



## SMALL CAP DIVERSIFIED VALUE Detailed Investment Strategy

### Investment Philosophy

H&W employs a research-driven, fundamental value investing approach. We invest in companies where our research indicates the present value of its future cash flows exceeds the market price. These opportunities often emerge when a company is experiencing a period of temporarily depressed margins or returns on capital. Empirical evidence suggests that companies generating above average returns on capital attract competition that leads to lower levels of profitability. Conversely, capital leaves depressed areas, often allowing profitability to revert back to normal levels. The difference between a company's price based on an extrapolation of current trends and a more likely reversion to mean creates the value investment opportunity.

Traditional Wall Street research for small companies is particularly limited, which creates inefficiencies and valuation anomalies. To exploit these valuation anomalies, the Small Cap Diversified Value strategy blends a sophisticated proprietary model with fundamental reviews by our experienced research team.

### Investment Process

H&W subscribes to a team-oriented, four-stage process. The goal is to employ a consistent, repeatable approach and create a diversified portfolio that exhibits attractive risk/return characteristics.

<u>Stage</u>	<u>Purpose</u>	<u>Responsibility</u>
1. Valuation Model	Identify undervalued investment candidates	Portfolio Coordinators
2. Analyst Review	Validate/adjust model assumptions and assess risk	Industry Analysts
3. Portfolio Construction	Create model portfolio	Portfolio Coordinators
4. Portfolio Review/Rebalance	Monitor portfolio and rebalance as appropriate	Entire Team

### 1. Valuation Model

The small cap market is composed of a vast number of publically traded companies. Automation technology is an effective tool to filter this universe to stocks that are statistically attractive and worthy of review by our analysts. We begin with a universe of approximately 3,000 stocks with market capitalizations between \$100 million and \$4 billion. Each stock is run through a valuation model designed to compare its stock price to its normal economic earnings power. The model derives normal economic earnings power by normalizing margins and returns on capital. It also adjusts for numerous factors that are often misrepresented by GAAP earnings. As an example, the model may capitalize certain operating expenses and/or adjust for pension plan status, over/under earning, non-cash expenditures, and various other factors. These adjustments result in a true economic profit margin that we normalize to accommodate for standard ebbs and flows of the business cycle.

The models identify the 500-600 most attractive candidates, which are disseminated to the appropriate industry analyst for review.

## 2. Analyst Review

The lack of sell side research in the small cap market creates an investment environment where understanding the basic economic forces impacting a particular company is sufficient in identifying attractive investments. Given the deep industry experience of our analysts, we are well positioned to identify opportunities and avoid risks that the valuation models cannot. The valuation models will invariably identify some stocks that are unattractive for reasons that the models cannot detect. Examples include significant shifts in business mix, structural or regulatory changes, and legacy liabilities. It is imperative, therefore, that the output of the models be reviewed by fundamental research analysts with deep industry knowledge. In many cases, our analysts have prior knowledge of the investment candidates either as prior investments or competitors, and are familiar with the investment merits and risks.

A thorough understanding of industry dynamics is also an invaluable tool in assessing each investment candidate's risk profile. The valuation model incorporates quantifiable risks (e.g. financial leverage) but the analyst review incorporates risks that are difficult to identify with models. Examples include unfavorable competitive dynamics, businesses in secular decline, imprudent capital allocation, and numerous others. The analyst determines the final risk/return profile, which is used to establish weights in portfolio construction.

## 3. Portfolio Construction

Based on output from the analysts, approximately 350-400 stocks are selected for the target portfolio. Subject to diversification guidelines, we weight the 100 most attractive stocks 0.4%; the next 100 stocks 0.3%; the next 100 stocks 0.2%; and the remaining 50-100 stocks 0.1%. The selection of stocks for the portfolio is subject to a maximum sector weight of 35% and a maximum industry weight of 15%.

## 4. Portfolio Review/Rebalance

The portfolio is rebalanced periodically due to changes in valuation or company fundamentals. We rebalance the portfolio no less than monthly.

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## Financial Definitions

*Cash flow:* Measures the cash generating capability of a company by adding non-cash charges (e.g. depreciation) and interest expense to pretax income.

Diversification does not assure a profit nor protect against loss in a declining market.