

<b>ASTON/RIVER ROAD SMALL-MID CAP (ARSMX)</b> Category: Small Value Analyst: Bill Harding Date: November 17, 2008	<b>GPA: 3.59 BUY</b> Status: In Use MIS Invest: \$20 million MIS Ports: PFPC: AG, GR, MCV
--	--

### Summary

This newbie has a strong pedigree. River Road is a boutique investment firm located in Louisville, Kentucky. The firm was established from a team lift-out from a prior firm. The team follows an absolute value approach in seeking well-managed, financially strong companies selling at a discount to their estimate of intrinsic value. They focus on identifying underfollowed and/or misunderstood stocks that are less efficiently priced and there is more opportunity to take advantage of mispricing. The team will apply the same investment process that has yielded tremendous success at its flagship small-value strategy since 1998 to this SMID fund by targeting stocks with market caps in the \$250 million to \$6 billion range. The team is experienced and is very committed to acting in the best interests of its shareholders.

### GPA

Factor	Weighting	Grade
Process	25%	4.00
People	25%	3.75
Performance	25%	3.50
Capacity	15%	3.50
Expenses	10%	2.50
Adjustment		
GPA		3.59

### *People*

River Road was established in April 2005 as a result of a team lift-out from Commonwealth Trust Co. and SMC Capital. The employees of River Road originally owned 55% of the Firm, with the remaining 45% owned by ABN AMRO. Given the sale of ABN AMRO to Fortis, River Road had the opportunity to exercise a clause in their contract with ABN AMRO that would allow them to buyback their share given a change in control. They recently have completed the buyback of the portion of the firm that employees did not already own by partnering with Asset Management Finance (AMF). AMF provides the lending for the buyback while in return River Road shares a portion of revenue. The term of the deal with AMF will be around 8 to 12 years and River Road can buy out AMF at any time as long as the internal rate of return target is met.

Currently, 8 out of 23 employees of the Firm have equity in the firm and buying back the remainder of the firm will allow them to offer more equity to employees as part of a long-term incentive plan. Even though key members of the investment team as still fairly young, leadership of River Road (Beck and Shircliff) have been extremely thoughtful in thinking about the second generation of portfolio managers at the firm. They set up an analyst portfolio in part because they wanted to see how the analysts would handle running money and look for leadership skills. At this point, Beck and Shircliff noted that Daniel Johnson and Justin Akin have impressed them the most and would likely take on portfolio management responsibilities at some point. That is a long run plan though as Beck and Shircliff noted that this is more like a 15 year succession plan.

The firm runs three strategies: Small Cap Value, Dynamic Equity Income and the recently launched Small-Mid Cap Value. Small Cap Value represents the firm's flagship product and they

had a nearly 8-year AIMR-compliant composite track record that they were able to bring with them to River Road. Although the Small-Value strategy is the firm's flagship strategy and boasts the longer track record, the firm also runs about \$1.6 billion in the Equity Income strategy.

James Shircliff is the firm's CEO and Chief Investment Officer and boasts 35 years of experience. He launched the firm's flagship Small Value Strategy at SMC in 1997 and prior to that was a partner and Director of Research at Southeastern Asset Management (Longleaf Funds) and also had stints at Oppenheimer and First Kentucky Trust Company. It's interesting to note that he was at Southeastern, as they have not lost many investment professionals over the years. According to our meeting with Andrew Beck, Shircliff left Southeastern due in part to a conflict with Mason Hawkins.

All told, there are 10 members of the investment management and research team that consist of four portfolio managers, a director of research, four analysts, and a research coordinator. Andrew Beck, a Senior Portfolio Manager, joined the team in 1999 and is a founding principal of River Road. He brings to the team nine years of investment experience. Greg Deuser, Director of Research and Risk Management, contributes 24 years of experience. The Firm has amplified the team by recently hiring Matthew Moran (former Morningstar equity analyst), Daniel Johnson, and Erik Keener as analysts. All the original team members remain with the Firm.

The team has its interests aligned with shareholders as the firm requires all access persons to have a minimum of 30% of their personal investable assets invested in River Road Asset Management funds or affiliated partnerships. The portfolio managers' bonus compensation is primarily based (70%) on the composite portfolio performance relative to both peer performance and the Russell 2500 Value benchmark. All investment analysts and managers also participate in firm profits, either through direct equity or profit sharing. Most importantly, after meeting with nearly every employee of the firm during our on-site visit, it appears that they are dedicated in serving in the best interests of their current clients and enjoy working with each other, which has led to excellent stability of the team.

**Grade: 3.50**

### *Process*

The team follows an absolute value approach in seeking well-managed, financially strong companies selling at a discount to their estimate of intrinsic value. The following detail the steps in the investment process:

- 1) Idea generation: begin with universe of stocks with markets caps between \$250 million and \$6 billion and screen universe using Value Line and FactSet. They may also generate ideas through other sources of information such as insider transaction data, SEC filings and firm announcements.
- 2) Security analysis: search for stocks priced at a discount to intrinsic value with an attractive business model, shareholder-friendly management, solid financial position and either undiscovered, under-followed or misunderstood.
- 3) Portfolio construction: broadly diversified across 60-85 names
- 4) Sell discipline: they will sell if their return objective is achieved, the company fails to execute or losses develop.

Examining the valuation discipline in more detail, the team appraises businesses by employing two methods. The first is to determine a company's ongoing value based on its ability to generate cash flows. The second is to evaluate the company's liquidation value based on a sum-of-the-part analysis. Either appraisal should represent what a reasonable buyer would pay to acquire the firm. To assist in the appraisal process, they look to relative private market transactions (when

available) and reasonable relative market valuations. The portfolio's top-20 holdings sell at a weighted average price to value of 80%. A company's market price must be 80% or less of appraisal to qualify for investment, with a target of 75% or less.

In terms of determining whether a company's management team operates in a shareholder friendly manner, they look for significant insider ownership, buying in shares and value enhancing actions, such as dividend increases, spin-offs, accretive acquisitions, paying down debt, etc. In regards to insider ownership, they generally like to see a high portion of the stock closely held. But there are risks in that it could be dead money, so they have to comfortable that management has a strong track record of being shareholder friendly. Although Coca Cola Bottling is an example of a company with a large percentage closely held that is "dead money", the company is paying down debt and surmises that they think the firm will be acquired by Coca-Cola. Out of the top-20 holdings, 11 are buying back shares and 10 are increasing dividends.

In assessing a company's business model, they look for easy to understand businesses that are predictable and sustainable and like to have a unique, competitive franchise. The upshot is a portfolio chock-full of companies in "boring" businesses such as laundry services, a chicken producer, nursing homes, wastewater treatment, prison management, supermarkets, and beverages.

Sell discipline: The team will sell a position for three reasons:

- 1) Objective achieved: review when stock trading at 90% to intrinsic value, usually out by 100% to value and definitely out by 110% to value. They will also trim when holdings exceeds 5-7% of the portfolio.
- 2) Failure to execute: fundamentals turn negative or warnings signs emerge within company or industry.
- 3) Losses develop: unlike other value managers, they don't average down. Rather, they step out of losing positions. They target a 1% threshold in total unrealized losses in the portfolio, which forces them to get rid of losing positions.

This strategy is extremely well defined and the valuation discipline is robust. The investment strategy draws some similarities with Southeastern (Longleaf funds), which isn't surprising given the fact that the company's President was director of research at Longleaf. But there are important differentiating aspects in terms of risk management, which I think make the River Road process more appealing. River Road places greater emphasis on identifying quality businesses, and pares back on losing positions, which helps prevent them from catching the proverbial falling knife, and doesn't run as concentrated a portfolio as Longleaf. While we generally like concentrated portfolios, it makes sense to not be overly concentrated in the small-cap space as due to the inherent volatility and liquidity constraints on small-cap companies.



## Custom Table

January 1998 - October 2008: Summary Statistics

	Return	Standard Deviation	Sharpe Ratio	Sortino Ratio (MAR = 0.00%)	Batting Average vs. Market	Up Capture vs. Market	Down Capture vs. Market	Alpha vs. Market	Beta vs. Market
River Road Small Value Composite	8.61%	13.23%	0.39	0.95	49.23%	76.29%	65.92%	4.62%	0.67
Russell 2000 Value	5.59%	17.16%	0.12	0.45	0.00%	100.00%	100.00%	0.00%	1.00

Source: Morningstar and Zephyr StyleAdvisor

## Calendar Year Return

As of October 2008

	YTD	2007	2006	2005	2004	2003	2002	2001	2000	1999
River Road Small Value Composite	-26.83%	-5.96%	30.83%	12.24%	33.06%	34.12%	6.76%	21.44%	-2.83%	-5.37%
Russell 2000 Value	-24.27%	-9.78%	23.48%	4.71%	22.25%	46.03%	-11.42%	14.02%	22.83%	-1.49%

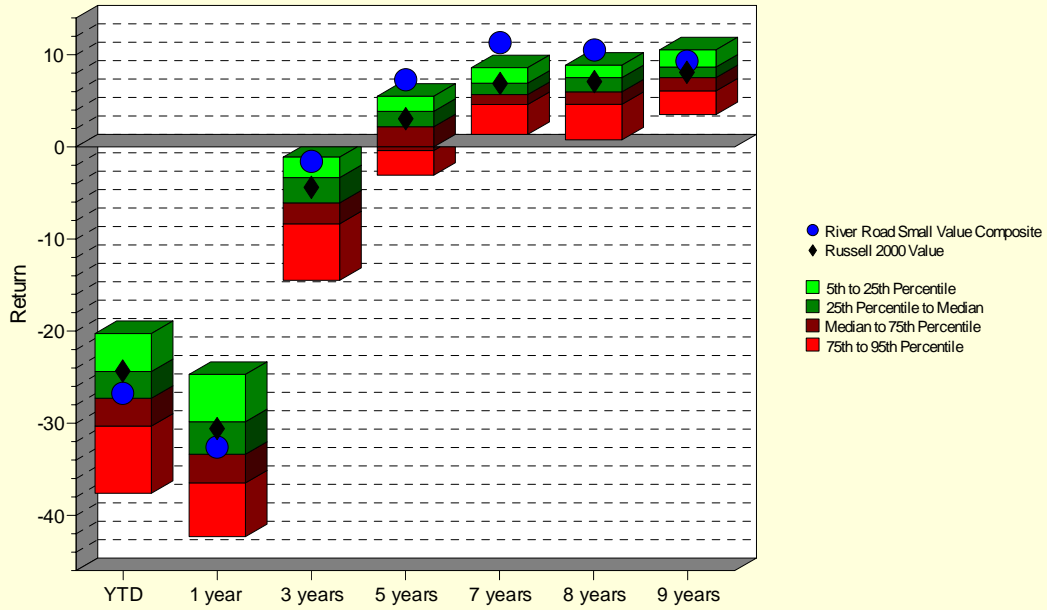
Source: Morningstar and Zephyr StyleAdvisor

The composite's showing relative to the Morningstar Small Value universe is exceptional as it ranks near the top of the group for all trailing periods over a year.

# Manager vs Universe: Return through October 2008

(not annualized if less than 1 year)

Zephyr Small Value Universe (Morningstar)

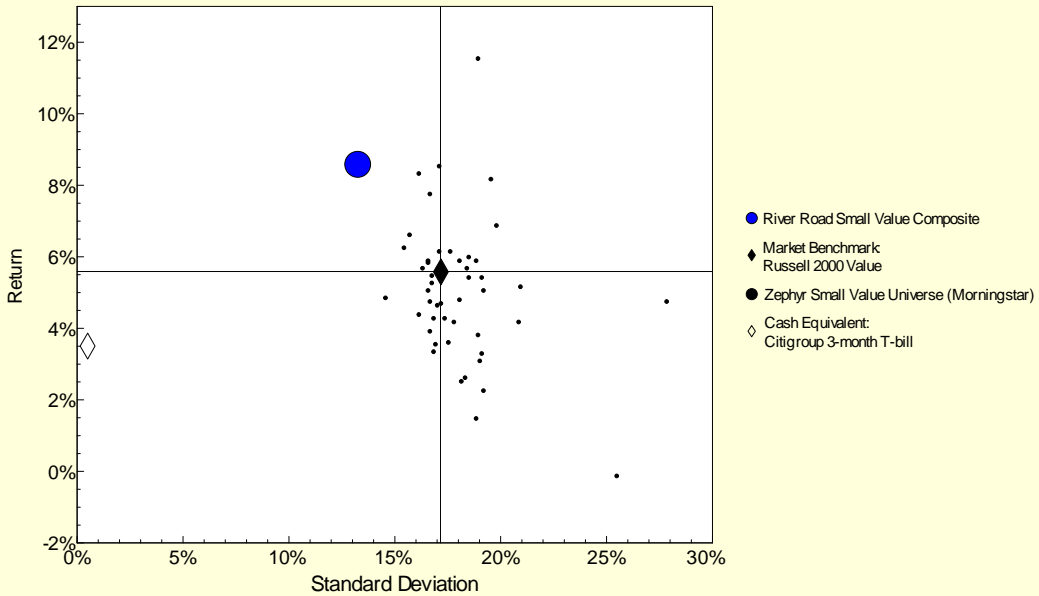


Source: Morningstar and Zephyr StyleAdvisor

# Manager Risk/Return

Single Computation

January 1998 - October 2008



Source: Morningstar and Zephyr StyleAdvisor

While we are confident that the team's stock-picking prowess, as evidenced by the small-value composite's track record, will transfer to the SMID strategy, we will still discount this grade somewhat to take into account the limited data for this particular strategy.

**Grade: 3.25**

### ***Capacity***

Although the strategy is very new, there was significant pent up demand due to the firm's closing of its small-value strategy. As a result, the team already runs over \$644 million in the SMID strategy (the fund is \$111 million). Capacity for the strategy is \$1.5 billion and they will likely initiate a soft close around \$1 billion. We have come across few other firms who have taken such a proactive and committed stance toward capacity. It is clear that this firm will gladly leave money on the table in order to serve the best interests of their clients.

**Grade: 3.50**

### ***Expenses:***

The fund's expense ratio is capped at 1.50%, which is fairly high in an absolute sense but it isn't unreasonable given the small asset base and relative to other small-cap funds.

**Grade: 2.50**

### **Due Diligence**

Fund company contact:

Joe Reid

Aston Asset Management

(773) 244-9578

[jreid@astonasset.com](mailto:jreid@astonasset.com)

R. Andrew Beck

River Road Asset Management

(502) 371-4102

[Andrew.Beck@RiverRoadAM.com](mailto:Andrew.Beck@RiverRoadAM.com)

### MIS DD Questionnaire

Completed November 2005 for Small Value Strategy

### On-site visit or interview

Our last on-site visit was in October 2008. Prior visits included meetings with with Andrew Beck in our offices in November 2005, June 2006, and June 2008, as well as on-site visits at the Firm's offices in September 2006 and November 2007. During the course of our visits, we have had the opportunity to meet with all the members of the investment team including portfolio managers Andrew Beck, Jim Schircliff, Henry Sanders, Thomas Forsha and analysts Justin Akin, Matt Moran, and Johnson.

### Last shareholder report

### SAI/Prospectus

February 2008

### Fund company materials

### M\* Analyst Report

NA

**GPA and Grade Scores are as of the date of this report. These scores are subject to change.**

**For Advisor Use Only. Not for Use with the Public.**

© 2008 Morningstar Investment Services, Inc. All rights reserved. The information, data, analyses and opinions contained herein (1) include the confidential and proprietary information of Morningstar Investment Service, Inc., (2) may not be copied or redistributed, (3) do not constitute investment advice offered by Morningstar Investment Services, Inc., (4) are provided solely for informational purposes and therefore are not an offer to buy or sell a security, and (5) are not warranted to be correct, complete or accurate. Morningstar Investment Services, Inc. shall not be responsible for any trading decisions, damages or other losses resulting from, or related to, this information, data, analyses or opinions or their use.