

Undervalued Market Leaders

A focused model driven fund portfolio can be quite a risky proposition. However, Mark Hillman, portfolio manager of Hillman Focused Advantage Fund, surmounts such risk by investing in companies that are market leaders, possessing a sustainable competitive advantage in their industries, but which are currently trading at a discount to their intrinsic value and believes that in the long run, they will outperform their competitors.

Q: What is your investment philosophy?

A: Our investment philosophy consists of three core beliefs. First, we believe that companies that possess a sustainable competitive advantage in their industries in the long run will outperform their competitors and achieve superior stock price appreciation over several economic cycles. Secondly, we believe in purchasing these companies' shares when they are trading at a discount to their fair market value. Lastly, we believe that consistent adherence to a discipline based on fundamental valuation techniques will produce superior results.

Q: How do you identify a company with a sustainable competitive advantage in its industry?

A: We are market generalists and do not focus on any particular sector. We focus on U.S. companies and evaluate them according to the five parameters explained in Michael Porter's "Competitive Strategy". They are: What is the company's pricing power with its customers? What is its purchasing power with its suppliers? What are the barriers to entry to protect that competitive position that the company might enjoy? What is the degree of rivalry amongst the competitors in the industry? Lastly, how relevant are the substitute goods for the goods or services that they provide, what substitutes are out there and at what point do they become relevant? The answers to these five questions help us get a good

handle on a company's competitive position and its sustainability.

Q: Based on your investment philosophy, what is the fund investment strategy?

A: We first try and identify U.S. companies that have a sustainable competitive advantage in their industry and are undervalued. However, identification is not an easy task. Most fund managers will start off with some sort of quantitative screen and based on valuation techniques screen through say, the Russell 1000 or the Russell 1000 Value index and come up with a short list of undervalued candidates. They will then take a qualitative look at the businesses and decide if they like them or not. We reverse that process because it's hard to be rational about a company's business prospects if you already believe that its stock is undervalued and it has passed through your valuation screen. So we do qualitative analysis and research first.

In trying to identify investment candidates, we go through a list of qualitative concerns that includes, besides the five points of the Porter model, some key questions. They are: Is the company an industry leader? Does it dominate a certain niche market? Has management proven that they're prudent and proactive over various economic cycles? Does the company have a strong franchise or brand loyalty and do they provide outstanding customer service within their industry? And lastly, given positive

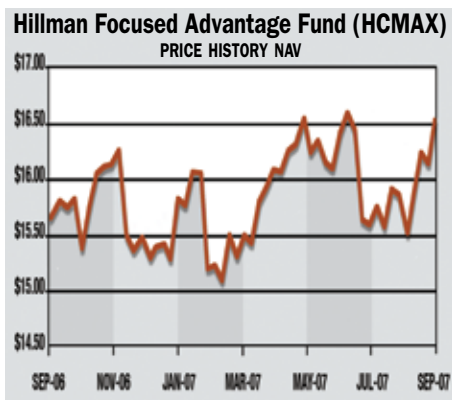


MARK A. HILLMAN President and Chief Investment Officer, founded HCM in 1998. Hillman brought into the firm assets of predecessor companies he had established in the early 1990s. His first investment advisory company, Custom Asset Management, merged with Menocal Capital Management, in 1993 and Hillman became Chief Investment Officer of the combined firms.

Prior to founding his first firm, Hillman was a financial consultant with Shearson Lehman Hutton. A graduate of Tufts University, Hillman had done graduate coursework at Harvard University Extension School.

An expert sailboat racer, Hillman has competed successfully in National and World Championships over three decades.

“We believe companies that possess a sustainable competitive advantage in their industries, in the long run, will outperform their competitors and also achieve superior stock price appreciation over several economic cycles.”



answers to all these questions, will the company still maintain its competitive edge and is financially sound enough to withstand any kind of short term problems or an economic downturn or any paradigm shift in how the industry works or any increased competitive pressures? We believe with a strong balance sheet and good cash flow a company can get through those kinds of tough times.

Any company that satisfactorily answers these questions convinces us of its sustainable competitive advantage and becomes a candidate for investment. Generally, through this process, about 100 companies fall into our investable universe of qualified candidates.

We then run valuation models on a daily basis, on all the companies in this universe. The quantitative metrics we use includes growth at a reasonable price model, a discounted cash flow model, a price-to-book model, a justified price-to-sales model and a dividend discount model. And we actually calculate five separate and distinct fair market values for each company so that there's no interplay amongst these models. We then take the highest of these five numbers and assign that as our fair market value. Finally, we sort these companies from most undervalued to most overvalued and then pick out the 20 most undervalued stocks.

We never make top down macroeconomic decisions about how much to allocate any one sector or industry. We research one company at a time first based on competitive advantage and then on valuation. Con-

sequently, when a company or industry is out of favor the valuation will show that and push us towards it and vice versa.

Q: Can you walk us through your research process?

A: I have been in the industry for over 20 years and experience tells me where to look and how to find information and determine who the various industry leaders are. Some are easy to identify and some come through a more stringent research process. For example, in the quick-café arena, one will easily identify Starbucks as the leader in that industry.

Another way to identify leaders is through companies you already know about that lead you to them. This is due to the concentric rings of quality that revolve around quality companies. We also collect information first hand by visiting companies as a consumer, researching their products and services and in the case of retailers, their stores.

For example, one of the retail companies in our universe is Staples, the office supplies leader. A visit to a Staples store will reveal that they're reselling phone service such as Verizon Wireless. Thus, Staples has just led us to Verizon, a quality company in the wireless business. A look at Verizon's wireless network reveals that its backbone is CDMA Technology the patent for which is owned by another quality company, QUALCOMM. Thus researching one market leader Staples led us to two other market leaders and if one digs further and finds out who manages their logistics, shipping and various other functions one will be led to many other companies as well as their competitors.

Ideas also come from the many contacts developed over the years, in various industries and with commercial and investment bankers whose intellect we trust.

Once we've identified investment candidates we have to look for sustainable competitive advantage. We therefore study the detailed financials and read various trade journals, and company filings and research

reports by independent analysts and listen to management conference calls. Our experience helps us glean all the information we need from those types of reports.

Q: Can you give us examples of stocks you have purchased that illustrate your research process?

A: One example is Goodrich Corporation. A supplier to both the commercial and military sectors of the aerospace industry, the components or systems that Goodrich provides, cover many parts for an aircraft manufacturer giving them a 50% market share in the arena. They are a leader in each of the areas where they operate such as airframe systems including landing gear, wheels and brakes for 100-plus seat passenger jets. They're global producers of various jet engine components and parts and also manufacture electrical systems.

Goodrich's customers are industry heavyweights such as Boeing, Airbus Industries, Rolls Royce, Southwest Airlines and the U.S. Military. Being the leader gives Goodrich a strong advantage because aircraft manufacturers are loath to experiment with parts and systems suppliers, if an aircraft fails there are very severe consequences. Boeing and other aircraft users rely on Goodrich for the long term availability of parts and giving Goodrich a long term competitive advantage.

Furthermore, although aircraft manufacturing is cyclical, supplier companies like Goodrich actually have very stable revenues because there is a dynamic market for replacement parts. Aircraft parts have to be replaced more frequently than the aircraft itself creating a steady revenue stream. There is also a steady cash flow to Goodrich for servicing the parts that they manufacture as most of the components and systems are of a proprietary nature and specially designed, and cannot be replaced in the aftermarket by other manufacturers.

We bought Goodrich in the aftermath of the September 11, 2001, tragedy when stocks of all aircraft and components manufacturers, were really beaten down. Goodrich, a market leader became dramatically under-

valued and was already part of our qualified universe because we understood their business and we bought it at what we felt was an extreme discount to its fair market value and held the company ever since. In any case, the general perception is that the aerospace industry will be going through a large product replacement cycle in the coming decade with the introduction of new products and projects.

Q: How is your portfolio constructed?

A: Ours is a focused portfolio of just 20 stocks that are the most undervalued securities in our qualified universe with each equally weighted to 5% of total portfolio. Nothing new is added into the portfolio until something is sold. When a new stock is added our goal is to get to 5% as soon as we can without affecting the share price.

We follow a simple rebalancing strategy while maintaining the portfolio of 20 stocks. If a stock declines to 2.5% of total portfolio value we buy it back up to 5%. If a stock increases to 10% of total portfolio value we trim it back to 5%. We don't want to have more than 10% invested in a company.

Q: What is your buy and sell discipline?

A: We hold our focused 20 stocks in the portfolio until one of two things happens. One, our quantitative metrics tell us that a company we hold has become overvalued. That's a signal to us to sell the stock immediately. The other reason for a sell decision is when the continuous monitoring of our holdings reveals that a particular stock no longer holds a position of sustainable competitive advantage, which is our primary investment criterion.

In either case of selling out, the stock is replaced with the one company in our qualified universe that happens to be most undervalued on the day the portfolio vacancy occurs. We value each security daily so we know which is the most undervalued in our qualified universe on any given day.


Q: Against what benchmarks do you compare your fund to?

A: We think the Russell 1000 or the S&P 500 are great benchmarks for what we do because they address the market caps that we focus on and the potential breadth of the kind of companies in which we like to invest. However, we do not make portfolio construction moves to make us look anything like the index intentionally. We think the Russell 1000 is a fair benchmark because we can invest in any company that has \$3 billion or more in market cap to meet the liquidity requirements of a concentrated portfolio like ours. Moreover, most companies that are market leaders are usually large cap and since more than 70% of our universe is large cap our average holding is almost always a large cap company.

We also don't tie ourselves to growth or value style of investing and don't really care if companies are in the value or growth categories. We only focus on whether they are great companies with sustainable competitive advantage, and try buying them when they're undervalued and selling them when they're overvalued. Again, we do not try to put ourselves in the core box either because one cannot effectively add value by sticking to one style box. We believe investing in great companies at the individual level and being strict about valuation is how you add value.

Q What is your view on risk? How do you manage or mitigate risk?

A: Obviously a focused strategy is going to be a little more volatile than other types so we think that by keeping the weightings equal and continually rebalancing the portfolio will help us to manage risk and not become too overly weighted in any one stock.

We however, do not try to do anything about systematic risk as we're always 100% long equities in the portfolio. Furthermore, by our own definition, our high quality universe consists of companies that are well managed, with strong balance sheets and have sustainable competitive advantage in their industries and we feel that within a context of managing equity portfolios this is a great way to reduce the risk. 

Hillman Focused Advantage Fund

Symbol	HCMAX
Website	www.hillmancapital.com
Address	Hillman Capital Management Inc. 7600 Wisconsin Avenue Suite 650 Bethesda, MD 20814
Tel. No.	800-226-0206
Inception	12/29/2000

PORTFOLIO	
Total Net Assets*	\$104.5
Avg Mkt Cap (\$ Weighted)*	\$94,500
Average Price/Earnings Ratio	18.59x
Average Price/Book Ratio	3.44x
Turnover Ratio	43%

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

RISK (AGAINST S&P 500 - 3-YEARS)	
Alpha	0.03
Beta	1.09
R-Squared	0.66
Ann. Std Deviation	10.07
Sharpe Ratio	1.04

RETURNS VS. S&P 500 INDEX		
	HCMAX	Index
1 Year (Cum.)	13.81%	16.44%
3 Year (Ann.)	15.00%	13.14%
5 Year (Ann.)	22.49%	15.45%

RETURNS VS. RUSSELL 3000 TR INDEX		
	HCMAX	Index
1 Year (Cum.)	13.81%	16.52%
3 Year (Ann.)	15.00%	13.74%
5 Year (Ann.)	22.49%	16.18%

FEES AND EXPENSES	
Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.53%

PORTFOLIO MANAGER	
Mark A. Hillman	12/29/2000

*millions
Data through: 09/30/2007
Source: Company Documents; Lipper

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