

## FRIC US Small Cap Fund Manager Change

We have enhanced the mix of the FRIC US Small Cap Fund by replacing core value manager, Martingale, with core value manager, Integrity Asset Management (Integrity). We have also replaced core growth manager, Times Square, with another core growth manager, Westcap Investors (Westcap).

Both Integrity and Westcap run similar processes to the managers they are replacing, so we do not anticipate any change to the risk profile of the fund. The new managers run diversified portfolios and focus on higher quality, lower-risk companies with solid fundamentals. This approach will combine well with the other managers in the fund, who run concentrated portfolios with higher tracking errors and operate in select areas of the market.

Perhaps surprisingly, it's difficult to find good core managers, like Westcap and Integrity, in the small cap investment arena. With less information available on small cap stocks, and the huge numbers of companies to research, most managers focus their research efforts on a select area of the small cap market, defined by specific indicators or cap size - making them more style-concentrated rather than broad growth or value.

### Small is beautiful

In the investment management business, portfolio managers have to be careful - success can sometimes be self-defeating. Managers who run successful strategies often experience rapid asset growth. As growing amounts of money are invested according to the same recipe, portfolio managers can lose some flexibility; it becomes harder to switch larger sums in and out of stock positions. This can affect a manager's performance. "Fattening the goose that laid the golden eggs could eventually lead to an unhealthy and unproductive animal."<sup>1</sup>

At Russell, we like managers who are aware of their capacity constraints and show that they manage asset growth well. This is one of the reasons we hired Integrity and Westcap. They have the capacity we need and have very carefully factored in future growth.

### Who is Integrity Asset Management?

Integrity is a start-up manager with only \$115 million in assets invested in the small cap value strategy. We followed founder and CIO, Dan Bandi, from his previous position managing small cap equities at NatCity Investments. Dan has expressed a commitment to keep the value product's asset base low. In fact, when we met Dan, he was rather candid about the issues caused by the larger asset base at NatCity. He said that a large asset base forces you to become a "circular thinker" - it took more time to get into and out of a position. With this stance, we're doubtful Dan will let asset growth become a concern at Integrity.

### Integrity's investment process

Integrity is a classic small cap value manager with a purely bottom-up process. It screens the universe for stocks with a market cap of between \$100 million to \$2 billion and also screens for high trading volumes. This means it invests in liquid stocks - ie stocks that will not be difficult to enter and exit quickly. Integrity seeks two elements: prudent value and

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<sup>1</sup> Beckers and Vaughan. The Journal of Portfolio Management. Summer 2001.

improving sentiment - ie catalysts for change. The value indicators Integrity uses are traditional, such as price/book, price/sales and price/cashflow ratios.

Dan Bandi is a key individual in this process - a talented and motivated investor with considerable experience. When we met the team, it became apparent that the decision-making structure Dan has built works very well- there is very little disagreement between team members on individual stock purchases or sales. Dan estimated that only 10% of investment decisions cause any disagreement. This streamlined process combined with Integrity's low asset base allows ideas to be implemented very quickly. Its emphasis on prudent value and higher liquidity stocks means Integrity constructs well-diversified, 'all weather' portfolios from higher-quality companies than the other value managers in the fund.

This approach complements the other value managers in the fund. Integrity's process is likely to do well in markets where fundamentals are rewarded, or when markets are defensive, while the other value managers run portfolios that are more concentrated. David J Greene and Co, another small value manager, uses a more focused process. Greene looks at a smaller number of stocks - but in a much greater level of detail than most other managers. Greene would rather have higher conviction about fewer stocks than have lower conviction in a greater number. This results in a highly concentrated portfolio and a return stream that diverges more from the benchmark than that of Integrity. Nicholas Applegate Capital Management (NACM) uses an initial screen to highlight attractive stocks, based on traditional value indicators such as price to earnings and price to book ratios. However, NACM also uses some growth indicators such as financial strengths and earnings revisions, looking for turnaround situations and positive momentum in share prices, whereas Integrity is classically value.

## Who is Westcap Investors?

Westcap is an independent money management firm located in Los Angeles, California; founded in 1992 and with just \$3 billion in assets under management. Our research analysts are very familiar with Westcap's other products and when it recently announced that it was launching a Russell 2500 Growth Index (US small cap growth) product, we were keen to research it and soon ranked it as a 'hire'. Westcap has a very similar investment process to that of departing manager, TimesSquare - a focus on companies with low earnings variability and a bias towards defensive growth.

### Westcap's investment process

Westcap's process differs from the other growth managers in the fund. It combines an appealing, thematic top-down view with bottom-up stock selection, making Westcap the only manager in the fund to employ a top-down element. This is quite unusual in small cap investment, where most managers aim to add all value from bottom-up decisions. Westcap also has relatively relaxed controls on sector and industry weights, whether resulting from top-down or individual stock decisions, which may result in some large positions. We believe this gives Westcap access to a very different return stream from the other managers in the fund.

Westcap's highly experienced team of 12 professionals is the foundation for this process - it has the expertise to conduct company analysis as well as take sector views. Stock specific research is concentrated on companies with consistent and sustainable earnings growth within industries that are expected to outperform over a two-year horizon - a broad definition of the growth style. Significant emphasis is placed on management quality and its past record of success, giving Westcap a greater emphasis on quality than other managers within the fund. Again, this core approach combines well with the other, growth managers.

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Gould Investment Partnership (GIP) is a growth manager with an earnings growth momentum bias. New ideas are generated through a number of screens, which identify companies with earnings growth of 30% or more, making it a much more aggressive manager than Westcap. Dick Gould has a dynamic investment style favours concentrating the portfolio in his highest conviction holdings. We expect that GIP will have the highest stock turnover of the managers in the fund, and a higher return variability than Westcap.

The other growth manager in the fund, Next Century, has a strong focus on more intangible factors such as the strength of management and business strategies. This allows it to see future growth in companies when the indicators that both Westcap and GIP use may not.

### Manager Weights

Manager	Previous Fund Weight	New Fund Weight
Next Century	11%	11%
David J Greene	7%	7%
Goldman Sachs	20%	20%
Nicholas Applegate	11%	11%
Gould Investment Partners	12%	12%
Martingale	22%	0%
Integrity Asset Management	0%	22%
Times Square	17%	0%
Westcap Investors	0%	17%