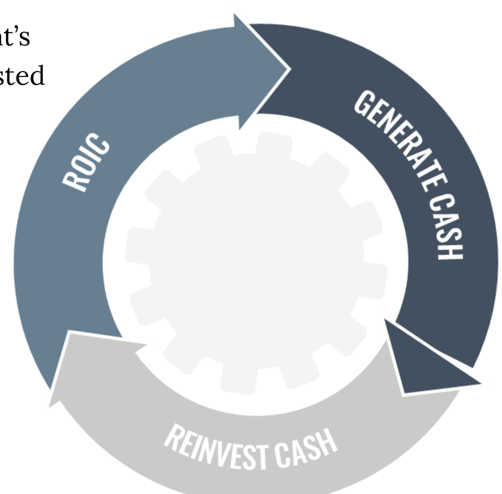
Our investment perspective

Value Investing – Value is in the Eye of the Beholder

The essence of value is simply acquiring an asset for less than it is worth. This notion carries through to value investing, where we seek to identify assets that are worth more than their current price. How is worth determined? For many assets worth can be buyer dependent, particularly if there is a large intangible component. Buyers of art, exotic cars, and trophy mansions, for example, are likely ascribing a substantial amount of intangible value to their purchase. Although financial assets are less likely to incorporate intangible value, emotions can cloud an investor's ability to objectively evaluate worth.

We seek to find undervalued investments by identifying businesses where we believe the current equity price does not reflect the firm's long-term cash generating potential.

How Shareholder Value is Created



The basis for value creation at any enterprise starts with management's ability to invest capital at an attractive rate of return. Return on invested capital, or ROIC[1], measures how efficiently management converts a dollar of invested capital into dollars of future cash flow. It often correlates with a competitive advantage, better products, or superior management.

The ability to reinvest capital back into the business is the next component of wealth creation for shareholders. Reinvesting cash-flow into high-return projects creates a powerful compounding effect to future cash flows, thus creating value for shareholders overtime.

We believe management's ability to generate investment returns is best reflected using CFROI®, which measures actual cash returns on investment. This measure is conceptually

[1] *Return on Invested Capital (ROIC) = (Net Operating Profit After Tax)/Invested Capital*

similar to ROIC, but is not skewed by non-cash items that are included in GAAP profitability calculations.

Drivers of CFROI®

There is no single path for a firm to achieve high CFROI® -- it is impacted by business factors such as revenue growth, operating margin, balance sheet efficiency, and investment opportunities. Businesses can achieve similar CFROI® levels with different combinations of these factors. For example, a high asset turnover/low margin business like Walmart and a low asset turnover/high margin business like Tiffany & Co. may be able to generate similar levels of return.

It is important to realize that these factors are not static, and therefore we must understand how they may change over time. This is especially true for cyclical businesses that may see meaningful swings in financial results depending on the strength of the economy. Changes in CFROI® factors may not be temporary, especially if a firm or sector is undergoing secular changes. It is vital to assess whether the underlying CFROI® drivers are being impacted by cyclical conditions or if there are secular changes in the business environment.

Our analysts spend significant time understanding the underlying business drivers that support a firm's return and reinvestment rates. We focus on management teams that pursue opportunities to reinvest cash at rates at or above historical return levels.

How Kennedy Approaches Value

The core tenet of financial asset valuation is that the present value of an asset is worth the future value of cash flows, discounted by a factor which incorporates an investor's required rate of return. However, investors often have differing views on future financial performance, leading to different valuation estimates amongst investors. A transaction will occur when the buyer's estimate of the asset's value equals or exceeds that of the seller.

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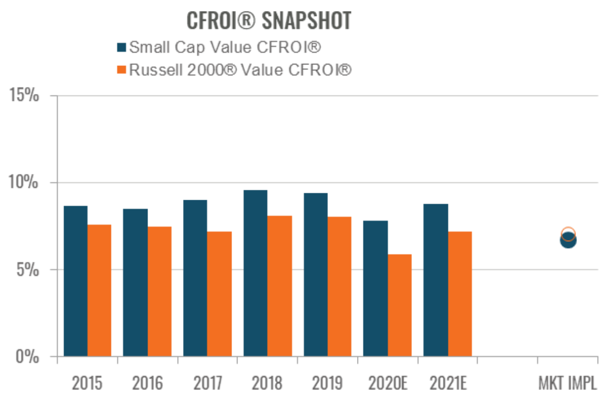
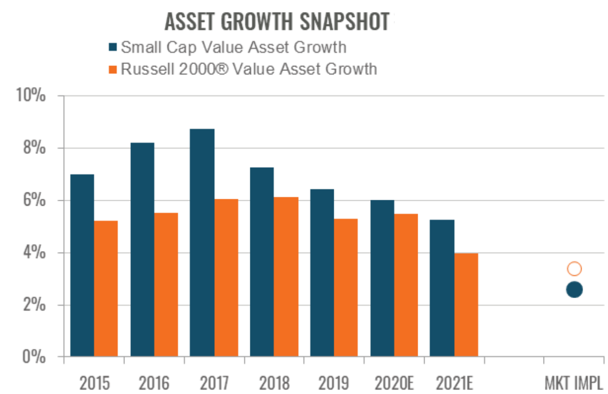
As mentioned above, we assess the valuation of a firm based on the firm's ability to generate cash flow returns on investments. More widely used valuation metrics focus on accounting-based, point in time, ratios such as price to earnings (P/E) or price to book. While these ratios provide the ability to compare businesses with relative ease, they do not measure the economic value of the asset. Without the context of CFROI® and reinvestment rate, it is difficult to tell if a low P/E firm is simply undervalued or a value trap. Additionally, a high P/E may be warranted if the CFROI® and reinvestment rate are growing.

We begin our investment process by identifying firms with favorable return rates, as measured by CFROI®, with a demonstrated ability to reinvest back in their business. Based on the current market price, we can calculate the firm's implied CFROI® and growth rate, which we view as the "hurdle rate".

Reinvestment of capital into projects with improving returns helps to further grow the value of a business. As the graphs below illustrate, our Small Cap Value portfolio is comprised of companies that, in aggregate, exceed the return profile and reinvestment rate of their peers. The blue dots in the graphs below indicate the level of future returns and growth rates implied by current market prices of the stocks in our portfolio. The orange circles in these graphs show the commensurate implied returns and growth rates for their peers in the Russell 2000® Value.





Source: Credit Suisse HOLT Lens™ and FactSet Research Systems, Inc. Characteristics are provided as supplemental information. The portfolio characteristics described herein are derived from the composite and are representative of accounts without constraints. To the extent that a KCM client imposes reasonable restrictions (which clients are allowed to do), the portfolio characteristics of that client's account may vary.

We seek to construct a portfolio where current equity prices imply future returns and reinvestment rates that are well below our analysts' expectations.

Summing It Up

Our primary advantage as a value investor is maintaining a long-term investment horizon. The time horizon for many investors has compressed, leading them to focus on current financial performance at the expense of appreciating long-term trends. Firms that have strong results today but lack the ability or desire to reinvest in the business may not be able to sustain these results in the future. Our framework ensures we are focused on performance throughout the cycle and not swayed by cyclical volatility. This often leads to investing in out-of-favor names, where we believe the market underappreciates long-term growth potential. We look for firms that are able to reinvest in their businesses at attractive rates of return but are currently valued at prices that we believe do not adequately reflect potential shareholder value creation.

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The Russell 2000® Value Index measures the performance of small-cap value segment of the U.S. equity universe. It includes those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000® Value Index is constructed to provide a comprehensive and unbiased barometer for the small-cap value segment. The Index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set and that the represented companies continue to reflect value characteristics.

The Russell 2000® Value is used as the benchmark. The Index is unmanaged and represents total returns including reinvestment of dividends. The benchmark is used for comparative purposes only and generally reflects the comparable risk or investment style of the Firm's strategy. The investment portfolios underlying the Index are different from the investments in the portfolios managed by the Firm. Certain accounts may also use other benchmarks not listed in the GIPS composite report. The Verification and Performance Examination Report does not cover the benchmark returns included in the GIPS composite report.