

Heritage Mid Cap Stock A

Fund Facts

Symbol	HMCA
Website	www.heritagefunds.com
Address	Heritage Family of Funds, 880 Carillon Parkway, St. Petersburg, FL 33716
Tel. No.	800-421-4184
Inception	11/06/97

Portfolio

Total Net Assets *	\$180.00
Avg Mkt Cap (\$ Weighted) *	\$3,100.00
Average Price/Earnings Ratio	26.39
Average Price/Book Ratio	3.77
Turnover Ratio	218.00%

Investment Information

New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$0
Min Initial IRA Investment	\$500

Risk (Against Std Index - 3-yr Average)

	HMCA	Category Avg.
Alpha	18.18	-0.17
Beta	0.79	1.11

Returns vs. Lipper Mid-Cap Core Index

	HMCA	Index
1 Year (Cum.)	-20.88%	-18.07%
3 Year (Ann.)	5.58%	-6.13%
5 Year (Ann.)	9.66%	2.85%

Returns vs. S&P 500

	HMCA	Index
1 Year (Cum.)	-20.88%	-23.02%
3 Year (Ann.)	5.58%	-13.84%
5 Year (Ann.)	9.66%	-1.33%

Fees and Expenses

Max Sales Charge - Front	4.75%
Max Sales Charge - Deferred	0.00%
Redemption Fee	0.00%
Total Expense Ratio	1.50%

* millions Data through: 01/31/03

Source: Company Documents; Lipper

Portfolio Manager

Todd L. McCallister	11/06/97
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Not Your Average Growth Fund

When the market was hot in 1999 and everyone thought technology funds would grow to the sky, Todd L. McCallister, a former Ph.D. economist, remained true to his strategy of finding sound businesses. With the market in decline, McCallister's Heritage Mid Cap Stock Fund earns a top ranking from Lipper for five-year performance. TICKER interviewed the stock picker in January when he explained how he has taken advantage of the market's volatility.

Q: The fund has outperformed its peer category by a handy margin. What is it about your strategy that gives you an edge?

A: We really don't track well with other growth funds. Maybe that is because we do something that is truly different. We think most growth funds concentrate into variable growth and are a lot riskier than us. It's pretty clear after five years that our risk is significantly lower than most growth funds. We didn't even begin to act like a growth fund in 1999 or 2000. People were up 60% - 90%, taking huge weights in technology. We've always been almost a pure stock-picking fund. We don't think that in the small- to mid cap area the way to beat the indexes is to make sector bets. It's unnecessary risk. There is enough inefficiency where you can simply be relatively sector neutral. It's something of a paradox in the industry. Because the industry is tilted toward absolute return, it actually hurts individuals in the industry. That's one reason why so few managers beat the indexes. They manage by taking big sector bets for short-term

results. I have talked to people who say to me, 'you never want to lag in an up market.' Those people are going to have high beta products. It will be very hard to replicate the results of 2000 because of the trading costs. The idea is to beat our benchmark, not our peers. I can't control what they do.

Q: What is the benchmark you're trying to beat?

A: That would be the Russell 2500 Mid Cap Index.

Q: I can see the average market cap is under \$2 billion.

A: If you look at our fund, it's probably smaller than most mid cap funds. We always have been on the small side of things. That's where we believe it is less efficient. We're kind of "smid" is a way to look at it. I think that's in line with the indexes, not in line with our peers. They're usually \$2 - \$3 billion bigger. Part of that, particularly with mid cap growth funds, is that they like well known stocks, and we don't. Also, part of it is many of



Q & A

TICKER's Choice

the funds are a lot bigger than us and need the liquidity. We're at \$300 million. We don't have the liquidity problems they do.

Q: What's the average number of stocks in the portfolio?

A: The range is 70 to 90. I would say five years ago it would have been 50 to 60. We've been very surprised at the increased level of volatility in the market in the last five years. That's done two things: One, the chance of getting a large return is greater than ever, and the chance of getting a small return is greater than ever. When I talk to consultants, they tell me that the difference between the top portfolio managers and the bottom portfolio managers is greater than ever. It's not because the managers are taking bigger bets on average. What's happened is the increased volatility has made the disparity between the winners and the losers enormous. So, we don't want to play that game. And two, due to increased volatility, our turn-over has increased.

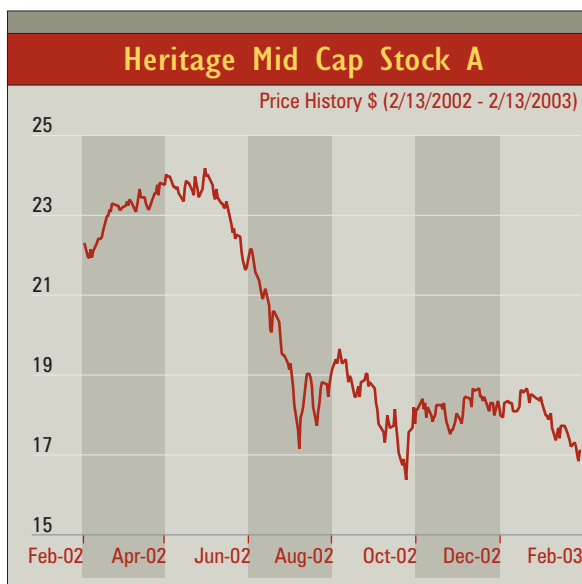
Q: What do you look for in evaluating companies?

A: We look for companies with great market structures that are monopolies. We're not just interested in growth rates. That's a huge inefficiency. Ticketmaster is a favorite name of ours, which is now becoming USA Networks. Ticketmaster is a monopolist. We tend to buy stocks like that. When I see an analyst value a stock on a PE to growth ratio, I go through the roof.

Q: Why do you go through the roof?

A: I just think quite often that analysts mislead people. Let's say you're going to buy a business with your own money - a dry cleaner across the street. You wouldn't go to the owner and ask, what is the PE to growth ratio? You'd

ask him: What does your accounting look like? What's the cash? What's this street corner like? Out of this analysis may spill some sort of PE to growth rate but it would only be an ancillary condition. We buy businesses, not just growth rates. We put emphasis on market structure, the nature of the business, and the franchise. We put a little less emphasis on the numbers or whether or not it's going to be a really big idea. Even though we try to act like private buyers, the volatility has caused us to have a much faster trigger than a private buyer. We're just amazed. Ticketmaster, for instance, went from 12 to 30 back to 12 in the past year. It's not that unstable a firm. It's a monopolist. Yet



you've got an increasing percentage of folks who, in my opinion, are trend traders, who trade on charts. They don't buy on fundamentals. I think in the long run, and I firmly believe this, knowledgeable, fundamental investors pile up good records and trend traders don't. But increasingly, trend traders dominate the market. I've worked along side some people who are clearly just trend traders. They like to buy when something is up. They control large pools of money. It's become a very popular investment style.

Q: They're called momentum traders.

A: When I started it was a little bit

unusual to see a market day that was up more than 1% or down 1%. I think one day in three is like that now. So the turnover is entirely consistent with what's going on.

Q: The past two years have been a challenging investment environment. How have you dealt with it?

A: In this time of panic, you can get very good companies cheaply. We just have to do some juggling. We generally keep enough cash for one or two buys. I think what has happened in those periods, and this is an advantage to being a fund with \$300 million. We will probably make swaps trade down in risk. We'll get the stuff that makes it a less attractive portfolio, but one that we think is pretty solid. We've been able to do that several times. If the market is going to nail a high cash company, we'll make a trade. We never have more than 5% or 6% cash. Part of the underperformance doesn't just come from market inefficiencies; it comes from people's response to business pressures. They take big sector bets, don't have a diversified fund, and compare themselves to other people. They're under enormous pressure to go with what's working. If you do that, you

take a risk. That's why you can't pile up a big long-term record because you just had to be big in technology in 1999. Our strategy is to buy monopolistic types of firms.

Q: How do you conduct your research?

A: The first thing we look for, which is outside the philosophy of Wall Street, are companies that have some sort of advantage, some sort of what I call market power. The easy way to explain it is simply to say we want to buy companies that we can give to our kids. Sometimes they may be dull even if it's in the tech space - yet, they may be dull with a good position. You

wouldn't necessarily want to give your kids some hot dotcom to run because you yourself would have to be a genius to run it. What's the Warren Buffett comment? This may sound facetious, but it's a little bit true when it comes our strategy: You want to own a business that an idiot could run because one day an idiot will run it. When you think of the 4000 companies you can buy that are small to mid cap, we'll have a focus list of 300. The list is dynamic, but it doesn't change all that much. Then we'll try to value those 300 stocks. We think that valuing stocks solely on its growth rate can be the

to have a lower trading volume and tend to be a little more ignored. I used to be a game theorist when I was an economist. There's something in game theory called the 'winner's curse'. They tend to overbid. We think there are all kinds of people with the 'winner's curse' in the markets.

Q: Do you travel much in conducting your research?

A: We call the companies. We meet every company at a conference we invest with. We don't necessarily go to their headquarters. The conferences

more cohesive. We're just a small group so I think we can get away with it. I have run into managers who do a pretty good job of keeping active files. We just keep plain old paper files. If we have issues, we don't even call each other. We just yell through the partition. I think that's an advantage.

Q: The top 25 holdings are quite a mix. There's no rhyme or reason to them.

A: The interesting thing about small cap and mid cap that is so much different from large cap is that you can

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About:

Todd McCallister is a chartered financial analyst and a member of the Chicago Quantitative Alliance. McCallister is a senior vice president with Eagle Asset Management. Prior to joining the company in 1992, he spent five years with Investment Advisers Inc. as vice president and director of asset allocation and quantitative research.

height of folly. You need to look at return on capital, market structure, and market position. It's very important that the company can finance itself by producing positive cash flow. An inefficiency of the market over the long term is that investors generally do not value internally financed growth companies. They do not value them appropriately. Externally financed growth is extremely risky. What I'm saying won't make the investment bankers happy. We did a study where we looked at all the firms in the Russell 2000 Index and at their growth rates, and compared it to internal profitability. We found that companies that are growing quite a bit don't have a lot of profitability nor a lot of internal cash. Those companies get a lot more coverage on Wall Street compared to companies that can do it on their own. The companies that we like tend

are a real savior for us since we can meet management. Our belief is that if you read the 10K and 10Q and talk to management, you get to know about 90% of what you need to know. The other 10% tends to be scuttlebutt. I really have a hard time with people who just look at charts and search for trends.

Q: Do you maintain a database of information to help you in your research?

A: No. We keep files on the companies, talk a lot with them, and try to keep it relatively informal. I suspect that keeping the Lotus 123 or the Microsoft type of database is a good idea, if you happen to learn how to type into it. If the group gets bigger, a program would definitely make the effort

diversify in this space and still own really good businesses. We own a trucking firm that has a 35% rate of return on capital. If you're a large cap manager and you want to own a cyclical trucking firm, you will not own a great business. You will own a heavy, iron-tough business. The great thing about this is that in a wide variety of areas you can find businesses that you would want to own and give to your children. You cannot do this in the large caps. If you want to take one of these franchise strategies in large cap, you're pushed into large cap pharmaceuticals and into a few consumer brand stocks that have wonderful brand names. If you take one of these Warren Buffett type strategies into large caps, you're not diversified. ■

Dave Jennings