

In Quest of Core and Catalysts

Identifying high return companies in the relatively volatile small-cap and mid-cap space requires considerable experience and expertise. Ryan Crane, portfolio manager of the Stephens Mid Cap Growth Fund and the Stephens Small Cap Growth Fund, and his research team employ a judicious combination of fundamental and quantitative analyses in their unique dual-approach strategy to make money from growth investments for their two funds.

Q: What is your investment philosophy?

A: We are growth investors. Our ultimate goal is to evolve a strategy that will enable us to invest in growth companies where companies can grow multiples bigger in our small and mid-cap growth portfolios.

Our philosophy is pegged on two different approaches to growth investments. One, to look for core growth companies, the stable, predictable and consistent performers, and two, to invest in companies that are likely to improve their earnings in the near term.

Q: Can you elaborate on these two approaches?

A: Growth is our keyword. One approach is to look for a core growth stock that is synonymous with stability in business, predictability in earnings and thus, consistency in stock performance. We are looking for unique business models that allow a company to enjoy outsized returns with lower risk and lower volatility to their financials, whether it is earnings, revenues or cash flows.

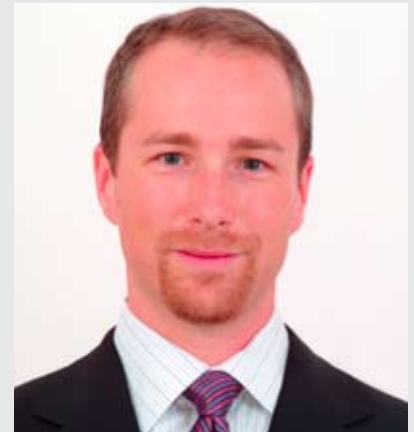
The second approach is to look for the earnings-catalyst type or the inflection point catalyst that can generate multi-year earnings growth. These stocks are at some inflection point - the business

models have transitioned and there is some event or trend that is going to last for more than a few quarters, even multiple years, but the market does not catch up to that fast enough.

Sell and buy side analysts do not change their models fast enough so we get this long time period when the stocks are able to beat earnings expectations year after year. We get really outsized gains from such a stock as it grows faster than market expectations. Again, we get multiple expansions, as people are willing to pay more for a stock that is growing faster than in the past.

Q: What is your investment process?

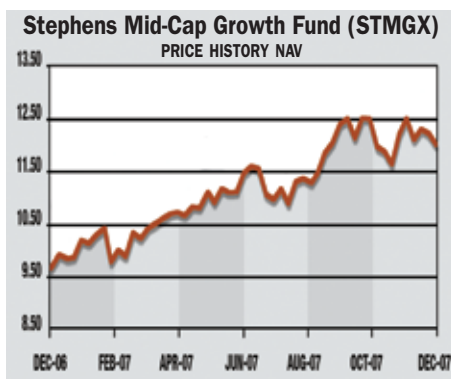
A: Our investment process is a combination of fundamental and quantitative analyses. Fundamental analysis helps identify and understand business models and the factors that drive them, and for the best of these we build an investment thesis on the stock. Additionally we have a disciplined quantitative process that helps in confirming any investment thesis we may have for a stock, or in some cases, a theme that is broader than just one stock. For example, a couple of stocks could fit into a theme. Our fundamental analysis can also help us identify a catalyst. Just because we believe one particular company is doing



RYAN CRANE is the Chief Investment Officer of Stephens Investment Management Group and the Senior Portfolio Manager. Prior to joining SIMG in 2004, Crane was Senior Portfolio Manager for AIM Capital Management, Inc., and was the lead manager of AIM's Small Cap Growth Fund and team leader of the small/mid-cap growth investment team. While at AIM, Crane helped grow the AIM Small Cap Growth Fund from \$28 million to approximately \$3 billion in assets. In addition, he was a portfolio manager on AIM Constellation, AIM Aggressive Growth, AIM Global Aggressive Growth, and AIM Emerging Growth Funds.

Crane received a Bachelor of Science degree with honors in economics from the University of Houston in 1994. He is also an investment counselor for the student managed investment fund at the University of Houston Bauer School of Business. He holds a Chartered Financial Analyst designation and his NASD Series 7, 9, 10, and 63.

“Our goal is to evolve a strategy that will enable us to invest in really great growth companies, like the 10-fold return type of investments, for our small cap and mid cap growth fund portfolios.”



better because of certain factors that have changed, which we have identified, we need to verify our findings. That is where the quantitative analysis comes in.

Often, we do the fundamental work first followed by the quantitative analysis. Sometimes, however, the quantitative approach is our first line of offense and defense. For instance, the number of companies in our investment universe is vast and we cannot be doing fundamental analyses on all of them at the same time. Here, our quantitative analysis will first give us the inflection points that would imply the company might have this core growth-like characteristic and then we do the fundamental analysis.

We also do not set price targets on stocks because we believe such targets are often a sure way of excluding ourselves from some of the best growth ideas. Our goal is to capture rising earnings curve and benefit from the sharply higher valuations.

Q: What are the differences in the strategies and research that you follow for your small-cap and mid-cap products?

A: The philosophical and stylistic kind of approach is almost identical for both products. However, there are differences arising from the different definitions accorded to small and mid cap stocks.

The small cap universe generally has more companies that would fall into the earnings catalyst type category. Most

of these less than \$500 million market cap companies are still growing and it is hard for them to already be at a point where they are exhibiting characteristics of a core growth, predictable, stable company. Therefore, our small cap fund tends to skew more towards the catalyst type companies.

Furthermore, we do not try to actively manage the ratio of core growth companies versus earnings catalyst companies in the two portfolios. It is a part of the bottom up process that we let float back and forth. Therefore, in strong economic or market environments we will inherently be more focused on the catalyst type companies which tend to be higher growth rate, higher beta stocks. The fluctuation of the stocks between the two categories is a self-correcting mechanism in the portfolio in the sense that when the market is good we will lean towards more catalyst companies and when the market is weak and the economy is slow, we will inherently shift back more towards core stocks.

The difference is that this fluctuation is a little more dramatic in the case of our small-cap product than the mid-cap fund. Consequently, in terms of diversification, we feel we can take a little bit more risk and be more concentrated in the mid-cap portfolio because it has more seasoned companies.

In case of the small cap fund, the ideal investment for us is one that is relatively, on the smaller side of small-cap companies, having market caps of just a few hundred million dollars and not widely followed. Those are the ones that we can catch early and achieve outsized returns to investments.

The bittersweet moment for a small cap portfolio manager is when you find this great stock, invest in it, get huge returns and then it grows to be a mid-cap stock, and at some point you are forced to sell it to stay style pure. Actually, our mid cap

product is, in part, a vehicle to leverage the information, themes and ideas that we have had success with in our small cap product. As these great growth stocks transition from small cap to mid cap we can continue to own them, albeit in a different product.

Q: Can you describe your research process?

A: Ours is a team approach. Although all team members have sector-specific responsibilities, their expertise is not just confined to their allotted sector. Management meetings are very important and we have met with more than 90% of the managements of all the companies we own. These meetings help in confirming again our thesis and get a better understanding of the fundamental story and what metrics we need to look at in our quantitative analysis of a company.

The research process involves in-depth fundamental work, and using that information to fine-tune the quantitative aspects of the metrics that we look for regarding each company. Initially we scrutinize growth in revenue, earnings, and cash flow on individual companies. Different industries, sectors and stocks have different metrics that can be equally important and may actually be leading indicators for earnings. Identifying and monitoring these key metrics is an important part of our process.

We also have a thematic approach to investing. We are bottom-up investors and look at one stock at a time. However, sometimes, when we capture a compelling investment theme that may be broader than just one company, we will look for other securities that might fit into that theme. It might be an overarching trend that's affecting multiple companies or an entire industry, and therefore from a research perspective, it's a big part of our research process, as it allows us to leverage what we believe is proprietary information across more than one investment.

Q: Can you give some examples of stock selections that illustrate your investment process?

A: One example is NVIDIA Corporation that provides graphics processors for computers. We bought this stock several years ago in our small cap fund when we first identified an important catalyst, which ultimately lead to the stock becoming a text book case for exploiting the biases that are commonly identified in the field of behavioral finance.

After suffering through a two-year period of no real growth due to a more robust competitor and unforeseen events, a meeting we had with the management team indicated that things were going better. Subsequent to this meeting, NVIDIA had a quarter where we identified an inflection point. It was the first time in 10 quarters that it had posted a year-over-year gain in earnings and beat the high end of earnings expectations.

From a fundamental standpoint, they were shipping this new, better product and would be able to regain some market share. The stock shot up 10% to 15% subsequent to the call that day and we bought the stock because for us this was a fundamental inflection point. Of course, even our most bullish expectations did not prepare us for the fact that NVIDIA would progress to be a \$19 billion company today.

We owned NVIDIA in our small cap fund, enjoyed huge returns and when it crossed the \$3 billion market cap level, we bought it in our mid-cap product. NVIDIA is an example of a stock that we owned in both our small cap and mid cap funds for a period of time. When it grew to nearly \$6 billion market cap, we could not justify owning it in our small cap portfolio and sold all the stock in chunks opportunistically over several months.

GameStop Corp, retailer of computer games, which is currently one of our

larger holdings is another example of a stock that we owned for years in our small cap fund, generated significant return, and transitioned it into our mid-cap product. We still own it in both funds, although currently it is at that market cap level where we have had to trim our position in the small cap fund. GameStop is a retailer of video games and entertainment software. It turns out that people are still playing them, even in their 40s. So here is this big picture trend theme of an expanding demographic, with a lot of discretionary income. In addition, there is this catalyst, the continuous flow of new products like Microsoft Xbox 360, Nintendo Wii, Play Station 3, from the three major players in this industry that has been driving sales.

The factor that first attracted us to GameStop was that it was seriously into the used games business and in a monopoly position, too. GameStop was soon extremely successful with a national presence because of its ability to price the used games. It had a fantastic system behind the pricing, purchasing, and flow of inventory in the used game business segment and this unique model allowed the company to enjoy abnormal returns.

Then, its biggest competitor, Electronics Boutique, entered the used games business. Just when the competition was starting to have a meaningful impact on the pricing, GameStop bought Electronic Boutique and thus regained its monopoly position. The synergies between the two retailers provided great pricing leverage on the used games and better stature with the game publishers. It is now the largest distribution channel for Electronic Arts and all game sellers. Moreover, the price increase on the new flow of games has raised the umbrella under which it could price the used games which was basically all margin, awarding GameStop even greater profitability.

Stephens Mid-Cap Growth Fund

Symbol	STMGX
Website	www.stephensfunds.com
Address	Stephens Investment Management Group LLC 3700 Buffalo Speedway, Suite 900 Houston, TX 77098
Tel. No.	866-735-7464
Inception	02/01/2006

PORTFOLIO	
Total Net Assets*	\$13.8
Avg Mkt Cap (\$ Weighted)*	\$6,600
Average Price/Earnings Ratio	35.26x
Average Price/Book Ratio	6.13x
Turnover Ratio	29%

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	\$2,500
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$1,000

RETURNS VS. S&P 500 INDEX		
	STMGX	Index
1 Year (Cum.)	24.69%	7.72%
3 Year (Ann.)	N/A	10.09%

FEES AND EXPENSES	
Max Sales Charge - Front**	5.25%
Max Sales Charge - Deferred	N/A
Max Redemption Fee***	2.00%
Total Expense Ratio	1.50%

PORTFOLIO MANAGER	
Ryan Crane	02/01/2006

* millions ** for amount invested less than \$25,000

*** 2 months after purchase

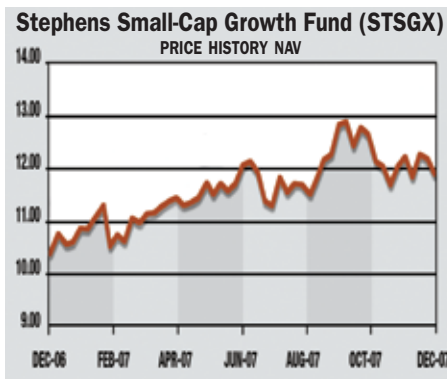
Data through: 12/31/2007

Source: Company Documents; Lipper

Q: How are your portfolios constructed? What is your buy-sell discipline?

A: Currently, our small cap fund has about 120 issues and the mid cap fund has around 90 stocks. The portfolios are relatively diversified on a stock specific level, but we may have a more meaningful amount of exposure to any one theme.

Our buy and sell decisions are made on a case-by-case basis, a very bottoms up approach. The common thread among all those decisions is confirmation of both the fundamental and quantitative analysis. For each of the stocks under consideration we have our discrete investment thesis. If the stock fits into the criteria underlined by our philosophy and if there is data that confirms our investment thesis, then we will buy that stock.



Although valuation is important, sometimes growth investors like us can make the mistake of getting too involved on the valuation side and not buy what might be our favorite idea just because it seems too expensive. Especially in case of catalyst stocks, we believe that in the price-to-earnings equation, the market can underestimate the earnings part, and that, there is an inflection point where earnings are going to be accelerating and growing much faster. In such cases we will decide to buy the stock.

On the core side of the fund or stocks that have more stable business model, valuation is more important. These are more stable, predictable companies; we try to opportunistically use valuations to trade around these positions. Typically, these are stocks that we will own for a long period of time, and we know when stocks get relatively expensive or cheap.

The sell side decision is a disciplined process. Our investment thesis will stipulate the criteria, right at the onset of buying, which will compel us to sell the stock. Once we identify and buy a stock, and later, if the factors driving revenue and earnings growth have changed, the stock is not working out as we thought or we see a change in that data, then that would trigger a sell decision. Again, that is part of the daily maintenance process that we do, which is, constantly monitoring and measuring those data items and factors that might cause us to want to sell, and constantly trying to identify new ones.

We also decide to sell if it is required to maintain the style purity of the portfolio. Ironically, these decisions are sometimes a result of our success – when our stocks grow beyond our definition of small cap or mid cap and we are eventually compelled to sell just to keep the portfolio in its mandate.

Q: How do you mitigate risk?

A: In small and mid-cap stocks company specific risk is a significant risk. So, diversification is one of the key tools that we use and limit ourselves on individual position sizes and sectors. In our small-cap fund we won't let a stock get to be more than about 2% of total asset. In our mid-cap fund we go a little beyond that, but limited to, just the low 2% range. We also have some rules internally about sector exposure relative to our benchmark - 50% band around benchmark sector weightings.

Portfolio risks are also related to our investment themes and trends. Take for example, healthcare IT spending. Here is a theme that cuts across both technology and healthcare companies. They all benefit from this trend of healthcare organizations spending money, upgrading and adopting new technology that are of great help to patients and doctors. We might have several investments in this type of theme, so the risk is that, if something goes wrong with this theme, we would be vulnerable.

Basically, we mitigate risk through in-depth fundamental research. We have someone focusing on these issues, sectors and themes and constantly monitoring them, and again identifying the quantitative metrics wherever possible, that can help us confirm the status of these themes.

Ultimately, we believe that our diversified approach and the combination of core and catalyst mitigates a lot of the market risk. When things slow down we have this basket of core companies that

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Address	Stephens Investment Management Group LLC 3700 Buffalo Speedway, Suite 900 Houston, TX 77098
Tel. No.	866-735-7464
Inception	12/01/2005

PORTFOLIO

Total Net Assets*	\$39.0
Avg Mkt Cap (\$ Weighted)*	\$1,800
Average Price/Earnings Ratio	34.43x
Average Price/Book Ratio	6.08x
Turnover Ratio	70%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$2,500
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$1,000

RETURNS VS. S&P 500 TR INDEX

	STSGX	Index
1 Year (Cum.)	14.03%	7.72%
3 Year (Ann.)	N/A	10.09%

FEES AND EXPENSES

Max Sales Charge - Front**	5.25%
Max Sales Charge - Deferred	N/A
Max Redemption Fee***	2.00%
Total Expense Ratio	1.46%

PORTFOLIO MANAGER


Ryan Crane	12/01/2005
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* millions ** for amount invested less than \$25,000

*** 2 months after purchase

Data through: 12/31/2007

Source: Company Documents; Lipper

are very stable and that stability shows up in the portfolio. Therefore, by design, in strong up markets the portfolio performs well due to the catalyst companies and overall valuation expansion, and in down markets, our core growth positions tend to be less economically sensitive and provide some downside protection. Over longer periods of time, we believe this combination offers the best of both worlds. 

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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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