Olstein
The Olstein Funds

NOTES ON VALUE INVESTING

WHAT IS ACTIVIST INVESTING? — A CATALYST FOR CHANGE

Activist investing is a unique form of value investing targeting companies that have significantly underperformed their peers or the overall market for a considerable period of time. Activist investors make substantial minority investments in the common stocks of such companies with the stated intent of influencing company management to take specific steps to increase shareholder value. An activist identifies the causes and sources of a company's chronic underperformance and recommends strategic, financial, operational or organizational changes that may provide a catalyst for increasing the value of the company's shares.

The activist's goal is to create a catalyst or triggering event that will increase shareholder value and result in stock price appreciation. There are two primary ways an activist tries to increase shareholder value. First, the activist can alter a company's strategic direction through changes in governance, management skill, capital allocation, asset deployment or sale/breakup of the company. Second, the activist can compel a company to use excess cash to increase dividends, engage in share buybacks, or improve the balance sheet to achieve greater operating leverage.

An activist investor asserts his/her intent to seek changes or influence management at a target company by filing a Schedule 13D (mandated under Section 13(d) of the 1934 Exchange Act) within 10 days of acquiring more than 5% of any class of the target company's securities. Specifically, Item 4 of Schedule 13D requires the activist to declare his/her reasons for acquiring the company's shares, particularly if the intention is to engage in merger and acquisition activity, seek a sale of any material amount of the target company's assets, pursue a change in the company's capitalization or dividend policy or propose other types of corporate changes.

THE ACTIVIST'S GOAL IS TO CREATE A CATALYST OR TRIGGERING EVENT THAT WILL INCREASE SHAREHOLDER VALUE AND RESULT IN STOCK PRICE APPRECIATION.

An Approach Rooted in Value Investing

The primary reason an activist targets a company is that its stock price is perceived to be significantly less than the company's potential value, whether measured by private market value, asset value, relative value, liquidation value or another valuation methodology. The primary goal of the activist investor is capital appreciation. While many traditional value managers also pursue this objective, the vast majority of such investors focus their efforts on identifying what they believe are undervalued stocks and monitoring their investments in such companies from a passive stance while waiting for the stock price to increase. The approach of a traditional value investor relies on company management, industry experts, or Wall Street research to provide relevant information regarding progress towards the value investor's investment thesis. Decisions regarding investments

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are often the result of "reacting" to news or developments concerning the company. Activist investors, however, adopt a drastically different approach — acquiring a significant stake in the undervalued equity of a target company and then promoting a specific plan for unlocking value.

Confrontation or Cooperation?

While activists pursue a number of strategies to influence corporate managements, the media, in general, has provided greater coverage of those activists that pursue a confrontational or hostile approach when communicating with a company's management or board of directors. Headlines in business media are virtually guaranteed through aggressive publicity campaigns, provocative shareholder resolutions, or drawn-out proxy battles. Other activists however (including Olstein Capital Management), shun a hard-edged, confrontational approach to pursue "behind-the-scenes" communications that underscores the perspective of an investor with capital at risk. Activists that pursue cooperative interactions with a company often find its board of directors and management interested in their insight and recommendations and open to a constructive engagement that seeks to increase shareholder value.

COMPANIES WITH HIGH CASH BALANCES BUT WITH STOCK PRICES CONSIDERABLY LOWER THAN INDUSTRY PEERS ARE LIKELY TO BE A MAGNET FOR ACTIVISTS

Targeting Activist Situations

Characteristics of companies targeted by activist investors include high cash balances, strong cash flows, high book-to-market values, excessive executive compensation or an uninvolved board of directors. The prevalence of one of more of these characteristics often reveals the issues that an activist will address and provides clues into the strategies that the activist will pursue to unlock a company's value potential.

High cash balance. Companies with high cash balances but with stock prices considerably lower than industry peers are likely to be a magnet for activists that target the company's payout policy. An activist may demand that excess cash be paid to shareholders either through increased dividend payments or through stock buybacks.

Steady cash flow and low returns on equity. A company with steady cash flow combined but with low returns on equity may draw the attention of an activist investor that advocates improved operational efficiency and increased cost costing measures.

Strong brands or franchises hindered by bad strategic decisions. Many activists target companies with strong brands and competitive products or services but whose results have been hampered by bad strategic decisions or management mistakes. In such situations an activist seeks to help the company refocus its business strategy on core strengths and may recommend hiring new management talent and skills.

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Disparate businesses with limited strategic underpinnings. Companies that have lost focus through over-diversification into disparate businesses often draw the attention of activist investors who propose spinning-off unrelated divisions or selling non-core, underutilized, or underperforming assets. Likewise, companies that have grown through merger and acquisition activity rooted in a questionable or weak rationale are often the target of activists seeking similar actions.

Weak corporate governance. While a range of corporate governance issues attract shareholder activists driven by financial objectives (increase shareholder value, changes to capital structure, cost cutting, etc.) or non-financial goals (socially responsible investing, divestiture from particular countries, environmentally conscious policies, etc.), an activist investor usually seeks to advance corporate governance proposals that are likely to enhance a company's financial performance. Companies with onerous takeover defenses, entrenched management teams with stagnant operating results, excessive executive compensation that does not reward long-term performance, an uninvolved or non-responsive board, are viable targets for activists seeking to link corporate governance proposals with improved company performance. In many cases corporate governance initiatives, especially those that seek to oust a CEO or chairman or challenge board independence, immediately lead to a "hostile" form of activism.

Although one or more of these factors may characterize a company's operations or financial standing and the activist may have strong recommendations or expertise regarding specific problems, he must first consider the company's legal and capital structure before determining if the company is a viable target for an activist campaign.

Effectiveness of Activist Investing

In their recent article, "Hedge Fund Activism, Corporate Governance, and Firm Performance," (*The Journal of Finance*, August 2008), Alon Brav (Duke University Fuqua School of Business), Wei Jiang (Columbia Business School), Frank Partnoy (University of San Diego School of Law) and Randall Thomas (Vanderbilt University School of Law) answer several important questions regarding the effectiveness of activist investing, including:

- How does the market react to the announcement of activism?
- Do activists succeed in achieving their objectives?
- How does activism impact firm performance?
- Do activists have a short-term investment focus?

To answer these questions Brav, Jiang, Partnoy and Thomas examined the results of 1,059 activist events initiated by 236 hedge funds during the period of 2001 through 2006, involving 882 unique target companies. Key findings of their research in response to these questions are summarized below:

- To measure market response to the announcement of activist intervention the study determined the average "buy-and-hold" return, in excess of the buy-and-hold return of the value-weighted all market index for 20 days prior to the Schedule 13D filing date to 20 days afterward. The filing day and the following day see a jump of about 2.0%; afterward the excess return keeps trending up to a total of 7.2% in 20 days. The study further found that the positive returns at announcement were not reversed over time.

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- Activists' success rate could only be assessed in the 548 cases where an activist proposed a specific agenda (beyond a general statement of communicating with management about value-enhancing strategies) in response to Question 4 of Schedule 13D. In 41% of these cases, activists achieved complete or near complete success (which the researchers define as achieving their main stated goals); and in 26% of the cases the researchers observed a partial success where the activist, through negotiations, gained major concessions from their target companies.

- The study showed that companies targeted by activists have higher return on assets (ROA) and operating profit margin (OPM) than their industry/size/book-to-market matched peers. Target company performance experiences a dip during the event year and recovers to the pre-event level one year after the event (the "event" is either the activist's public statement of its intent to engage company management or the filing of a Schedule 13D). The recovery continues into a significant improvement in performance two years following the event. Changes to payout policies recommended by activists (increased dividends or share repurchases) occur sooner after activist intervention with payout increases occurring in many cases in the year of the activist intervention and peaking in the year afterward.

- Activists are not short-term in focus as some critics have claimed. The median holding period for completed activist situations is about 1 year, calculated from the date an activist files a Schedule 13D to the date when the activist no longer holds a significant stake in a target company. This calculation substantially understates the actual median holding period because it necessarily excludes a significant number of the 1,059 events examined for which no exit information was available by March 2007. Further analysis of portfolio turnover rates of the funds in the sample suggests holding periods of closer to 20 months.

Olstein's Approach to Activist Investing

Olstein opportunistically engages as an activist investor in situations where it believes such an approach will add value to the investment process. When engaging as an activist, Olstein emphasizes investments in small and mid-sized companies where it is possible to make significant investments in individual companies and increase the likelihood that management will act upon its strategic recommendations. Olstein often focuses on "deep value" situations where it believes the public market price does not reflect Olstein's estimate of the company's intrinsic value, or where there is an identifiable impediment to the recognition of private market value. In such situations Olstein will usually approach company management in a cooperative vein offering strategic advice and transactional experience. Desired outcomes of Olstein's activism may include, but are not limited to, the liquidation of non-core assets, changes to payout policy, a new or changed management team, enhanced revenue management strategies, and greater operating efficiencies.

The preceding commentary represents the opinion of the Manager and is not intended to be a forecast of future events, a guarantee of future results or investment advice. This information should be preceded or accompanied by a current prospectus, which contains more complete information, including investment objectives, risks, charges and expenses of The Olstein

Funds and should be read carefully before investing. A current prospectus may be obtained by calling (800) 799-2113 or by visiting the Fund's Website at www.olsteinfunds.com.

There is no assurance that the Olstein Funds will achieve their investment objective. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. The activist strategy invests in stocks of underperforming companies and any shareholder activism might not result in a change in performance or corporate governance. These stocks could also experience less liquidity and higher share price and trading volume volatility than stocks of other companies.

Not FDIC insured / Not bank-guaranteed / May lose value.

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