

Unlike the U.S.

It probably comes as a surprise to many Americans, but the U.S. accounts for only 45% of the world market capitalization. More importantly, it presents investment opportunities that cannot be found domestically. Portfolio manager Leonardo A. Vila would dig through the entire supply chain to find the right small company of an investment theme.

Q: How would you describe the investment philosophy of your fund?

A: We are a growth fund and we're bottom-up stock pickers. We invest in international small-caps and that excludes US companies. By prospectus, we define small-caps as companies with maximum market capitalization of \$5 billion, however, we tend to focus in the \$1 - \$2 billion range. Our investment strategy is to focus on the small companies with annual EPS growth rate of 15% per year.

Q: Do you base your decisions on historical or projected earnings?

A: We're always looking forward as we're investing in the future. I'd leave history to the books. The important thing is that this growth is annual. Too many research reports talk about compounded annual growth rates but three- or five-year numbers don't mean much to me because a company can be flat for two years and then perform in the last year. If that doesn't happen, you've just wasted three years.

So we want to see a near-term 15% earnings growth rate per year but we're also valuation sensitive. If the market has lower earnings expectations, on the surface it may appear

that we'd pay a lot for the stock initially. However, what invariably happens, particularly in the sectors that we've been heavily exposed to in the past two years, is that the expected E in the P/E equation moves up and shrinks that P/E ratio. So we pay a lot early but the market will catch up, and ideally, will drive up the stock price. The market usually begins to buy the stock after we've held it and in any investment process, there is definitely a first mover advantage in identifying those stocks.

Q: What type of companies do you usually invest in?

A: The businesses of many of those companies can be broadly divided into two camps. First, the most beneficial for US investors is the investment in a local business. If the business is within the boundaries of Japan, for example, the customers pay in yen, so there is no currency risk if the sole focus is the Japanese domestic economy. It has no relation to Germany's unemployment rate or to France's GDP rate. This is an opportunity to invest in another country's own economic growth and that's the first key for differentiation.

The second area of interest lies in the fact that the US government and

Fund Facts	
Symbol	ISCA
Website	www.federatedinvestors.com
Address	Federated Investors Federated Investors Tower 1001 Liberty Avenue Pittsburgh, PA 15222-3779
Tel. No.	800-341-7400
Inception	2/28/1996

Portfolio	
Total Net Assets *	\$ 524.7
Avg Mkt Cap (\$ Weighted) *	\$ 2,300
Average Price/Earnings Ratio	17.4
Average Price/Book Ratio	4.0
Turnover Ratio	78.8 %

Investment Information	
New Investment	Open
Min Initial Investment	\$ 1,500
Min Subsequent Investment	\$ 100
Min Initial IRA Investment	\$ 250

Risk (Against MSCI EAFE ND IX - 3 Years)	
Alpha	-0.14
Beta	1.28
R-Squared	0.84
Ann Std Deviation	14.07
Sharpe Ratio	1.72

Returns vs. Lipper Int Sm/Mid-Cap Gro Fd IX		
	ISCA	Index
1 Year (Cum.)	34.85 %	27.26 %
5 Year (Ann.)	12.75 %	23.15 %
10 Year (Ann.)	14.21 %	10.14 %

Returns vs. MSCI EAFE ND IX		
	ISCA	Index
1 Year (Cum.)	34.85 %	26.56 %
5 Year (Ann.)	12.75 %	10.02 %
10 Year (Ann.)	14.21 %	6.39 %

Fees and Expenses	
Max Sales Charge - Front **	5.50 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee ***	2.00 %
Total Expense Ratio	1.88 %

Portfolio Manager	
Leonardo Vila	Feb-1996

* millions ** for amount invested less than \$50,000
*** within 1 month after purchase

Date through: 6/30/06

Source: Company Documents; Lipper



TICKER's Choice

its people consume a lot and we pay a lot. If we can't pay now, we'll go into debt for it. Nonetheless, very little is made here. And if it's all made abroad, why not invest in the companies that are taking your money. The easiest example is the oil companies. If you're paying \$3 a gallon at the pump, we'll follow that hose at the gas station and it will lead you to Canada, Norway, the North Sea. So we invest in the companies that are taking our money and expect we'll get some of it back in stock price appreciation or a dividend to offset that per gallon charge.

Q: *Are there other reasons for considering international investing? I guess you would like to benefit from the local economic cycles that most people in the US are not aware of.*

A: Yes, there are some. We take many things for granted and we think that the way things are here must be the way they are all over the world and that's far from the truth. Overseas you still have regulatory changes accommodating some industries or industries that don't exist here, at least not on a large scale.

Despite the US being number one in many different areas, in some places other markets are way ahead of us. I'll choose something as simple as a cell phone as an example. Cell phone adoption rates overseas grew much faster and today the greater penetration is still overseas. We have the handsets here, but compared to the Europeans, we hardly utilize our cell phones for anything else but calls. Everybody else is using it for many different things. Not only for surfing the web or for messaging, but some use their cell phones as an electronic wallet to pay for goods and services.

There is a real cell phone culture overseas, boosted by the fact that they have one technology platform, GSM. Here we have maybe two or three platforms. There is no consensus and that's a problem. And many of the

ring tones, wallpapers, and games that you can download onto your cell phone are produced overseas and come from Korea and Japan. We're getting their old technology and they are light years ahead of us.

The other area is that, for better or worse, Europe and Canada are more socialist and "green" than us and the governments have greater impact. There is some effort in the US but it is more talk than action. For example, at the 'State of the Union Address' in January, Bush talked about decreasing our dependency on foreign oil, but he hasn't really backed that up with significant budget allocation or initiatives. It was just good sound bites, throwing a couple hundred million dollars, and that's it. It's a feeble effort by comparison.

Meanwhile, in Europe they have a 2010 target to have 22% of energy coming from alternative sources. People scoff at the idea of windmills and we barely have them here, but windmills are prevalent in places like Denmark and Spain. Also, Germany subsidizes homeowners who install solar panels on their homes. They have net metering which give the homeowner the right to sell excess energy into the power grid and the utility must pay for it. It distributes the energy produced during the day because you're not at home, for example, or when you're not using as much energy. Effectively, you become a supplier of energy – a utility.

The solar space is an excellent investment opportunity. In fact, one of the biggest oil companies, BP, has a huge solar division. So if even the big oil companies are looking at solar, that should be telling you something. It means that they have been depleting oil reserves and oil is not going to be there forever, so they're looking for other ways to make money out of the energy business.

Q: *Many people are not aware that the energy business is not the oil business.*

A: Yes, energy now comes in many different forms and we have to open our eyes. But this is not something new outside the US. The investors have the opportunity to evaluate a portfolio manager who is in touch with the foreign markets and is knowledgeable enough to make the right investments with the U.S. dollar given to them. It's also about being aware of the changes in the society. There are investment opportunities that are cultural and exist only within one country.

Q: *Why do you prefer to invest in international small-caps? Aren't they more difficult to find and research?*

A: They can be difficult but they can diversify away your risk and your volatility with only being exposed to the US. And small companies exhibit better growth profiles. Big companies, like IBM, GM, or Microsoft, create a task force or a committee to solve problems. Small groups get the work done. This is what these small companies do. They specialize in their businesses, which consist of only one or two things.

Most are very transparent, unlike Enron or a Tyco with all of their different divisions. As an investor, you don't even know where they are making and where they are losing money. You don't learn that they are taking the profits from one business to supplement another until the annual report is out 13 or 14 months later, if you ever do. So smaller companies are far easier to understand, much more transparent, and more pure-play businesses.

Even if you look at the pharma industry, for example, a lot of the big companies outsource research to small biotech firms that specialize in say, cancer research. That alleviates the big pharmaceuticals from building an in-house effort, which sometimes can be more costly. So many of the small companies are beneficiaries of the outsourcing activities of the large caps.

Another outsourcing idea, especially in this global economy is the concept of logistics. How does a European producer get his goods into the back roads of China? He knows there are customers over there, but he doesn't know how to do it. Does he need to know how to do it? No. He needs to hire a company like Kuehne & Nagel, one of the world's logistic leaders, and they will move his goods all the way to the final destination and take Asian goods and distribute them into Europe's end customer.

Q: *How do you find and crystallize your ideas? What is the process that makes a stock from your watch list into a holding on the portfolio?*

A: It's an interactive process with a lot of different components. The first one is a quant screen that helps us narrow down the universe because there are a lot of stocks out there. And being in this business as long as I have, I not only look at the names that float to the top of the list, but I also look at the industries to see if there is a pattern. It is important to note that some industries transcend global borders, like energy. Everybody around the world will pay \$70 a barrel.

Q: *Mining companies would probably also fall in the same category.*

A: Yes, mining is a perfect example. A copper mine in Australia could probably benefit as much as one in Canada because copper prices are rising. They may have a different cost base, but if the price goes up, they both should incrementally benefit.

Secondly, we meet with many management teams throughout the year. We go overseas and they come to New York where I am located. We also go through the numbers; we attend conferences abroad and in New York. Sometimes they are thematic conferences, like an oil conference, or country-specific conferences.

But we do tend to invest on a thematic basis. From the whole idea about solar energy or natural gas, we'll take the industry apart and seek opportunities to make money along the entire supply chain.

For example, the gas in the Middle East is in the ground and to get it out, you want to hire the number one engineering and construction company. Japan's Chiyoda is a small-cap company with excellent technology that gets the lion's share of the projects there. It was recently awarded the largest liquefied natural gas project ever, \$4 billion worth to build an

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about

Leonardo A. Vila

Leonardo Vila is vice president and senior portfolio manager with Federated Investors, his employer since 1995. Previously, he was an equity research manager with American Stock Exchange. Prior to that, he was an associate with J.P. Morgan & Company. He has also served as a senior programmer analyst with Manufacturers Hanover Trust Company and a systems analyst with Kemper Group.

LNG facility. That process takes gas out of the ground to a liquid state by cooling it, so that it can be transported by ship to the major markets, predominantly UK, US, Japan, and China. Then you look at the fact that you need ships and you can invest in shipbuilders.

Q: *You mentioned earlier that you have a bottom-up approach. Does that mean that you're looking one company at a time in local economies?*

A: Yes, but as a quick extension I look for industry patterns. If I'm looking at oil drilling companies, maybe one's better than the other or maybe there are three in great shape. So I'll do comparisons between companies in the same business. I'll examine a company, but what brought me to that name could be either the quant screen or the theme that I'm working on like the energy cycle, the metal cycle, or the tech spending, which hasn't occurred. I've been a tech bear for about 3 years now.

Q: *What are the most important elements of your risk control process?*

A: We run performance attribution reports on a monthly basis, which lets us know what has been working and what hasn't been working in terms of contributing to the fund's performance. That's done on a country and sector level on a relative basis because you might want to really give up on some stocks. Then I have some customized reports that I run, such as stop-loss reports and some tools that basically throw problematic names in my face to warrant my attention. Otherwise, I have market-to-market reports all day long wherever I go around the world. One of the other risk controls that we employ is to not allow a single investment to exceed 2% of total assets for very long. ■

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