

SMID Selection

Paradigm Select Fund focuses on exploiting inefficiencies in the small to mid-cap markets by a bottom-up fundamental stock selection process. Fund manager Jason Ronovech has found that conservatively managed companies, if purchased at a discount to intrinsic value, can provide consistent returns. The portfolio is distributed among a variety of industries with holdings in undervalued companies with solid long-term growth prospects.

Q: What is your investment philosophy?

A: We look for high-quality small to mid-sized companies trading at significant discounts to what we believe they are worth. The \$500 million to \$5 billion range is full of under-followed companies, and getting in early allows us to invest in companies with strong long-term prospects for capital appreciation.

Q: What are the key criteria of your stock selection process?

A: First and foremost is valuation. We screen for companies that are trading at significant discounts compared to the market and compared to their historical multiples on earnings and cash flows. Then we conduct in depth fundamental research on these prospects to determine their investment merits.

There are three investment criteria that stand out in our fundamental research process. The first is the company's potential to accelerate organic revenue growth through new product introductions, pricing, new markets or gaining market share. Then, we look for companies that have strategic initiatives to improve their profit margins. Third, we look for companies with strong cash flow generating abilities and strong balance sheets.



JONATHAN VYORST & JASON RONOVECH co-manage The Paradigm Select Fund (PFSIX).

Q: Small and mid-cap companies are usually not very well covered by analysts. Do you do your own independent research?

A: Our independent research starts off with the company's financial statements. We get a sense of what the trends have been, then we build our own models and assumptions. To figure out the probability of success of a company meeting our investment criteria, we'll also go through a detailed call with the management team. We also conduct industry research to understand the economic environment and headwinds and tailwinds that the company will experience.

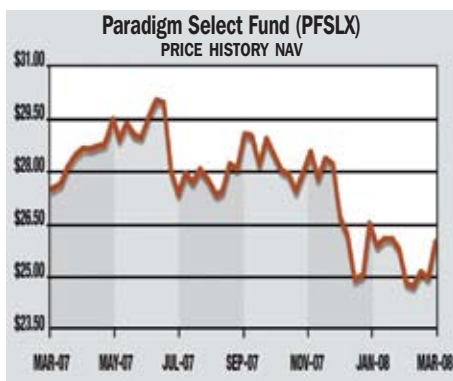
Q: Could you give us a couple of examples to illustrate your process?

A: The fund's historic performance has

Vyorst, MBA, (AT LEFT) joined Paradigm in 2007 from William D. Witter. He previously worked as a portfolio manager and analyst for Allianz, First Manhattan, Third Avenue Value Fund, and Drexel Burnham Lambert. He has a BA from Cornell and an MBA from Yale.

Ronovech, CFA, (AT RIGHT) has been with Paradigm Capital Management since 2000, working on the firm's small-cap value separately managed account strategy in addition to mutual funds. He has a BA from Hamilton College.

“The SMID market cap range is a sweet spot for identifying small but established companies with compelling valuations that we believe have solid long-term fundamentals. Our goal is to outperform consistently with lower volatility than our benchmark.”



been driven by stock selection in individual sectors. The fund has done very well in the energy sector and in the industrial sector. These were relatively under followed sectors five years ago with many compelling investment opportunities.

In the energy sector, one of the top performers has been Whiting Petroleum, an oil and gas exploration and production company. It was trading at a significant discount to its peers on its proven reserves. People were looking at what the company had done in the past and what the current reserves were and weren't really thinking about what the potential was. When the Fund purchased the stock, it was at a compelling value, it was a business with a strong management team, and well positioned in their markets. The price of oil reaching \$100 a barrel amplified returns.

Another successful energy stock was Denbury Resources. They use carbon dioxide flooding to extract excess oil from mature oil fields. Denbury was trading at a significant discount to its peers and to what we thought the company was worth. They were able to capitalize as the price of oil rose and the value proposition of the work they do increased. Both of these companies weren't widely followed at the time when we got involved with them.

Q: Are there other industries where you have done particularly well?

A: Another area that the fund has done well in is the aerospace industry. One of the top performers there is Woodward Governor, a company that makes products that manage the delivery and the burning of fuel in aircraft engines or industrial turbines. There was a huge demand for the company's products in both the aerospace and industrial markets. They'd invested a lot in the business, so there was the opportunity to leverage those investments and expand margins as they met the demand.

Q: How do you go about building your portfolio?

A: We have a roughly 60 stocks in our portfolio. About 80% of the portfolio comprises reliable, cash flow generating companies and 20% of our stocks are in a 'special situation'. A 'special situation' might be a turnaround scenario, an asset play or a restructuring due to which the company is trading at a large discount to what we think its intrinsic value is.

We initiate positions at 1.5% of the portfolio. We believe that having a balanced portfolio, with fairly equally weighted positions, produces strong returns and minimizes risk over time. At the time of purchase, we like to see at least 50% upside to our intrinsic value target. We also like to minimize the downside to 10% to 20% at the maximum. Another part of our philosophy is to have a diversified, balanced portfolio of companies across different industries.

Q: Could you describe your sell discipline?

A: Generally speaking, if we expect a deterioration of fundamentals, we are

going to exit the position. If a company hits our valuation target, we are going to exit the position and replace it with a better alternative.

Q: Do you measure against a particular benchmark?

A: We view the Paradigm Select Fund falling in the SMID category. It is a fund that invests in small and mid-cap stocks, and our benchmark is the small mid-cap benchmark, the Russell 2500. It's representative of the broad market that we're investing in. If you look at the characteristics of that index, it's very similar to the characteristic of our fund.

Q: Do you consider selling a position automatically if the stock falls 20% from your purchase price?

A: We are aware what our stocks are doing every day. We believe you can't be emotional and you have to be very disciplined when it comes to evaluating stocks. If the stock is down 20% from where you bought it and nothing at all has changed in the company itself, in the industry they play in, and in the market in general, then there is no reason to change your thoughts on the company. But if you bought it for two or three reasons specifically, and one of those turns out to not be playing out as expected, then you have to reevaluate whether the weaker fundamentals warrant exiting the position.

Q: What changed after the manager change in the fund in August 2007?

A: The fundamental strategy and investment process remain consistent. There were a number of consumer-related stocks that we had concerns about that we sold given the deteriorating fundamentals of those companies.

Brunswick, the boat manufacturer, was an example of that and Jackson Hewitt, the tax service provider. We exited some auto suppliers like Visteon Corp., too.

We also sold and reduced our exposure to a lot of companies that we thought had significant risk to the slowdown in the housing market and not only residential but non-residential construction. NCI Building Systems is one of them, HNI Corp. is another one. We also sold stocks with uncertain exposure to the credit crisis such Moneygram.

Q: Do you find any industry or sector particularly attractive? Could you give some historical examples of your best positions there?


A: We have increased our exposure to the healthcare sector and I think that's where a couple of our favorite ideas are right now. An interesting company that we own now is K-V Pharmaceutical. Its market cap is about \$1.3 billion. K-V is a combination of a branded specialty pharmaceutical company with a number of products that target the women's health market. The company also has a very successful generic business. They apply their drug delivery technologies to put a little twist on products that have gone generic and they are able to capture a pretty strong share of the markets they are in. The company invested significantly in their sales force, in their manufacturing abilities, and in research and development over the past few years and now those investments are coming to fruition.

On the brand name side, K-V Pharmaceutical is taking significant market share and they have the leading number one products in all the categories that I mentioned. They have an inter-

esting new product that is coming to market this month. It's called Evamist and it is a hormone replacement therapy drug for women with menopausal symptoms. Currently on the market there are pills, patches, gels and they all have different variety of drawbacks. This product is interesting because it is slight mist that is sprayed on the skin once a day and it evaporates quickly. There is no odor, there is no residue and it is effective in how it works. It is a potentially large product for the company and they already have a sales force ready to sell it.

On the generic side, about six months ago K-V Pharmaceutical received approval for a generic version of Toprol. This is a blockbuster beta-blocker drug for high blood pressure. K-V Pharmaceutical has been doing a phenomenal job gaining close to 70% - 75% market share in two of the doses that they market. Hopefully, in the next month, they are going to get approval for two other doses. They have been making a tremendous amount of profits off of this product that they have been able to re-invest into new products like Evamist and we have seen earnings go from about a dollar a year ago to about two dollars this year. We believe that there is significant potential beyond that.

Q: What risks do you perceive and what do you do to mitigate them?

A: In terms of stock specific risks, we have our anchor on valuation when we initiate a position and this reduces most risks. If you are buying a stock that is trading at historic lows compared to the market and compared to where the company has traded before and you back that up with fundamental research where you feel that trends are improving, then you'll have minimized that company's specific risk. 

Paradigm Select Fund

Symbol	PFS LX
Website	www.paradigm-funds.com
Address	Paradigm Capital Management Inc. Nine Elk Street Albany, NY 12207
Tel. No.	800-239-073
Inception	01/01/2005

PORTFOLIO

Total Net Assets*	\$9.4
Avg Mkt Cap (\$ Weighted)*	N/A
Average Price/ Earnings Ratio	N/A
Average Price/Book Ratio	N/A
Turnover Ratio	N/A

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$10,000
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$1,000

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

Alpha	0.34
Beta	0.86
R-Squared	0.82
Ann. Std Deviation	11.06
Sharpe Ratio	0.41

RETURNS VS. RUSSELL 2500 INDEX

	PFS LX	Index
1 Year (Cum.)	-7.54%	-11.27%
3 Year (Ann.)	8.23%	6.01%

RETURNS VS. RUSSELL 2000 INDEX

	PFS LX	Index
1 Year (Cum.)	-7.54%	-13.00%
3 Year (Ann.)	8.23%	5.06%

FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	2.00%
Total Expense Ratio	1.50%

PORTFOLIO MANAGER

Jason Ronovech	2007
Jonathan Vyorst	2007

*millions

Data through: 03/31/2008

Source: Company Documents; Lipper

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