

Looking for Total Return

Getting the best long-term total return from stocks that appear to be currently underpriced is a difficult task. Quaker Core Value Fund manager John Geewax has quantitative investment approach that involves a blend of value and growth concepts. His team looks at yield, growth, valuation and an acceptable discount rate to get the best total returns from their stocks with a view to outperform the S&P 500 Index.

Q What is your investment philosophy?

A: Our investment philosophy is to get the best long term total return from stocks that appear to be currently underpriced. While identifying companies worldwide, we look for a combination of yield, growth, valuation and what we consider an acceptable discount rate. We believe, this quantitative approach will get us the best total return and the stocks we buy will ultimately outperform the S&P 500 Index. It is very similar to what a venture capitalist or a private equity investor would do, or what an ordinary person would do if he were buying a house, or any other asset.

The idea therefore, is to look at a company with the ability to generate cash, grow the cash and at the same time, look at the risk inherent in those cash flows, relative to the overall macro environment. And, unlike value managers who just look at yield and valuation, and growth managers who look at growth, or other mutual fund managers who just consider risk or the concept of beating a bench mark, we like to combine everything together. We are thus in a blend area where we can rotate between growth and value. We look into growth and the value basket and if the company meets our total return criteria including the dividend and earnings, it interests us.

Q: In your total return concept, are you

looking for absolute return regardless of the market or relative return?

A: We look at relative and not absolute return, because we are looking for yield, growth and risk relative to the industry, to the sector and the market which implies we are correlated to market volatility.

Looking for relative returns implies we are always looking to outperform the market – in both its upside and downside. For instance, if the market is up 5% we aim to beat it. Again, in a market downside, say market is down 6%, our downside must be less than that. In short, we want to capture the upside better than the market and protect ourselves better than the market in the downside.

Whereas, a fund manager who looks for absolute return, has a fixed target for return and must always achieve a positive return relative to the market irrespective of market volatility.

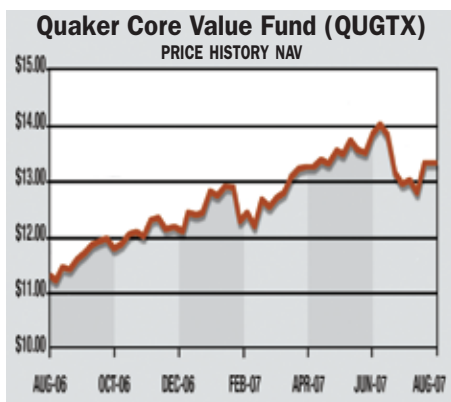
Q: What is your investment strategy? How do you go about finding these companies?

A: We focus on the best 10% of the largest thousand companies in our universe that comprise the Russell 1000 Index. We first try to identify the best of the financially sound large companies in each and every sector and put them through extensive and complicated earnings valuation screens. We believe from the risk point of



JOHN GEEWAX co-founded Geewax, Terker and Company in 1982. As Chief Investment Officer, Geewax oversees the portfolio management, research and development, and trading functions of the firm.

Geewax began his investment management career in 1980, while teaching Corporate Finance and Security Analysis at The Wharton School. In 1979, he completed his PhD coursework (all but dissertation) in Economics and Finance at The Wharton School. He received his MBA from Wharton and his Juris Doctorate from University of Pennsylvania in 1978 and 1983, respectively.



view, large companies have an advantage over small companies because of their cheaper borrowing costs.

The idea is that we want to discount future cash flows and retained earnings, and we have to figure out where the stock is likely to trade at. For example, Proctor and Gamble has historically traded 10% above the market multiple. Therefore, we really want to know the range of where a stock is trading, and thereby discover its normal range on the valuation. Our valuation then would be to look at expected growth in the following years; the dividend policy, current and historical; the current valuation relative to where it's been, and then try and calculate the discount rate of a stock.

In calculating the discount rate we are more interested in the volatility on the downside because there is a risk to underperforming the market; if the the company does not meet future expectations. So we do everything necessary to explain a downward price volatility of a stock. We're looking at all the fundamental characteristics, such as, variance of earnings, vari-

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ance of sales, change of earnings, change of forecast and profit margin changes as well as price volatility characteristics of a stock to try and explain the profitability of the next quarter, that the volatility is more on the downside than on the upside and that's our discount rate. We put that altogether in what we would call standard dividend discount model.

We then compare that expected return to the current price. Our expected return should be much higher than the required return, because all those expectations are not built into the current price.

That is why we own both high growth stocks and distressed stocks, and slow but steady growth stocks, like Proctor and Gamble, where the expected growth in international sales is not factored in the valuation model and the reduced variability in earnings is not built into the price of the stock yet. Even though we've often been compared to value people, in reality we cover all sectors, all capitalizations and growth and value styles. Ultimately, our goal, each and every month is to have the highest total return stocks in our portfolio, beat the S&P 500 each and every quarter.

Q: Can you walk us through your research process from when you get an idea and what you do with it?

A: First, in researching a company, we make extensive use of computers and modelling, and our sources of information are the financial statements and the footnotes to those financial statements, as well as any other management guidance on earnings. We are always looking to analyse that information faster and better.

We look at customer data, supplier data, in fact, all available corporate finance information as well as every analyst's estimate, changes in estimate, and price data in a very detailed fashion to form our own indicators of yield, growth, valuation and risk. Our valuation and risk concepts allow us instead of just focusing on technology companies or financial companies, to compare similar companies across sectors.

Q: Can you give a couple of examples of growth and value stock picks, as a result of this research process?

A: A value pick would be News Corp., a globally diversified media company with various media channels stretching across the world. Because of its large size it can withstand the current turmoil in the U.S. newspaper industry caused by the shifting of media budgets from Newspaper and TV to the Internet. Consequently, this company is quite cheap, a survivor, and dominant player in the global media landscape. Moreover, the variability of its earnings and its profit margin is much lower than its competitors. That gives it the lowest discount rate and the highest cash flow in the whole industry and it ended up in our portfolio.

Examples of growth picks are Proctor and Gamble and Johnson & Johnson. In those cases, although the U.S. market is undesirable from a growth point of view, the foreign sales, for both these companies, have become a larger component of total sales, and the margins on foreign sales have started to expand. Moreover, the margins overseas have always been lower than the U.S. sales and so although their price-to-earnings ratio is a little expensive relative to the market, yet, relative to where they traded in the past, it's average. We believe those are two of the margin increases stories and you have less variability relative to the domestic market in those two stocks than anywhere else. It's basically a risk control story, of reasonable valuation with more growth than the overall market.

Q: How do you build your portfolio?

A: Ours is a bottom-up approach. We get our industry diversification by comparing stocks relative to an industry. We will always own the best companies in a sector hence we will be represented in all sectors. At any given time we hold anywhere from 60 to 100 stocks in our portfolio.

Our aim is to form a minimum variance portfolio. Consequently we are not bound by arbitrary rules for weighting stocks in our portfolio. We just use a more statistical technique but ultimately, given our best ideas, it boils down to how we form a

portfolio that will correlate better with the S&P 500 and not cost a lot to transact, and still give us higher total return. Our job is to beat what everyone can buy as a certainty equivalent, which is the S&P 500, minus 10 basis points.

Our allocation is therefore unequal. We overweight bigger caps; the smaller caps would be underweight relative to the big caps. For instance, if we have 4% of GE and it's 3.8% in the Russell 1000, then we are 0.2 overweight. So we probably cover about 30% to 40% of the S&P 500 by weight and the other 70% to 60% are over weighted relative to the large cap index.

Furthermore, if we only have 10 consumer non-durable names, they will be slightly over weighted relative to their liquidity, so we move them from 5% of the portfolio to 10% or 15%. At the same time if we have 50 technology names in the index, and they are 50% of the portfolio, we have to trim them down to 30%, because the probability of not outperforming the S&P increases dramatically in such a case.

Our turnover averages 100% which is a sore point for most investors. This year has been a volatile one so it's high at 160% but we've outperformed the index by 500 basis points.

Q: How do you go about buying and selling positions in the fund?

A: Ours is a minimum variance portfolio since we buy the best total return stocks in every sector and expect them to be independent of sector volatility. This implies controlling for all correlations, interest rate risk, variability of earnings and sales.


This is because we are interested in geometrically compounding our return. We may have the best 10% stocks however we do not know which one is going to be number 1 and which will be number 50. That's why we look at the correlations and the downward price volatility. If we're wrong we have to sell it, if we're right and we're going to have to buy it, then that involves transaction costs, and maybe we have to contend with the probability of not beating the S&P 500.

Take GE, for example. From a valuation point of view, in this market, GE is low risk even with their finance unit. GE is a very popular name in terms of growth of foreign sales, changes in its business units from getting rid of the finance and getting rid of the cyclical to more growth. However, the bottom line is that its price-to-earnings is just too high, too expensive for the growth that it will achieve given its current discount rate. In the past its discount rate was below average. Consequently, we consider that it is a more volatile stock in this market, and although we have owned it for more than three years now, we are selling it.

Q: How do you view the risk and what do you do to manage it?

A: Risk is very important to us both at the company and stock level. The stock has to do with beating the benchmark which represents the overall equity market, because you can buy ETF representing the market at a cheap transaction cost. Generally, we have a quality bias, and this bias permeates our whole philosophy.

Our whole process involves looking at fundamental factors driving the risk; not only debt equity or margins, but relative to its industry. Everyone has a different business model so you have to model things appropriately. We first look at fundamental factors, leverage factors, margins, changes, cash flow and their changes relative to their cycle, relative to their industry to avoid the bankruptcy and then secondly if it flows through to the lower variability of earnings and sales of the companies we own. We will also probably not buy companies with lowest Price-to-earnings or price-to-book companies, because oftentimes companies in this group tend to decline in the long term.

We then finally look at the macro level for each individual firm, we're also looking at changes in interest rates and macro factors and the overall discount rate of price-to earnings to what is often called the earnings yield minus the government bond rate to see how the company reacts to those macro factors. Our aim is to avoid companies that have a high exposure to macro events. 

Quaker Core Value Fund

Symbol	QUGTX
Website	www.quakerfunds.com
Address	Quaker Funds Inc 309 Technology Drive Malvern, PA 19355
Tel. No.	800-220-8888
Inception	03/26/2002

PORTFOLIO

Total Net Assets*	\$3.5
Avg Mkt Cap (\$ Weighted)*	\$65,600
Average Price/Earnings Ratio	18.38x
Average Price/Book Ratio	3.35x
Turnover Ratio	184%

INVESTMENT INFORMATION

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

RISK (AGAINST RUSSELL 2000 GRO TR IX - 3 YRS)

Alpha	0.61
Beta	0.62
R-Squared	0.77
Ann. Std Deviation	10.13
Sharpe Ratio	1.24

URNS VS. RUSSELL 1000 VALUE INDEX

	QUGTX	Index
1 Year (Cum.)	20.14%	12.85%
3 Year (Ann.)	17.49%	14.54%
5 Year (Ann.)	18.54%	14.54%

RETURNS VS. RUSSELL 2000 GRO TR INDEX

	QUGTX	Index
1 Year (Cum.)	20.14%	16.36%
3 Year (Ann.)	17.49%	15.06%
5 Year (Ann.)	18.54%	16.27%

FEES AND EXPENSES

Max Sales Charge - Front**	5.50%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Gross Expense Ratio	1.89%
Net Expense Ratio	0.84%

PORTFOLIO MANAGER

John Geewax	03/26/2002
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*millions **for amount less than \$50,000

***waived for shareholders going direct to the fund

Data through: 09/30/2007

Source: Company Documents; Lipper

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