The Olstein Funds

OLSTEIN ALERTS

ARE YOU A SPECULATOR OR VALUE INVESTOR?

"The most realistic distinction between the investor and the speculator is found in their attitude toward stock-market movements. The speculator's primary interest lies in anticipating and profiting from market fluctuations. The investor's primary interest lies in acquiring and holding suitable securities at suitable prices. Market movements are important to him in a practical sense, because they alternately create low price levels at which he would be wise to buy and high price levels at which he certainly should refrain from buying and probably would be wise to sell."

Benjamin Graham, *The Intelligent Investor*

Currently, Wall Street's concept of risk is associated with short-term volatility or short-term fluctuations in the value of a portfolio of stocks. Most investors associate risk with any decline in the price of a stock even though the decline may be caused by temporary factors or may only be cyclical in nature. No investor is forced to sell unless they believe otherwise. It is our belief that only traders and speculators should be concerned about short-term price fluctuations, measured in months, days, or hours, as it is their objective to capitalize on short-term price movements.

A trader or speculator seeks to take advantage of short-term market momentum by purchasing stocks either currently performing or likely, in the very near future, to perform relatively better than the market and selling these stocks as soon as the momentum or psychology begins to turn negative. Given their short holding periods and the short amount of time between buy and sell decisions, the greatest risk facing the trader or speculator is misjudging the momentum or psychology of the crowds leading to poorly timed buy and sell decisions.

On the other hand, the long-term value investor attempts to capitalize on market fluctuations by buying stocks at bargain prices created by short-term issues that are either cyclical in nature, the result of short-term problems, reaction to negative market psychology, or just plain investor misperception. A long-term investor does not lose money because stock prices may temporarily decline. The chance of downside fluctuations is present for all securities and spending time analyzing monthly fluctuations

ONLY TRADERS AND SPECULATORS SHOULD BE CONCERNED ABOUT SHORT-TERM STOCK PRICE MOVEMENTS MEASURED IN MONTHS, DAYS, OR HOURS.

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or attempting to minimize these swings by giving up potential positive future return is, in our opinion, a poor use of time and capital. It is our opinion that monthly fluctuations have little to do with the measurement of risk for an investor whose investment horizon is three years or more.

A VALUE INVESTOR WITH A THREE-YEAR OR LONGER HORIZON DOES NOT LOSE MONEY BECAUSE THE MARKET PRICE OF HIS PORTFOLIO DECLINES ON A MONTHLY OR QUARTERLY BASIS.

Owners of commercial businesses assess risk on the basis of losing money on operations, not as to whether or not they would be forced to sell the business at an inopportune time. Similarly, a value investor with a three-year or longer horizon does not lose money because the market price of his portfolio declines on a monthly or quarterly basis. If an investor cannot tolerate such fluctuations, a money market account or very short-term U.S. Treasury security should alleviate the stress of monthly price fluctuations.

We are not particularly concerned as to whether or not our most recent portfolio purchases are currently under performing the market or may continue to under perform for the next quarter or two. We believe the sustainability of a company's ability to generate free cash flow is the necessary life vest that buoys our conviction to ride out periods in which our portfolio holdings may be working through what we believe are temporary problems that have driven the price of a good company down to our required discount. If a company was private and had no public market price, the owners would not be assessing the value of the business on a monthly or quarterly basis.

When managing the risk of the Fund's portfolio, we concern ourselves with the probability of permanent loss of capital over three- to five-year periods. We manage the overall risk on a stock-by-stock basis as we build the portfolio. We seek to mitigate risk by buying stocks at prices, which in our opinion, have a low probability two years later of selling for a price 25% lower than the price we are currently paying. We could experience a permanent loss of capital if the circumstances leading to the current undervaluation and underperformance turn out to be longer lasting or more permanent than anticipated (note: when purchasing a security, our expected time frame for a turnaround is two years or less).

More importantly, since our process seeks to accurately estimate sustainable future free cash flows, we are always concerned that our estimates are too optimistic and thus our valuations three to five years hence become unrealistic. If we are wrong and the company is not able to turn around, it is our opinion that much of the negativity surrounding the company should already be accounted for in the current stock price and as a result, serve to mitigate additional price deterioration. Thus, we attempt to

WE CONCERN OURSELVES WITH THE PROBABILITY OF PERMANENT LOSS OF CAPITAL OVER THREE- TO FIVE-YEAR PERIODS.

reduce long-term volatility by purchasing companies at prices which we believe already incorporate short-term negativity.

During the life of an investment in a portfolio of equity securities, the market value of the portfolio and individual holdings will fluctuate but losses are not permanent unless one must sell. It is true that long periods of temporary losses increase the chances that an investor might have to take a loss, if unforeseen circumstances reduce the period of time one is able to hold the investment. Temporary losses test an investor's long-term commitment to a specific investment discipline, but this fact is true for any investment that fluctuates in value.

Before reaching any conclusions on risk tolerance, it is also important to analyze a strategy's long-term absolute returns. If a portfolio shows long-term absolute returns which compensate an investor for the potential permanent loss of capital or for the fluctuations that take place in a portfolio of common stocks as measured over a reasonable number of years, then the investment should be deemed to be a wise one.