

# Leveraging Changing Expectations

*Stock prices reflect investor expectations of relevant corporate developments, according to the managers of the Nakoma Absolute Return Fund. They believe that the way to make money is by having a more accurate forecast of these corporate developments than the consensus forecast.*

## What is your investment philosophy?

We describe our investment philosophy as expectations investing. We believe that stock prices reflect investors' expectations of relevant corporate developments. It's the weighted average of optimistic and pessimistic forecasts for company performance. Changes in investors' expectations drive stocks and markets higher or lower.

We think stock prices rise when subsequent events positively surprise the consensus and fall when subsequent events negatively surprise the consensus. The way to make money is by having a more accurate forecast of those corporate developments than the consensus forecast because we believe it is the change in investors' expectations that leads to changes in stock prices.

Our investment philosophy holds that careful management of portfolio risks can produce a low volatility return distribution. We're not attempting to avoid risks by hedging out all risk exposures, but we want to avoid unintended risk exposures and make sure portfolio exposures are not excessive. We believe that if we effectively implement our investment process we can produce a low volatility absolute return series.

## What is your investment process?

The Nakoma investment approach is composed of three integrated processes: dynamic asset

**“When we think of portfolio construction, we think about how each new idea or each position affects the expected return distribution for the portfolio.”**

allocation, fundamental stock selection and risk management.

It's an integrated process, where the implications of asset allocation, stock selection, and risk control processes feedback into one another to arrive at the final portfolio.

The first step in our asset allocation process is to define the distinct investment scenarios we believe investment market participants are anticipating. When we think about investment scenarios investors are anticipating, we categorize the factors they focus on in 1 of 3 groups: factors related to the economic environment and corporate profits, factors related to inflation expectations and interest rates, and factors related to investor sentiment and market valuation. We do this in order to understand the expectations underlying the optimistic or pessimistic views of the market environment at any point in time. This allows us to estimate the implied rates of return associated with those optimistic or pessimistic views. We then evaluate the underlying trends using a variety of indicators we think provide some insight into whether the trends are validating the more optimistic views or the more pessimistic views. When we see underlying trends pointing toward either the more optimistic or more pessimistic direction, we'll adjust the targeted net market exposure accordingly. If we see trends validating the optimistic view, all else equal, the target net exposure of the fund will be rising. When we see trends validating the more pessimistic views, all else equal, the target net exposure will be falling.

Asset allocation is used to establish a target net market exposure. All else equal, we look to increase the portfolio's market exposure when the market risk premium is more favorable and decrease exposure when the environment is less favorable. In practice, the adjustments in the net exposure are

**DAN PICKETT**, CFA, Managing Director and Chief Investment Officer has been a portfolio manager for the firm since the end of 2002 and has been in the investment industry for 20 years. Pickett began his career at American Family Insurance group in Madison, Wisconsin, where he was responsible for the management of the firm's investment portfolios and the day to day operations of the firm.

From 1988 to 1997, Pickett was a portfolio manager and Director of Research at Columbus Circle Investors, and institutional equity manager in Connecticut.

From 1997 to 2002, Pickett was Director of Research at Southridge Capital Management, a Connecticut-based hedge fund specializing in private placements. While at Southridge, he managed a long/short equity with Mark Fedenia. He holds a BBA (honors) and MS in Finance from the University of Wisconsin-Madison.

**MARK FEDENIA**, Ph.D., Managing Director has been a portfolio manager for the firm since the end of 2002 and has been in the investment industry for 30 years. Fedenia is responsible for developing risk management tools and participates in the management of the firm's investment portfolios. From 2000 to 2002, Fedenia collaborated with Pickett in the management of a long/short equity fund.

Previously, Fedenia designed portfolio management systems for Shaw Data Services in New York and co-founded Almark Enterprises, a financial consulting and software development firm.

Fedenia holds a BS, MS and Ph.D. in Finance from the University of Wisconsin-Madison. Fedenia served as the Director of the Applied Security Analysis Program at the University of Wisconsin-Madison from 1986 to 2007.

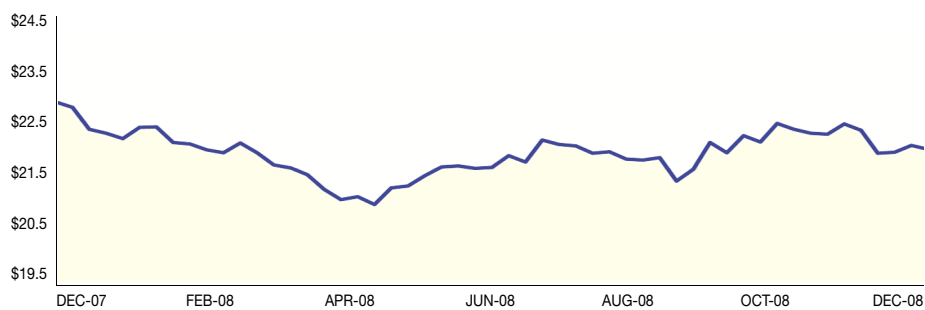
**JOEL KURTH**, CFA, Managing Director/Portfolio Manager is a portfolio manager who joined the firm in January 2008. He began his career in the investment industry in 1995. Kurth participates in the management of the firm's investment portfolios.

From 1998 to 2007, Kurth was a portfolio manager at Ark Asset Management, an institutional equity manager in New York City. From 1995 to 1998, he was a Securities Analyst at Columbus Circle Investors, an institutional equity manager in Stamford, Connecticut.

Mr. Kurth holds a BBA (with honors) and an MS in Finance from the University of Wisconsin-Madison, where he also participated in the University's Applied Security Analysis Program.

## Performance - Price History N.A.V.

Nakoma Absolute Return Fund (NARFX)



	2007*	2008**
S&P 500 Daily Index	5.49%	-37.00%
Nakoma Absolute Return Fund	15.10%	-4.34%

\*AS OF 12/31/07 \*\*AS OF 12/31/08

usually gradual, driven by the initiation of new ideas into the portfolio. Significant changes in the investment environment may lead to more abrupt changes in market exposure. In general, asset allocation is used to manage volatility as much as to generate return.

The second part of our process is stock selection. We seek to generate the bulk of the performance in the fund here. The process is conceptually similar to the asset allocation process where, with the market environment, we're identifying the factors we think are the drivers of investor expectations for market performance.

We do the same thing at the stock level. We identify the key drivers for each stock we have an interest in. Those drivers are categorized as related to the overall macroeconomic and political environment, related to some sort of secular change occurring, related to industry factors or specific to the company. The drivers differ from company-to-company. In some industries that are driven by industry events like the energy industry or other cyclical areas, the macro and industry factors will be similar across companies. In other sectors, like the pharmaceutical industries or technology industries, there will be more company specific drivers influencing how the stocks perform.

The second step in the stock selection process is to understand expectations distribution with respect to those drivers. What are the optimists anticipating with respect to the macro drivers for that cyclical stock? What are the pessimists anticipating with respect to the new product trends for that pharmaceutical company? We seek to understand what expectations are

reflected in the current market environment. Then, as with the macro environment, we will evaluate underlying trends of key leading indicators we think will give us some insight into whether or not the company's performance is likely to be better or worse than expected. We're identifying where there's the potential for positive surprise or negative surprise relative to investor expectation. It's not a short-term focus. While we always would like to have short-term surprises, we're focused more on that 12-to-18 month time horizon. We recognize that, in many instances, opportunities arise because the market has a very short-term focus. That can create an opportunity where our longer-term expectations differ from the market expectations.

### What is your risk control process?

Our risk control process is structured very similarly to our stock selection process. With the stocks, we're identifying the key drivers ultimately of price and return. However, with the risk control process, we're identifying what we think are the key drivers of portfolio volatility, the key risk exposures in the portfolio. As with the macro and the stock analysis, we look to understand what the expectations are with respect to key risk drivers, but more importantly, we want to know what the portfolio exposure is both on the long side of the portfolio and on the short side of the portfolio with respect to each of these key risk factors.

In addition to the risk exposure analysis, we also use a number of conventional approaches to dampening portfolio volatility. They are things like maintaining a relatively diversified portfolio with 40-to-70 stocks at any point in time and maximum positions sizes on the long side and the short side of the portfolio.

We also use stop loss limits. Typically, with stop losses, we'll set a limit that's 10-to-15 percent away from the current market. It's not a mechanical stop loss whereby if the price is violated, we immediately eliminate the position. Rather, it triggers an even more intense analysis of the underlying drivers of the stock to identify a potential missing driver or reassess the relative importance of identified drivers. In some instances, it leads to either reduction or elimination of a position in the portfolio. In some cases, we may decide to add to the position.

### Can you give us one historical example that will also give us an idea about your research process?

An example of a long position that we've had in the portfolio is Varian Semiconductor Equipment Associates, a semiconductor equipment manufacturer. We established a long position in Varian in the summer of 2006.

The idea arose from our analysis of the technology sector. We look at sectors the same way we do individual companies. It's a convenient way for us to evaluate trends that will affect a broad group of stocks by regularly reading information about developing trends in markets. When there is change, we've found that it's more difficult for analysts to forecast and there's a greater potential for either positively or negatively surprising developments. In the specific case of Varian the key drivers are tied to capital spending in the semiconductor industry.

There is secular increase in complexity of technology devices that is increasing demand for more complex semiconductor equipment. Growing revenue share comes from orders for new equipment, so having design wins with semiconductor companies is a big driver.

Varian is a relatively small company in comparison to some of their competitors with expertise in more complex equipment and leverage to the rapidly growing flash memory market. We thought there was opportunity for the company orders to exceed market expectations given trends in new design opportunities. Our initial long position was driven by our expectation that their revenues would eventually exceed investor expectations as they generated new business, primarily with Intel but also with some of the flash memory manufacturers where they had particularly high exposure relative to the competition. We thought

the increasing complexity and devices also gave Varian a competitive advantage relative to the legacy manufacturers that had larger established positions and where there was a risk that they might actually lose market share.

While we were optimistic about Varian because of their market share opportunities, we were somewhat concerned about the semiconductor capital spending cycle. The industry had experienced a substantial increase in spending particularly in the DRAM segment of the market, so we were concerned that capital spending might slow. In order to hedge out the risk of slowing capital spending in the industry, which would negatively affect Varian as well as the other companies in the space, we established short positions in a number of Varian's competitors: Novellus, Lam Research and Applied Materials.

We had a long position in Varian hedged out with a short position in a handful of other semiconductor equipment companies. We maintained that position for a little over a year and benefitted as Varian generated some significant design wins. During the period when we held the stock, expectations rose materially for Varian as did its stock price. We actually lost a little bit on our hedges, as those shares also increase in price, but significantly less than Varian. Having the hedges gave us the confidence to maintain a larger Varian position than we would have without the ability to hedge the industry risk. Eventually, we began reducing the Varian position, not necessarily because we became less optimistic about Varian, but because we were no longer more optimistic than the market as market expectations rose with Varian's success. At the same time, we had become more concerned about the prospect of slowing capital spending in the semiconductor sector. Ultimately, we eliminated the position in Varian and maintained the short positions in the other semiconductor equipment companies we held effectively transitioning the short positions from hedges to ideas expected to generate a positive return for the portfolio.

#### **Do you have any investment benchmarks? What is the portfolio construction process?**

We're managing the portfolio to achieve positive rates of return in the range of 2%-4% above Treasury Bills with relatively low (i.e., bond market) volatility and low correlation to stocks and bonds. In the very long run, we seek to achieve

equity market-like returns with bond market-like standard deviation.

When we think of portfolio construction, we think about how each new idea or each position affects the expected return distribution for the portfolio. There are position size limits on individual holdings intended to dampen the exposure to mistakes that are inevitable in any stock selection process.

The maximum position size of a long holding is 5% and the maximum position size of a short holding is 3%. The short holdings maximum is smaller because the return distribution on short holdings is less favorable than the return of opportunities with long holdings. You can lose an infinite amount with a short and the most you can make is 100%.


We also look at each new idea in relation to how it affects the risk exposures of the portfolio. Ideas are usually selected because of their expected return. However, as in the case with the semiconductor equipment companies example, there are also ideas that find their way in the portfolio to hedge out certain risks that we identify.

It is a dynamic process. The risk control process can lead to ideas finding their way into the portfolio just as the stock selection process can.

#### **Can you also explain a little bit on your concepts behind shorts?**

For us, there are two kinds of shorts. One kind is where we have a view that's different than the market's view with respect to the fundamentals. When we say the market's view that means what we think is priced into the market. That would be an idea where we expect to generate a return if our analysis proves accurate. The other kind of short positions in the portfolio are hedges where we're attempting to balance off a risk exposure in the portfolio we're unwilling to accept or we're unwilling to accept at whatever level is implied by the long positions that we have.

#### **By prospectus what percentages can be held in short and what percentage can be held in long?**

We can be as much as 25% net short, 60% net long. We could have a significant short position in the portfolio. The maximum gross exposure allowed is 150%. In practice, the amount of leverage we have used in the fund has been limited. 

## **Nakoma Absolute Return Fund**

Symbol	<b>NARFX</b>
Website	<a href="http://www.nakomafunds.com">www.nakomafunds.com</a>
Address	Nakoma Absolute Return Fund P. O. Box 2175 Milwaukee, WI 53201
Telephone	866-662-5662
Inception	12/18/2006

PORTFOLIO	
Total Net Assets*	\$151.7
Avg Mkt Cap (\$ Weighted) *	\$29,300
Average Price/Earnings Ratio	18.65x
Average Price/Book Ratio	3.25x
Turnover Ratio	124%

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

RISK (AGAINST S&P 500 DAILY REINV IX - 3 YEARS)	
Alpha	N/A
Beta	N/A
R-Squared	N/A
Ann Std Deviation	N/A
Sharpe Ratio	N/A

RETURNS VS. S&P 500 DAILY REINV INDEX		
	NARFX	Index
Since Inception (Ann.)	5.05%	-18.40%
1 Year (Cum.)	-4.34%	-37.00%

FEES AND EXPENSES	
Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.99%
Gross expense ratio - FY 2008	2.57%

PORTFOLIO MANAGER	
Dan Pickett	2006
Mark Fedenia	2006
Joel Kurth	2008

\*millions  
12/31/2008; Source: Company Documents; Lipper

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