Olstein

The Olstein Funds

NOTES ON VALUE INVESTING

EVOLUTION OF AN INVESTMENT — FROM IDEA TO PORTFOLIO HOLDING

We are continuously searching for opportunities to invest in companies that possess the balance sheet strength, competitive advantages, operating efficiencies and appreciation potential that we believe will help us achieve our investment objectives. In light of this ongoing challenge, we thought it would be helpful to discuss our process for investing in new portfolio holdings – from identifying investment ideas; to the screening process that helps us filter these ideas; to the analysis we perform not only to understand how a company's operations generate sustainable free cash flow, but to also identify positive or negative factors that may affect that cash flow; to a discussion of our valuation methods and- ultimately, the decision to add a company to one of our portfolios.

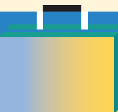
Generating Investment Ideas

In our universe of investable stocks, there are always companies – whether they are good companies that have temporarily faltered, or companies facing adverse competitive, industry or economic issues – that have been punished by the market. Because Wall Street exerts considerable pressure to meet the short-term expectations of the "earnings guidance game," many investors fail to perceive a company's potential to create long-term shareholder value. The market usually reacts to problems by punishing the stock of the company, often creating compelling opportunities for the patient investor willing to allow a company the necessary time to work through temporary problems. We constantly monitor our universe of investable stocks utilizing both qualitative and quantitative screening methods to identify companies that we believe have either temporarily stumbled or have been severely punished by misperceptions in the market.

Since companies that are 'out of favor' or have stumbled due to temporary problems stimulate our interest as investment opportunities, we monitor a series of regular and robust quantitative screens that seek to identify companies experiencing significant deviations from historical performance. While it is naïve to expect that companies will repeat history precisely, historical performance can provide important insight into a company's future performance since cycles do exist and reversion to the mean is a frequent pattern.

Our quantitative screens analyze data from current and historical financial reports, tracking important data points and performance measures such as: historical returns on capital, inventory turnover and asset utilization, debt levels, free cash flow, book value growth, performance versus peer growth, balance sheet changes, and other factors. Noteworthy deviations or exceptions from historical performance usually rise to the top of our quantitative screens, prompting further investigation of a specific company. It is important to note that the combination of company-specific knowledge with industry performance benchmarks allows us to develop a working model of what we believe are normalized rates of return and operating performance and helps us narrow our ideas into a workable list of companies that merit further analysis.

Additionally, many of our investment ideas are rooted in broad economic or industry trends that we expect to alter the competitive landscape, industry dynamics and/or business strategies that might affect the future valuations of a broad range of companies thus creating a constant stream of valuable investment ideas. Our primary approach to



WE READ FOR "HEAT," LOOKING FOR SUBTLE PHRASES OR TRIGGER WORDS THAT, IN OUR EXPERIENCE, MAY SIGNAL A SIGNIFICANT CHANGE IN AN INDUSTRY OR COMPANY THAT COULD UNLOCK OR CREATE SIGNIFICANT LONG-TERM VALUE FOR SHAREHOLDERS.

uncovering such ideas is a fairly conventional qualitative technique – reading. Our collective reading covers a range of publications including general business media, specialized investment publications, trade publications, academic and economic research publications and government filings. The origins of some of our best investments can be found in these extensive and eclectic reading materials. However, unlike recreational reading, we read for "heat," looking for subtle phrases or trigger words that, in our experience, may signal a significant change in an industry or company that could unlock or create significant long-term value for shareholders.

To supplement our reading, we also employ another qualitative technique to uncover ideas – an approach commonly referred to as 'hitting the pavement.' As we have said many times before, we don't need to talk to top management to understand a company's unique business proposition and the source of its competitive advantage. We often gain such insight by speaking with the company's customers, vendors, field managers and competitors. Furthermore, we regularly discuss trends, innovations, legislation and other issues with trustworthy industry experts who help us understand the likely beneficial or harmful effects of such changes on specific companies or business models within an industry. These outside sources and consultant relationships have been developed over the past 40 years. While Wall Street analysts may lump hundreds of companies within an industry together for their research purposes, our focused approach not only allows us to develop a unique understanding of a company, its operations and future challenges, it also encourages us to escape conventional thinking by adopting multiple perspectives on an industry and the companies that compete within it.

Initial Analysis

In isolation our qualitative and quantitative screening processes only provide untested ideas. Whether we find an idea through a quantitative screen, an obscure trade publication, or a government filing, the real work begins with our forensic analysis of a target company's financial statements. Our initial analysis filters ideas to eliminate companies that we believe are either fully valued or already priced-to-perfection. We also seek to separate companies with serious structural, financial or secular problems from those companies that are simply not performing to their full potential.

WHETHER WE FIND AN IDEA THROUGH A QUANTITATIVE SCREEN, AN OBSCURE TRADE PUBLICATION, OR A GOVERNMENT FILING, THE REAL WORK BEGINS WITH OUR FORENSIC ANALYSIS OF A TARGET COMPANY'S FINANCIAL STATEMENTS.

Our initial analysis focuses on several important factors:

- **Balance sheet strength** — understanding that there is a strong correlation between above-average investment performance and error avoidance, we believe that in order to achieve long-term success, an investor must first consider the financial risk inherent in each investment opportunity before considering the potential for capital appreciation. Our assessment of downside risk begins with an analysis of a company's balance sheet. Balance sheet strength enables a company to stay focused on strategic priorities during tough economic times rather than being forced to adopt short-term survival strategies which are often not in the best long-term interests of shareholders.

- **Effectiveness of business model/Unique business fundamentals** — we judge the effectiveness of a company's business model by its ability to generate free cash flow during both favorable and unfavorable economic cycles. Through our initial analysis we not only develop an understanding of how a company's operations generate free cash flow, we also seek to answer several important questions, including: What are the unique fundamentals of its business model that the company must cultivate? What elements of the business model are vulnerable to an economic slowdown or downturn? What is the ongoing level of investment required to maintain and/or grow free cash flow? Are there specific aspects of the business such as divisions or product lines that are underperforming and should be sold or shut down?

- **Industry standing and competitive strength** — an important measure of the effectiveness and uniqueness of a company's business model is its competitive

strength and standing within its industry. Companies with sustainable competitive advantages can protect their operating margins and generate free cash flow in the face of strong industry competitors. During our initial analysis we assess the durability of a company's competitive strength by understanding the economies of scale within its infrastructure, the strength of its customer relationships, the importance of its intangible assets and the value of its business proposition.

- **Temporary problems vs. structural problems —** while most companies endure varying degrees of performance problems, many may not be able to implement the changes needed to achieve a transformation that creates long-term shareholder value. To weed out possible value traps we look for specific financial, competitive and structural characteristics that, from our experience, indicate that the problems a company faces are temporary. When evaluating the investment potential of a company experiencing problems, we start by analyzing several company-specific factors, including: the viability of the core business, balance sheet strength, clean accounting, the cash flow pipeline, the quality of management and decision making, and the severity of the company's problems. Conversely, we also look for factors that we believe inhibit a company's ability to overcome its problems, including: weak core products and services, insufficient financial resources and controls, ineffective management, lack of transparency or poor corporate governance and previously failed attempts to get the company back on track.

WE DEFINE A HIGH QUALITY OF EARNINGS BY HOW REALISTICALLY WE BELIEVE A COMPANY'S FINANCIAL STATEMENTS PORTRAY WHAT IS TAKING PLACE WITHIN THE BUSINESS — ESPECIALLY WITHIN THE COMPANY'S CORE BUSINESS OPERATIONS — AND HOW REALISTICALLY WE BELIEVE THE FINANCIAL STATEMENTS REPRESENT THE SUSTAINABILITY OF THE COMPANY'S EARNINGS FROM OPERATIONS.

In-Depth Forensic Analysis

Since companies that successfully pass our initial analysis have, in our opinion, normalized free cash flow potential that is not recognized or properly valued by the market, our next step is to develop a deeper understanding of the stability and reliability of the company's free cash flow potential under different scenarios. We undertake an intensive, forensic analysis of a company's financial statements, footnotes and other regulatory filings in order to assess the company's normalized cash earnings, the capabilities and fiscal conservatism of the management team and finally the quality of its earnings.

We define a high quality of earnings by how realistically we believe a company's financial statements portray what is taking place within the business – especially within the company's core business operations – and how realistically we believe the financial statements represent the sustainability of the company's earnings from operations. We measure the quality of a company's earnings in three primary ways: (1) Do the financial statements and other filings allow us to understand the reality of the company's unique business fundamentals, its competitive edge and ability to generate free cash flow? (2) Does company management engage in conservative or aggressive accounting practices? and (3) is all material information necessary to evaluate the company being disclosed?

As investors, we believe that an equity security is worth the discounted value of the issuing company's future expected excess cash flow. Thus, to value a company according to a model of discounted cash flow, an investor must adjust reporting earnings to arrive at true cash earnings. Our forensic analysis begins with an understanding that GAAP (Generally Accepted Accounting Principles) requires a company to report earnings on an accrual basis, which entails two basic premises. First, because accrual accounting states that revenue is recognized when a transaction occurs in which value has been exchanged, this event may lead or lag the exchange of cash. Second, because the cost of a transaction should be recognized over the same period of

time as the revenue associated with that cost, this period may also lead or lag the passing of cash.

In reporting GAAP-based earnings, companies have wide discretion, which includes making numerous assumptions about the future. Because management has a vested interest in putting its best foot forward, the numbers produced under GAAP often leave room for unrealistic assumptions and misleading numbers. Most companies use financial accounting and reporting practices to present themselves in the most favorable light, meaning that they engage in some type of earnings management or make assumptions that may prove to be unrealistic.

As we perform our analysis of financial statements we assess the quality of a company's earnings and make adjustments to reported earnings in order to eliminate what we believe are management biases or unrealistic assumptions. Our forensic analysis not only allows us to hone important data inputs for our valuation models, it also provides keen insight into factors that may be indicative of future earnings changes, the success of a company's strategy, the sustainability of its performance and the impact of management decisions on future cash flow. As we have stated many times before, we firmly believe that a forensic analysis of financial statements is more useful to an investor than discussions with company management, or listening to management forecasts and earnings guidance. Some of the additional benefits that our forensic analysis provides us include:

- a higher probability of more reliable estimates of future cash flow that are critical to projecting the future value of the company
- a measure of the sensitivity of our valuations to changes in free cash flow estimates
- a gauge of balance sheet strength and the company's ability to withstand problems that may last longer than originally expected
- the capacity to evaluate the effectiveness of management at creating long-term shareholder value
- an ability to detect early signs as to whether or not a company's business policies and strategic direction are capable of achieving the financial objectives necessary to reach our calculated values.

Olstein's Valuation Methodology

After completing our initial and in-depth analysis of a company, we undertake an extensive valuation analysis using several discounted free cash-flow-valuation methods.

MOST COMPANIES USE FINANCIAL ACCOUNTING AND REPORTING PRACTICES TO PRESENT THEMSELVES IN THE MOST FAVORABLE LIGHT, MEANING THAT THEY ENGAGE IN SOME TYPE OF EARNINGS MANAGEMENT OR MAKE ASSUMPTIONS THAT MAY PROVE TO BE UNREALISTIC.

We have summarized our primary valuation methods below:

- **Free Cash Flow Valuation Method:** While many investors employ relative valuation techniques, that is, applying the market value of comparable companies to the valuation analysis of their target company, we seek to determine the intrinsic value of a company. By definition, a company's intrinsic value is the present value of future free cash flows the business can generate. Our free cash flow valuation models are based on providing equity holders of a company with a premium return over the prevailing rate of US Treasuries for taking the risk of investing in equities. The premium returns required are based on our confidence levels as to the predictability of future free cash flow, the quality of the balance sheet and the sustainability of a company's competitive advantage.
- **Total Asset Method:** The TA method calculates free cash flow returns on equity and values the company on a multiple of book value. Our objective is to calculate a share price an investor should pay for a stock which is based on the company's return on equity divided by a required rate of return and is expressed as a multiple of the company's current book value. The required rate of return is set as a premium return to U.S. Treasury rates. The premium return we require is based on the same factors discussed under the free cash flow method above.

- **Operating Earnings/LBO Valuation Method:** The Operating Earnings/LBO Valuation Method analyzes the value of a business from the viewpoint of a 'financial buyer' who expects all investment returns to result from future operations of the business. When using this method to value a company, we assume that we are buying the company through a leveraged buyout. Our analysis assumes that we must borrow the entire amount to acquire the company at existing junk bond rates, which must then be paid from the acquired company's cash flow. The value that a financial buyer would pay for an LBO is closely tied to the potential buyer's expectation of sales growth rates, the ability to improve operating margins and/or working capital levels, the ability to reduce capital expenditures without affecting the business and finally existing junk bond rates. The LBO method enables us to gauge the takeover value of the company with modest improvements in operations.

Once we determine the value of a company based on our estimates of normalized earnings and operations, we test our range of valuations against current market reality and the company's historical earnings performance. We further test our valuations through extensive scenario analysis – best case, worst case, likely case – assigning probabilities to different scenarios to assess the company's true potential for capital appreciation over our expected holding period.

The Buy Decision

The ultimate result of our analytical process is either a 'buy' or 'pass' recommendation for the company under review. Each of our analysts documents in writing their analysis of a company following a specific format that describes the investment idea and thesis, the company, its operations, products and services, and overview of its industry and competitive universe. The analyst's research report also discusses our valuation analysis comparing it to historical market prices and price earnings ratios, as well as providing detailed scenario analyses showing best, worst and likely case for appreciation based on differing future cash flows and economic outcomes. The analyst's report must also include a recommended price (or range) and strategy for purchasing the stock along with a comprehensive list of reasons to sell the stock.

Preparation of a written research report summarizing the analysis and valuation of a company becomes the basis of a formal presentation to the firm's research department and portfolio managers. During each presentation the investment team rigorously reviews and may challenge any and all aspects of the analyst's recommendation, including: the investment thesis, the fundamentals of the company's business model, industry economics and competitive dynamics, the framework for assessing future operations and cash flows, as well as the assumptions underlying the valuation and scenario analysis. The team shares their thoughts and opinions on the company, its historical performance, factors likely to affect company or industry performance, and other issues pertinent to the company under consideration.

After this exhaustive review of the analyst's work with the investment team, the Chief Investment Officer ultimately decides if the stock will be included on the firm's Buy List. Portfolio managers determine whether or not to purchase a stock approved for the buy list, the prices to pay and what the size of the position should be at various price levels. All strategies are summarized in writing on a firm "buy list" available to all analysts and portfolio managers.

A Disciplined Approach

We believe we practice a disciplined approach to investing, seeking long-term value creation with an emphasis on investing in companies that have experienced temporary problems and are therefore selling at a material discount to their intrinsic value. A long-term investment horizon and patience are important ingredients of our investment discipline. We hope this overview of our investment process has been helpful to understanding how we develop investment ideas, determine a company's intrinsic value and decide on what stocks to include our portfolios.

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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 Olstein Funds follow a value oriented investment approach. However, a particular value stock may not increase in price as the Investment Manager anticipates and may actually decline in price if other investors fail to recognize the stock's value or if a catalyst that the Investment Manager believes will increase the price of the stock does not occur or does not affect the price of the stock in the manner or to the degree that the Investment Manager anticipated. Also, the Investment Manager's calculation of a stock's private market value involves estimates of future cash flow which may prove to be incorrect and, therefore, could result in sales of the stock at prices lower than the Fund's original purchase price.

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

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