

Secular Tailwinds

The Parnassus Equity Income Fund looks for companies that not only generate income, but are also socially responsible. Portfolio manager Todd Ahlsten and his team of six analysts are trying to identify the best businesses whose goods and services will be more relevant in the long haul than they are today. The fund's philosophy lies on the premise that these businesses combined with secular tailwinds and reasonable prices can give investors appropriate returns.

Q: What's your investment philosophy?

A: We want to own a select list of businesses that have expanding or growing markets and purchase them when they trade below their intrinsic value. Fundamentally, we look for companies that sell goods and services that over the next three to 10 years will be more relevant in our lives than they are today. We look for a catalyst that can reflect company's fundamentals in the next one to two years.

We are socially responsible investors. We look for companies that have good corporate governance, strong ethics and reputation, and companies that are good corporate citizens with good environmental records. We think those companies combined with secular tailwinds, reasonable prices, and rigorous research can outperform benchmarks and give investors appropriate returns over time.

I believe that over the long haul the U.S. economy has a tendency to grow 2% to 3% a year when measured after adjusting for inflation which ranges between 2% and 3%. If a company can't grow its revenues on a nominal basis between 6% and 8% a year, it's probably not relevant to our society and to investor community in terms of investment return over the long haul. We are looking at what top line growth a business can produce over a 3 to 5 to 10-year period and how that looks versus the long-term economic trends. That helps us determine the stock valuation.

Q: How does the U.S. economy growth translate into corporate profit growth?

A: We believe that if the goods or services the companies sell are more relevant over time, they should be able to improve margins on higher sales volume. If a company has at least 6% to 8% revenue growth it should translate into an earnings rise of 8% to 10% leading to intrinsic value growth of 8% to 10% a year. We are trying to identify businesses that can increase their intrinsic value at least 10% a year.

Companies in different industries lead to value in different ways. We do long-term 10-year discounted cash flow projections and we sum up what the intrinsic value of a business is. Then we create a 1-year, 3-year and 5-year price target out of that process and determine where the intrinsic value is today and where it can be 3 to 5 years from now. Then, we risk adjust the prospects to determine the upside versus the downside. We are looking for two to one ratio for the upside to downside risk on companies that can generate 10% IRR.

Q: How is your research process organized?

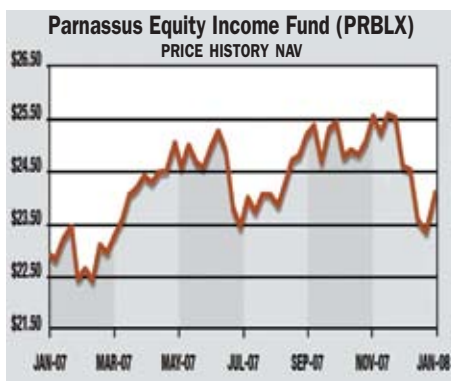
A: We have a team of six analysts organized by industries. They have a list of companies in their universe which they filter through. We separate the winners and losers and then we have valuation parameters on how the industry is valued, and



TODD AHLSTEN is presently the Portfolio Manager for the Equity Income Fund and the Fixed Income Fund. He began his career at Parnassus in 1994, when he joined the firm as a full time Research Analyst. He was subsequently promoted to Director of Research in 1998.

Ahlsten graduated from the University of California at Berkeley Haas School of Business in 1995 with an emphasis on finance and accounting.

“We want to own a select list of the best businesses that have secular tailwinds and we want to buy them when they are trading below their intrinsic value.”



investigate which companies are valued at a premium and at a discount.

We filter the companies to find out which opportunities look best within their industries in terms of potential discounts, intrinsic values-growth rates and secular tailwinds. Then, we identify the most attractive stocks in those industries based on IRR adjusted for risk.

We typically spend 4 to 8 weeks per investment before it's included in the portfolio. We talk to managements, customers, competitors, suppliers and industry consultants. We then use a very rigorous 5-step process of going through fundamentals, financials, and management rating. We look for catalysts and, finally, we evaluate the upside and downside risk.

Q: Could you illustrate your research process with an example?

A: To start with, we believe that there's tremendous secular growth in energy and the global demand for natural gas and crude continues to rise. So, we wanted to find companies that have the best secular growth dynamic, the best and the lowest cost reserves and the way to turn potential reserves into probable and approved reserves. That led us to invest in companies like XTO Energy, which has the lowest cost reserves and a tremendous pipeline of drilling prospects. Moreover, it has great owner operator management and it was trading at an attractive valuation when we first bought it.

We collected a select list of energy companies like XTO, which can not only generate great earnings today, but can replace

reserves at the lowest costs. These companies have management teams that are proven to find more reserves and do prudent acquisitions. Moreover, their owner operators have access to capital. These are companies that have good balance sheets and reserves in politically stable areas and can grow these businesses over the long haul.

Q: How do you build your portfolio in terms of diversification and sector exposure?

A: We tend to be in the large cap category because of our preference for companies that pay dividend. We don't overweight an industry more than two times the S&P 500 benchmark and we don't underweight an industry more than 50% of the S&P benchmark.

I discuss with my analysts what the current news flow in their sector is and what are the secular trends and the different industry dynamics. I also travel and attend most major industry conferences every year. It's a very interactive research process built on contacts, relationships and rigor.

Q: Some investors call themselves 'relative return' investors, while others are 'absolute return' investors. Do you classify yourself into either of these categories?

A: If you don't beat the S&P 500 over time, you are probably not going to stay in this business very long. We just look at absolute returns. If you buy a really good business with 15% to 20% or higher return on capital, if you buy a company that is going to grow faster than the economy, if you buy a company that you think can hold its margin structure at least flat or grow it over a 5 to 10-year period and if you buy a company with a solid management team, this by nature should help you outperform the market.

Q: Could you give a historical example of a buy decision you have made using your research process?

A: Aflac Inc. represents our stock re-

search and investment preference. It fits into our secular growth requirements as it provides supplemental insurance in the US and Japan. And, over the years Aflac has managed to grow earnings between 13% and 15% a year. Aflac with its product offerings is still underpenetrated in the market and it meets our criteria of secular dynamics.

First, over 75% of Aflac's earnings come from Japan. We have a fundamental belief that the dollar is going to be weak over the long haul, so having 75% of your earnings coming from Japanese Yen is a very valuable franchise.

Second, in the United States Aflac is underpenetrated with its supplemental insurance and has tremendous growth dynamics, so the other 25% of earnings in the U.S can continue to grow. Third, Aflac has no subprime mortgage exposure so it's not involved in the current credit crisis.

Fourth, Daniel Amos has been running the company for decades as an owner operator and the management team is hungry to build longer term wealth.

Fifth, Aflac increased its dividend every year and is actively buying back its own stock. The board of directors is shareholder-friendly as it's got the corporate ethics we're looking for. They are in secular growth where they stick to what they know. They don't go out and do acquisitions in markets they are not competent in. They have got a great international business that's non-correlated to the US economy. That's the kind of businesses we want to own.

Q: How do you define intrinsic value?

A: First, we look at discounted free cash flows over 10 years and put a terminal multiple on discounted back and it gives us an evaluation of what the company's worth.

We'll do different scenarios on growth

and margins to get a view of the over/under bet. We like to call it a 'growth solver', saying that if, for example, Google can grow 19% with a 30% operating margin next 5 years, what's that worth? This gives us an over/under look at what the market expectations are and then we make investment decisions based on that.

Second, we have a valuation criterion called 'Holt Value' and it values companies based on the excess economic return they make. In a nutshell, how much capital can you put to work, what's your discount rate and what's your return on that capital.

Q: How do you build your portfolio? How many stocks do you have and what is stock turnover in the fund?

A: Generally we hold 60 to 65 stocks, which makes our portfolio relatively concentrated. We don't typically overweight a sector more than two times the S&P 500 index and we don't underweight a sector more than 50% of index weight. In terms of diversification, typically the top 10 holdings of the portfolio represent around 30% of the fund.

In the last couple of years our turnover has been higher than I would like - around 100%. A couple of years ago we significantly underweighted financials and that caused some turnover. Some stocks have been near the high end of their trading range and we have a tendency to pare back and then add when they get to the lower end of their trading range.

We allocate capital in two ways. The first is what we call permanent capital and the second is opportunistic capital. That adds to turnover as well because we actively manage our holding in companies to take advantage of market volatility. In a perfect world, turnover may be 50% to 60% but in recent years it's been up at 100%.

I've hired several strong analysts in the last three years and as we have popu-

lated the fund with their ideas that has increased turnover a little in the short term. I've also harvested some gains from the time when I had more names in the portfolio.


Q: What kinds of risk do you monitor and what do you do to mitigate it?

A: We use macroeconomic analysis and top-down analysis which helps us steer where we think the economy is going. We also try to capture most of the risk at the company level by drilling down and doing rigorous research.

If you do extensive company-specific research it forces you to delve into the macro economics analysis and try to do sensitivity analysis for the company's stock during the different phases of economic cycle. We always keep in mind whether the company's products will be more relevant in the next three to five years, and if so how the stock will trade when the investment environment is favorable or adverse.

We are always trying to understand where the secular and demographic shifts are, where a specific stock or sector trades in recessions or economic expansions, and what are the historic multiples. We also try to understand risk based upon a lot of probability diagrams of where the market values different companies in a recessionary environment, and how the current cycle is different from the previous cycles.

We have 10 or 15 different metrics to evaluate risk including industry dynamics, the secular dynamics, demographics, and global growth. While we think at the macro level we also analyze where the company fits in the economy and in the industry.

Our portfolio tracking error has typically ranged between 4% and 5% and reached as high as 7%. Our goal is to be at a certain point uncorrelated to the benchmark. We are an actively managed fund so our tracking error tends to be on a higher side of the range. 

Parnassus Equity Income Fund

Symbol	PRBLX
Website	www.parnassus.com
Address	PARNASSUS INVESTMENTS One Market Suite 1600 San Francisco, CA 94105
Tel. No.	800-999-3505
Inception	08/31/1992

PORTFOLIO

Total Net Assets*	\$824.9
Avg Mkt Cap (\$ Weighted)*	\$61,000
Average Price/Earnings Ratio	20.4x
Average Price/Book Ratio	3.92x
Turnover Ratio	N/A

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$2,000
Min Subsequent Investment	\$50
Min Initial IRA Investment	\$500

RISK (AGAINST S&P 500 DAILY REINV IX - 3-YEARS)

Alpha	0.20
Beta	0.89
R-Squared	0.87
Ann. Std Deviation	8.09
Sharpe Ratio	0.62

RETURNS VS. S&P 500 DAILY REINV INDEX

	PRBLX	Index
1 Year (Cum.)	4.73%	-2.31%
3 Year (Ann.)	9.09%	7.28%
5 Year (Ann.)	10.08%	12.04%

RETURNS VS. RUSSELL 3000 TR INDEX

	PRBLX	Index
1 Year (Cum.)	4.73%	-3.08%
3 Year (Ann.)	9.09%	7.61%
5 Year (Ann.)	10.08%	12.77%

FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	0.99%

PORTFOLIO MANAGER

Todd Ahlsten	2001
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*millions

Data through: 01/31/2008

Source: Company Documents; Lipper

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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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