Investment Philosophy

Our discipline is based on the following underlying concepts:

1) Most all portfolio managers and individual investors screen for stocks which meet a predetermined profile.
2) Mutual fund managers have a tendency to herd into and out of stocks.
3) Investment styles cycle in and out of favor.
4) High reward can be achieved with minimal risk.

In the investment world there are two very basic, widely used methods of selecting stocks: fundamental and technical. The fundamental view typically seeks out companies that meet certain financial criteria set forth by the investor. This may be made up of items from a company's financial statements as well as market related items such as price to earnings ratios and beta. The technical approach uses graphs of a stock's price and volume over time to forecast future price increases or decreases.

Regardless of which approach the investor chooses, it is highly likely that computer screens are being used to sort through the universe of tradable stocks to find those that meet the required criteria. These screens are typically structured to find stocks which meet the investors "style". The style could be Value or Growth, Small Cap or Large Cap, etc. Once discovered the Technician will refer to the stock's chart and look for price patterns which confirm their findings. The Fundamentalist will review the stocks which pass the screens and look deeper into the company's financials, perhaps even visiting the company headquarters and interviewing management.

Whether discovered by fundamental analysis or technical charting, the investor will likely purchase the stock that meets all of their various screening criteria. At this point he is relying on the hope that many other investors will favor what they have seen and buy the stock as well. For if enough investors are attracted to the same criteria at the same time, the concept of supply and demand sets in and the stock rises in price.

Supply/Demand Economics is fundamental to our approach. For a stock to have a sustained rise in price there must be substantial sponsorship, or buying interest, specifically from large organizations such as mutual funds and other "institutional" investors. Simply screening for companies which pass specific criteria is not good enough. There must be undeniable proof that institutional buying is present before a stock is purchased. If not, it is more than likely that the investor will own a company which he may decide is very attractive, but find that few other investors think so. The result is that money is tied up in a stock which underperforms; an opportunity cost we are unwilling to accept.

Once a stock begins a sustained upward move in price mutual fund herding takes effect. In today's market many portfolio managers are having a difficult time outperforming the broader market averages. If a manager cannot beat his benchmark then there is no value added to active management and the client would be better off investing in a passive index fund. Furthermore, there is competition to outperform one another amongst portfolio managers representing the various investment styles.

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"Our research process keeps our portfolio always moving in the right direction, Northwest, giving us a higher return while taking less risk."

The fear of under-performing their peers, or worse the market, causes mutual fund managers to "style drift". In an effort to keep up with their peers, managers will purchase a stock which otherwise would not come up in their screens. This results in herding. Mutual fund herding is easily detectable and results in further support for the upward movement in a stock's price. Conversely, portfolio managers can also herd out of a stock which can create a substantial move downward in price. It is believed that nearly 90% of transactions in the stock market are initiated by professional investors. This is a group we cannot afford to ignore and in fact intend to capitalize on.

Mutual fund managers' inconsistent performance is a result of the normal cycling of investment style within the market. Most all institutional managers declare their investment style and are therefore required to remain focused in that area. Again, styles can be growth or value, small cap or large cap, income, balanced, etc. When the manager's style is in vogue his performance can be very good. If his style is out of favor the manager's portfolio can under-perform markedly. The temptation to "style drift" can be large and contributes to the herding effect. While a manager may move slightly off center in an effort to keep up, his overall portfolio will largely remain true to his declared style. This contributes to the stickiness of the current style trend and allows us to take advantage of it.

The concept of style cycling is very important to our philosophy. When a stock has the characteristics considered desirable by the current style trend, its price can be bid up for that reason alone. Likewise, should a stock not have the characteristics currently in favor, its value as an investment may be unrecognized by the market. We take advantage of this rotation by determining what investment style is currently in favor and positioning our portfolios accordingly. We call this "Dynamic Style Rotation" and our practice of it prevents us from being confined to any one area of the market. This allows us to position ourselves in such a way that we are always "A Step Ahead of Wall Street".

The final piece of our philosophy involves the management of risk. It is commonly thought that to increase potential return requires taking more risk. We believe that this is not necessarily true. Our investment process involves measuring the amount by which a stock is outperforming the market. This is called Alpha. We also measure the amount of risk an investor would have to take to own a stock. This is called Standard Deviation (volatility). We are only interested in stocks which have high Alpha and low Standard Deviation. In other words, high return and low risk which we measure with what we call the "RvR" or reward over risk.

Not only do we apply the RvR to individual stocks we also apply it to the portfolios. We use a sophisticated allocation model, based on a hybrid of Modern Portfolio Theory, to place just the right amount of any one stock in our portfolios. This way we are constantly pushing to maintain a high reward, low risk profile.

We accomplish all of this through the extensive use of computer modeling, otherwise known as quantitative analysis or "financial engineering". We are capable of identifying the current style, locating the institutional sponsorship, staying ahead of the curve, maximizing return, minimizing risk and allocating stock positions to maintain positive momentum. This value added approach to portfolio management is unique and objective. With it we have the ability to provide you with outstanding performance.

"For many portfolio managers selecting the right stocks is a formidable task. Our intensive research tells us just which companies to pick."

The Discipline

Emerald Capital Management designs portfolios intended to provide the highest possible returns. We consider our methods proprietary and naturally reveal only as much information as necessary for you to make a sound judgement as to its validity. Our sophisticated process of financial engineering is summarized as follows.

Step One: Our research is produced monthly. We begin by collecting data for over 40 fundamental criteria on more than 10,000 domestic stocks. We are not interested in low dollar or low volume stocks. Those issues trading below a specific price and/or volume threshold are removed. This leaves approximately 7,000 stocks.

From this universe we are able to determine the characteristics or "style" that is currently in favor on Wall Street. This is accomplished through extensive computer modeling where, in essence, we reverse engineer the stock market by breaking down each of the 7000 stocks into its various fundamental components. Not only are we able to reveal the favored characteristics, we also determine each characteristic's degree of importance to Wall Street.

Having discovered which of the fundamental criteria are most in favor, we reconstruct each stock and assign it a **Master Score**. This score reflects how much impact each of the various criteria have had on the historical return of the stock. The Master Score also contains a forward looking component which tells us what potential impact the fundamentals can have on a stock's future return.

Step Two: Each stock is assigned an **RvR**, or Reward/Risk rank. This is determined by dividing Alpha over Standard Deviation. Alpha, in simple terms, is the amount of return a stock provides in excess of market return. Theoretically if the market is up 10% and a stock is up 15%, the difference of 5% is the stock's Alpha. Of course the actual computation is far more involved and results in a more statistically significant number.

The Standard Deviation is computed as a measurement of a stock's risk. This number reflects how far a stock's price typically deviates from its "normal" price. A stock with a high standard deviation will have wide price swings over time where a stock with low standard deviation will have day to day prices which stay fairly close to each other.

The goal is to select stocks which have very high Alpha and very low Standard Deviation, thereby providing maximum return while taking minimal risk. The RvR of each stock is computed and tracked historically. Those stocks with improving RvRs over time are of most interest to us.

Step Three: Here we first eliminate any stock which has a negative RvR. These are stocks having low return and high risk. The remaining stocks, usually about 3000, are put through a stringent screening process. We score each stock based on several earnings criteria including growth rates and earnings estimate performance. We also score on volume and market capitalization as it relates to this smaller universe. We refer to these as **Minor Scores**.

The stocks are then assigned a **Composite Rank**. This rank reflects a combination of Master Score, RvR and the various minor scores. We then take the top 300 stocks by Composite Rank and these become our **SuperStocks** Buy List.

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"The many stringent filters used to select our stocks leave behind a lot of rubble."

The SuperStocks as a group contain the fundamental characteristics currently sought after by Wall Street. These stocks provide the greatest amount of return with the least risk. They also contain the highest probability of future return potential.

Step Four: **Multi-Factor Optimization** is applied to the SuperStocks. We build a portfolio of 50 stocks taken from the SuperStocks buy list. Our proprietary linear-programming computer model runs thousands of iterations and presents us with the best combination of 50 stocks which are then allowed to advance to the final portfolio construction phase.

Step Five: We now decide which stocks, if any, should be sold from the existing portfolio. We use a variety of criteria including how long a stock has been off the SuperStocks list and whether or not the stock has exceeded acceptable risk levels. We are also concerned with a stock that has become over weighted in the portfolio due to a significant run up in price. Finally, we view a stagnate position as a cost of opportunity and therefore will sell a stock which does not meet our performance standards within a reasonable amount of time.

New additions to the portfolio are taken from the 50 stocks that have thus far survived our stringent process. At this time we again utilize our multi-factor optimization model and ask the questions: Which of the 50 stocks best combine with the existing portfolio? Which additions will move the portfolio to provide even higher return with lower risk? Which new positions will skew the portfolio closer to the style currently in favor?

Prior to being allowed into the final optimization process each stock must pass our thorough due diligence. We verify all data used in the selection of the stock as well as it's current and historical price and volume performance. We review for any news which may impact the success of the stock including management changes, mergers and acquisitions and earnings related information.

This final optimization process is applied to create all of the various portfolio compositions. The result are portfolios of high performance securities. The stocks in each individual portfolio are appropriately weighted to take only as much risk as necessary to maximize the potential return, and to possess the combined characteristics we believe Wall Street is buying right now.

Should you desire more detail regarding the construction of our portfolios we would be delighted to offer a private consultation.