimming is in order if the position grows much beyond this. Furthermore, in our approach we do consider the global economic picture in the analysis.

Our reliance on events and attractive valuation leads to low turnover in the portfolio and hence the fund tends to be tax efficient too.

#### Q: What is your buy and sell discipline?

**A:** Our investment strategy ensures that we buy positions in companies with good fundamentals, including a low price-to-earnings ratio based on future profitability, short term undervaluation, and usually with good cash flow generation.

Selling is always tough. Sometimes we have to fight against the “halo effect.” This is a situation where we consider the sale of a company that had heretofore given great returns. When the price target decided upon during our initial analysis is attained this triggers a reexamination of the holding to decide whether there are still possibilities for additional attractive gains. If not, we would scale back or sell the position. If however, the updated analysis suggests that given our parameters there is still upside, we would retain the position and may even add to it depending on the size of the position in the portfolio.

Another sell situation, an undesirable one, is where we find out that in our initial

analysis we missed something negative or we were wrong in our views and analysis. In some cases, a negative change may have occurred in the company’s fundamentals. In both cases we sell.


#### Q: Do you focus on any specific market caps? What benchmark do you consider while building the portfolio?

**A:** Our benchmark is the Russell MidCap Index. Lipper categorizes the Fund as a multi-cap core fund. Our investment strategy leads to a style somewhere in the middle of growth and value. We invest in undervalued stocks of all sizes but primarily in mid-cap companies, which are defined as having a market value between \$2 and \$10 billion.

We started this fund nearly ten years ago because we came across ideas that were unsuitable for our small cap portfolios, but wanted to use them.

#### Q: What are your views on the risk and how do you keep risk under control?

**A:** Again, our investment strategy relies on market events as catalysts to make investments. This limits downside risk by avoiding stocks with full valuations. We do look to diversify industry representation in the portfolio consistent with restrictions on concentration in the Funds’ prospectus.

Generally, we also try to avoid risky, commodity type businesses, because, despite our analysis, such an investment is still subject to the price swings of the underlying commodity. The one exception is the significant representation we have had in oil and gas exploration and production companies for some time. Oil prices are rising due to increased demand from emerging markets and not because of a supply disruption, as was the case with previous price increases since the 1970’s. They provide insurance in addition to current attractive fundamentals. 

## Westport Fund

Symbol	<b>WPFRX</b>
Website	<a href="http://www.westportfunds.com">www.westportfunds.com</a>
Address	Westport Advisers LLC 253 Riverside Avenue Westport, CT 06880
Tel. No.	888-593-7878
Inception	12/31/1997

#### PORTFOLIO

Total Net Assets*	\$36.3
Avg Mkt Cap (\$ Weighted)*	\$16,900
Average Price/Earnings Ratio	25.58x
Average Price/Book Ratio	3.42x
Turnover Ratio	1%

#### INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$2,500
Min Subsequent Investment	\$0.00
Min Initial IRA Investment	\$2,000

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

Alpha	0.48
Beta	0.92
R-Squared	0.61
Ann. Std Deviation	8.56
Sharpe Ratio	1.49

#### RETURNS VS. S&P 500 DAILY REINV INDEX

	WPFRX	Index
1 Year (Cum.)	17.29%	15.13%
3 Year (Ann.)	17.79%	12.16%
5 Year (Ann.)	16.09%	12.00%

#### RETURNS VS. RUSSELL MID CP TR INDEX

	WPFRX	Index
1 Year (Cum.)	17.29%	16.18%
3 Year (Ann.)	17.79%	17.33%
5 Year (Ann.)	16.09%	17.82%

#### FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.49%

#### PORTFOLIO MANAGER

Edmund H. Nicklin, Jr.	1997
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\* millions

Data through: 08/31/2007

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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