Investing into an Expanding Universe

Formerly a micro cap fund, First American has changed the market capitalization limitation to allow for more names from the small cap sector. Co-manager Joe Frohna informed Ticker that although the name has been changed to the Small Growth Opportunities Fund, the investment approach remains the same.

Q: Can you describe this fund's team management approach?

A: It's not really team managed. I was the sole manager for all of last year. I just named a co-manager, Brian Bies, in late December.

Q: I understand that the fund has changed its name.

A: Since January 31, it's been renamed the First American Small Cap Growth Opportunities Fund. What it does is allow us to move up in market cap slightly, because this fund has been closed to new investors since July 2001. We just reopened the fund December 16, 2002.

Q: How large a market capitalization is the fund now allowed to invest?

A: By having that artificial $500 million market cap limitation, it precluded us from investing in sectors like that. If I can go to $1 billion, it opens the door to some of these companies that previously were uninvestable as well as giving us more liquidity so that as we do take on additional assets we won't struggle as hard putting them to work. The bottom line is that we're searching for companies under $1 billion that have the ability to grow 20% top and bottom line. That's not to say that it's evident today. That's where we make the most money, where it's not necessarily evident today. We come up with a thesis on which we can see that transpiring over the next 12 months. Our horizon is really looking out over 12 months.

Q: Is there an initial screening process for the huge universe of 6000 names?

A: It's really a proprietary screen that I run of things that I think are important in this universe of stocks. It's looking at companies with accelerating fundamentals, whether it is operating margin improvement, top line improvement, or ROE improvement. One of the things on which I put the heaviest weight on is insider buying activity or just insider holdings. I can't give you anything numerical to prove it, but just from doing this for a number of years, especially in micro cap stocks, when you follow the insiders of these companies, you'll do pretty darn good, because they tend to have a lot more skin in the game from a personal wealth standpoint. They're more likely to make good decisions that will impact the stock price positively. That's a major focus.

Q: I can see from the chart that the best time to have bought shares of the fund was in October 1998 right at the bottom of the market. The performance over five years has kept you in the top 2% in the category.

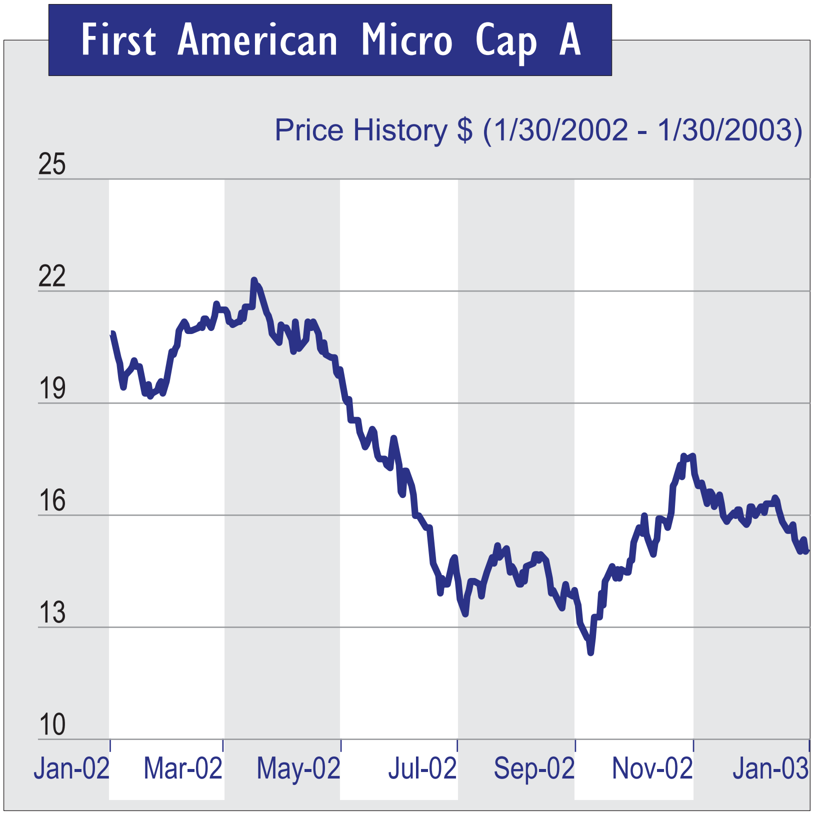
A: You're right. A lot of my peers who had big numbers in 1999, like I did, fell off the cliff in 2000, 2001 and 2002. We had positive returns in 2000 and 2001. Obviously, 2002 was a very negative year. I don't feel terribly about how we've done, relative to our peer group. We've managed to stay up through thick and thin. What differentiates us is that we stuck steadfastly to our valuation philoso-

First American Micro Cap A

Fund Facts		
Symbol	FRMPX	
Website	www.firstamericanfunds.com	
Address	First American Funds, One Freedom Valley Drive, Oaks, PA 19456	
Tel. No.	800-677-3863	
Inception	08/01/95	
Portfolio		
Total Net Assets *		$52.90
Avg Mkt Cap ($ Weighted) *		$326
Average Price/Earnings Ratio		---
Average Price/Book Ratio		2.55
Turnover Ratio		123%
Investment Information		
New Investment		Open
Min Initial Investment		$1,000
Min Subsequent Investment		$100
Min Initial IRA Investment		$250
Risk (Against Std Index - 3-yr Average)		
	FRMPX	**Category Avg.**
Alpha	-3.97	-5.36
Beta	1.02	1.10
Returns vs. Lipper Sm-Cap Core Index		
	FRMPX	**Index**
1 Year (Cum.)	-26.42%	-20.65%
3 Year (Ann.)	-6.46%	-2.89%
5 Year (Ann.)	13.96%	1.09%
Returns vs. S&P 500		
	FRMPX	**Index**
1 Year (Cum.)	-26.42%	-23.02%
3 Year (Ann.)	-6.46%	-13.84%
5 Year (Ann.)	13.96%	-1.33%
Fees and Expenses		
Max Sales Charge - Front		5.50%
Max Sales Charge - Deferred		0.00%
Redemption Fee		0.00%
Total Expense Ratio		1.93%
Portfolio Manager		
Management Team		---

** millions* *Data through: 01/31/03*

Source: Company Documents; Lipper



phy. I think that is what got us out of a lot of names earlier than many of my peers. In addition, we made some - I don't think you can call them contrarian bets - but certainly out-of-cycle bets. In 1999 and 2000 we had a big bet on energy that worked tremendously that year.

Q: The turnover rate of 125%, relatively low for a micro cap fund, tells me that you tend to stick with a few positions and try to ride them.

A: We do. That's why we hope we're catching them early and not just chasing the tail at the end of the story. We hope we're in there early before everyone else figures it out and then have everyone figure it out while we're already invested and then sell off to the guys that want to play the momentum game. That's our philosophy. Be early getting in and early getting out.

Q: So, you do have a buy/sell strategy built into the fund?

A: The real method of my madness is that we try to find as many investable themes as we can. I look first at the macro picture: interest rates, the economy, etc. Right now we're significantly under weight financial stocks. We're betting that there will be an economic recovery, so we're significantly over weight producer durable and tech type names and over weight energy. We're about equal consumer discretionary, which is a catchall term for a lot of different names.

Q: What is the purpose behind having so many positions in a specific sector?

A: We try to buy as many names as we can because we think we can capitalize on a particular theme. That helps in a couple of ways. One, you reduce single company risk exposure. If you had a governance issue like you had in 2002, one company isn't going to blow up your whole portfolio. Second, it allows us to get in and get out of positions much more easily as opposed to owning a 3% or 4% position in a single name. This allows us to be more nimble.

Q: Do you have predetermined entry points?

A: I have a watch list of about 250 companies. Those are all ones that in prior periods have met one of two criteria. Either the valuation was right but the fundamentals were wrong, or the fundamentals were right but the valuation was wrong. We want both of them to line up. I keep a chart of 250 companies that have gone through our filtering process. We know the stories. We're just waiting for one of those two things to change. I have set up all these alerts, so when a stock hits a given point from just a price perspective, we're quickly on top it. I can look at the file and make a phone call to my analyst or to the company that I follow directly and ask for a quick up date. If I get a green light, we make it a new holding in the fund. It's an evolving process where names are continually coming in and going off that watch list.

Q: This tells me that you have support from a team of analysts.

A: We have about 15 analysts who are all sector-based. Depending on what stock it is, I would go to one of them and get their initial opinions about, number one, that company and number two, their outlook for the entire sector. It's a give and take process that we've put in place. The analyst is compensated to have names in a paper portfolio for the micro cap fund. If I need an idea in financials, for example, I would go to my financial analyst's model portfolio that he keeps and ask, "What names does he like?" It helps them generate ideas and stay on top of things. The incentive program that we put in place keeps them on top of things pretty closely.

Q: I have noticed that one or two names in a poor performing sector can do well. How closely do you monitor this situation?

A: You could have a new product cycle in a company that is in a bad industry and is grabbing huge chunks of market share. We look for stories like that as well as one-off type names that can grow counter cyclical to the industry that they're in. That's why we have to stay on top of these stories to identify those types of situations. Especially in a small cap land, a lot of companies are niche companies. If their particular niche is doing well, the stocks can be huge home runs. We don't want to dismiss any sector because the overall statistics look bleak. For a small cap manager, I think it really takes some time to become good at it because there are so many names that you have to know and focus on.

Q: In terms of research, how much emphasis do you place on cash flow?

A: That's all we really focus on, frankly. We want companies that can be self-funding to finance growth initiatives, assuming that they're in a growth business. We don't even use P/E analysis other than for quick discussions on companies. I don't put a lot of weight on it, because the E that you're putting into the P/E calculation is calculated differently for a lot of different companies nowadays. For example, for stock options, certain companies have adopted expensing options and others have not. So, you can't even compare a P/E across the same industry or across different industries. What we use most often is the enterprise value to EBIDTA calculation where you're looking at the entire capital structure of a company as well as the cash flow being generated by that capital structure.

Q: How do you manage the volatility in micro cap and small cap stocks?

A: Liquidity and volatility in my mind go hand-in-hand. It's the lack of liquidity that makes the volatility. It goes both ways. In negative markets, it's tough. There might only be one or two institutional shareholders in one of many names. If one of them decides to pull the plug on a stock, there aren't a lot of institutions willing to pick it up. It tends to have a more pronounced downward impact. That's why I like to say we want to be early to the party and early leaving, just for that reason. If we're late, there is nobody to sell it to. In a positive trending market, liquidity works for you. If there is an attractive story and everybody likes it, there is not a lot of stock to go around, so the demand takes the price upward and before you realize it, you've got a nice winner on your hands. We'll sell stocks if we get the slightest hint that things aren't going the way we had planned and we'll review it from the sidelines. Volatility comes with the territory. It's not that I like it; it's just that I've become accustomed to and managed through it in both good and bad times. It goes back to the way we do fundamental research here. When the market is walking away from names for no good reason and we have fundamental conviction on those names, it allows us to step up to the plate when nobody else will. We made a lot of money buying stocks that have been beaten down for no good reason. The time of greatest uncertainty is the time you make the most money. We've been able to capture more upside than we've given up on the downside. We've outperformed in 13 of 14 up- quarters since inception, and under performed in eight of the 14 down-quarters. That's really the secret to our success. That's what we call adding alpha to the process.

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Joseph Frohna

Joseph Frohna, managing director, senior equity portfolio manager, joined First American Funds in 1995. With nine years of financial industry experience, he is a co-portfolio manager of the Small Cap Growth Opportunities Fund and manages institutional portfolios. He previously worked in the Sales and Trading division at Salomon Brothers, and at Arthur Andersen as a manager in the Tax division. Joe earned his B.B.A. at the University of Wisconsin, Whitewater and his M.B.A. from the University of Michigan. He is a member of the Association for Investment Management and Research and holds the Chartered Financial Analyst and Certified Public Accountant designations.

Dave Jennings