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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Sector-Neutral, Relative-Value Investing

DUANE R. ROBERTS, CFA, is Executive Vice President and Director of Equities at Dana Investment Advisors, Inc. Mr. Roberts graduated from Rice University with a B.S. in electrical engineering and mathematics in 1980. He earned an M.S. in statistics from Stanford University in 1981 and an MBA from Southern Methodist University in 1999. Mr. Roberts joined Dana Investment Advisors in June 1999. He serves as Lead Portfolio Manager for the Large Cap Core and Socially Responsible portfolios. He also is actively involved in the investment process for all other Dana equity strategies. Mr. Roberts is a Chartered Financial Analyst and is a Member of the CFA Institute and the CFA Society of Dallas-Fort Worth.

SECTOR — GENERAL INVESTING

TWST: Please give us a history and overview of Dana Investment Advisors.

Mr. Roberts: The company is an employee-owned boutique investment management firm. We manage about $3.3 billion between both fixed income and equities. The company started in January of 1980 and was primarily a fixed income shop until 1999. I joined in 1999 as we started to develop some institutional equity offerings. From 1999 until the market peaked at the end of 2007, we grew our equity business to the point where Dana assets under management were about equally balanced between fixed income and equity assets. Since that point, fixed income assets have surged ahead of our equity assets in part because of the recent market declines, but also because we've seen very strong growth in our fixed income products over the last two or three years.

TWST: You manage the Dana Large Cap Core strategy. Please tell us about that.

Mr. Roberts: The Dana Large Cap Core strategy is our flagship equity product, and on an institutional separate account basis, started in June of 1999. We've added additional equity products, but Large Core remains our largest and longest-tenured product. The mutual fund version of that product began in March of 2010. It's essentially the same target portfolio, and is managed using the exact same process used for our separate accounts. The mutual fund gets traded a little more frequently because of cash flows. But without cash flows, it would be treated just like any other institutional account.

TWST: Why did you decide to launch the mutual fund product? Was it an effort to reach a larger number of people?

Mr. Roberts: That was one of our primary reasons for launching the Dana Large Cap Core mutual fund. We started the mutual fund relationship with a firm called Trinity Fiduciary Partners. They had been running an SRI equity mutual fund, the Epiphany FFV Fund, and were looking to have us involved in the portfolio management of that Fund. They also wanted to offer a fixed income product that had some social screening attached to it. We started the Epiphany FFV Strategic Income mutual fund to do that, with Dana as the subadviser. Dana Large Core really didn't readily fit with Trinity's focus on SRI, but with the relationship established for the social funds it gave us outlet means to implement our Dana Large Core strategy as a mutual fund in a cost-effective way. That was really how it came about in terms of the timing, but the main motivation was to give us a way to open up to a larger group of potential investors. It is a disadvantage to the client if they are relatively small to be managed as a separate account in our strategy. We rebalance quarterly and some of those trades can be small. We're not selling entire positions and buying entire positions, but we're just doing some rebalancing. And for some accounts the trading costs can become high relative to the account size. Our rebalancing strategy just doesn't really fit in all circumstances. In terms of transactions costs, the mutual fund ends up being much more efficient for smaller clients.

TWST: Within large-cap area, how would you define your philosophy and strategy?

Mr. Roberts: The short description that I use is "sector neutral relative value," and those four words give hints to the two philosophies that drive our process. Sector neutral is probably the most visible component of our risk controls, and then relative value suggests what we're trying to do in terms of individual security selection.

On the risk control side, we look at risk primarily in two ways. First and foremost, we want to minimize volatility. A lot of that just comes from the mathematics of compounding. If you can minimize volatility, then for any given arithmetic average return, you generate the highest cumulative wealth. So to the extent that we can minimize volatility, that's a good thing for cumulative wealth, and ultimately that's every investor's goal. The secondary part of risk for us is what I'll refer to as benchmark risk. We don't think the markets are perfectly efficient, but we do think that there is consensus wisdom in the market that it would be foolish to ignore, because even if the market is wrong, the market can be wrong for extended periods of time. So managing portfolios with the thought that we're smarter than the market can sometimes be a very dangerous thing. Don't ignore consensus wisdom. We don't want to become victims of group think, but we do believe that you need to pay attention to what the market is trying to tell you.

Highlights

Duane R. Roberts manages the Large Cap Core and the Socially Responsible strategy for Dana Investment Advisors, Inc., and he shares his philosophy and asset-selection strategy. Mr. Roberts uses a "sector neutral relative value" approach. He benchmarks to the S&P 500 Index, and looks to emulate sector weights while minimizing volatility. The portfolios, however, are well-diversified across market caps, and they have a value tilt.

Companies include: Apple (AAPL); Chevron Corp. (CVX) and Discover Financial Services (DFS).

As a result of these two perspectives on risk, we want to have portfolios that are geared toward minimizing volatility, but resemble the broad market in as many ways as possible. Much of that gets reflected in top-down portfolio construction designed around those risk goals. As I said, the most visible part of that portfolio construction is that we're neutral to our benchmark in terms of the sector weights of our portfolio. The Large Cap Core product is benchmarked to the S&P 500.

One of the side effects of sector neutrality is that it takes that part of the investment management decision off of our plate and lets us focus on other areas where we think we can add value. We have not figured out how to consistently predict sector strength. Sometimes it's easy to predict when sectors will perform well from an economic point of view, when their businesses will do well, but that doesn't necessarily mean it's easy to predict when the investment returns from those stocks will do well. That's a much more difficult problem. We have not figured out how to do that consistently, and our belief is that it adds risk and volatility to the portfolio that is not really compensated by excess returns. So sector neutrality, as I said, is the most visible part of our risk controls. But there are many other things that come into play as well. We pay attention to industry weights. We are not industry neutral, but I like to say we're industry aware. We avoid significant overweights or underweights to industries. We look at the distribution of market caps in our portfolios, and we want to make sure our portfolios don't overemphasize the megacaps or overemphasize the midcaps. We want to have a well-diversified portfolio in terms of market caps. We monitor a whole array of portfolio characteristics. While we don't have specific targets in many cases for these characteristics, we do try to keep them within certain bounds of what the benchmark characteristics are.

One characteristic that stands out is dividend yield. We do not manage our portfolio specifically for yield per se, but a lot of the characteristics we're looking for in the companies whose stocks we own tend to be correlated with high dividends. So in general, our portfolios have a dividend yield that's above our benchmark.

"Often our historical growth metrics actually look stronger than the market. Where we tend to lag, and not by a lot, is in the long-term growth forecast. We like data that we can see, understanding of course that a lot of the data we can see is backward looking."

Growth is another characteristic worth mentioning. Because our stock selection process is value oriented, our average growth rate is typically just slightly behind what the S&P 500 might be. But at times it's ahead, and it depends on which growth metric you're using. Often our historical growth metrics actually look stronger than the market. Where we tend to lag, and not by a lot, is in the long-term growth forecast. We like data that we can see, understanding of course that a lot of the data we can see is backward looking. We like things that are objective and not based on analyst projections or management's oftentimes optimistic guidance.

So while there's not a specific growth rate we are targeting, or a target dividend yield, we will set ranges for those characteristics and many other characteristics relative to our benchmark. We're going to make sure we have portfolios that resemble the broad market in terms of growth, that resemble the broad market in terms of dividend yield, that resemble the broad market in terms of valuations. Our stock selection tends to put us at a discount, as we definitely have a value tilt in what we do. But all of those characteristics are part of our overall development of the portfolio from a top-down basis. That reflects the second part of our risk philosophy, which is to minimize the risk of deviating significantly from the broad market.

TWST: What are some of the top holdings that you have right now that you like and why do you like them?

Mr. Roberts: I mentioned the risk side. The second half of our investment process, and where we try to add our value, is in the individual security selection. Our security selection process has a value tilt. We're value managers in our mindset, but in part because of our sector neutrality, the valuation analysis tends to be done on a sector-by-sector basis, so it's all sector relative. We also pay attention to growth, and we don't want to sacrifice growth in the portfolio. So it's also growth relative. We think of growth as an important part of the valuation equation. We are trying to add value by looking for the individual securities that have attractive valuations relative to their sector and yet don't sacrifice on growth. Our portfolios are typically 50 to 55 holdings. At any point in time, we are going to have some stocks that lag a little bit, but with our risk controls the laggards don't harm the overall portfolio performance very much. We hope that more of our picks are winners rather than losers, which over the long term will benefit performance, and our track record indicates that historically we have been able to do that.

I'm always a little uncomfortable highlighting individual securities in our portfolio, because there will always be winners and losers in the portfolio, and we like all our current holdings. Investment consultants classify us as stock pickers, because our excess returns are generated almost exclusively from stock selection. But personally, I consider my skills to be better described as portfolio management. Stock selection is one of the basic building blocks of portfolio management, and is an area where our team has been very successful. So rather than discuss favorite stocks, let me highlight a few names that reflect the types of companies we want to own in our portfolios.

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Apple (AAPL) is a company we like right now. This is a company that has a real strong growth profile, but that's not the reason we were attracted to it per se. When we first started buying **Apple**, we were attracted by its valuation given its growth profile. Now, you could argue that its valuation is no longer cheap, but I think when you look at it relative to other technology companies — and certainly relative to its growth, it remains attractive.

1-Year Daily Chart of Apple

Chart provided by www.BigCharts.com

If you look at price-to-earnings ratios, price-to-cash flow ratios, price-to-book, enterprise value to EBITDA, or any other valuation metric, you'll see our overall portfolios at a discount compared to the benchmark. Roughly speaking, our portfolios average about a 15% discount relative to the market, depending on the particular valuation metric and market environment. That value tilt is reflected in the types of companies that we are looking for. The current markets are somewhat remarkable because of the number of stocks that we are seeing with single-digit p/e.

The energy sector in particular stands out in this regard. A current holding that reflects our value bias is **Chevron** (CVX). **Chevron** trades with a forward 12-month p/e of 6.9 and even the trailing p/e is less than 10. Those valuations are quite attractive. The valuations we are seeing in the financial sector are also incredibly low. The risks in financial stocks right now bother me more than the risks associated with the energy companies. But a company like **Discover Financial Services** (DFS) — with modest valuations and a strong, steady upward trend in earnings estimates — is attractive to us. You can almost go to any of the economic sectors and identify securities that are being priced at single-digit p/e. While we don't think that low p/e alone is reason enough to buy a stock, below-market valuation tends to be a characteristic that is common in our portfolios.

1-Year Daily Chart of Chevron Corp.

Chart provided by www.BigCharts.com

Another key component of our stock selection is to look for companies that are operating well and seem to be delivering at or above expectations in terms of their earnings. We monitor estimate revision trends, earnings and price histories, and earnings growth trends as well. The goal with that analysis is to try to avoid the companies that are cheap but likely to stay cheap. We want to find companies that are inexpensive, but that are delivering growing earnings so that at some point the market overall may start to recognize that maybe these stocks are attractive values and start to reward those stocks.

TWST: You have participated in some socially responsible investing seminars. Is the social responsibility screen an important part of your process at this point?

Mr. Roberts: I'm the Director of Equities at Dana, so I have some involvement in all of our equity strategies. I am the Lead Portfolio Manager on two of those products. One is the Large Cap Core product that we've been talking about, but the other is a Socially Responsible product. The SRI product is a core product benchmarked to the S&P 500, but it applies social screening as well. It is a strategy I personally believe very strongly in for a variety of reasons. The SRI product was started in January of 2000, seven months after we started the Large Cap Core product. If you look at the period from January of 2000 until the present, our socially screened product has actually performed better than the Large Cap Core. Now, a lot of people anticipate that when you do a socially screened product you are going to sacrifice performance because you're limiting your universe. To the extent that the only things involved in social screening are exclusionary, then maybe that does happen. But there are other things that I think are coming into play.

1-Year Daily Chart of Discover Financial Services

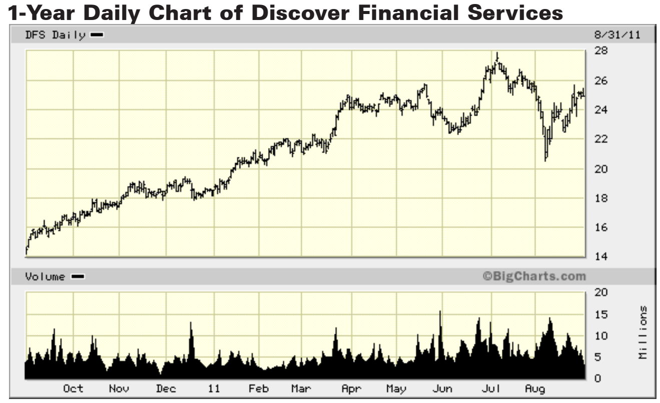

Chart provided by www.BigCharts.com

When I talk about the fact that trailing performance on our social product is better, I have to acknowledge that because of the social screening we tend to go a little lower in terms of market caps of the stocks we consider, and this midcap tilt has been a benefit to the product. But even after you adjust for that market-cap bias, the SRI product has performed a little bit better. That motivated us to look at some of the things that are involved in the social screening, and we now believe very strongly that there are certain elements of the social screening that are just good investment factors.

For example, screening or identifying strengths in terms of corporate governance leads us to more shareholder-friendly companies and companies that may have higher management quality because of their board structures or governance practices. If so, that's just a good investment factor. If you screen for companies that seem to be taking a proactive role in managing environmental risks, their own environmental risks in the long run, it may not add to return in the short run, but it may reduce the risk associated with the stocks. So on a risk-adjusted basis, it looks better. In the long run, if a company can avoid major environmental issues, it may actually have a long-term benefit to investment returns for its stock. So just like screening for lower valuations is a very standard thing in investment management that nobody gives a second thought, we think there are some elements of the social screening that turn out to be good investment factors. Some of those things that we've done in our SRI strategy are now being done in all of our strategies, regardless of if there is social screening or not.

TWST: Is the volatility in the market right now impacting your investment choices?

Mr. Roberts: We pride ourselves on having a well-defined process and on being disciplined in adhering to the process. Hopefully, that helps remove some of the emotion that could come into play at a time like now. But at times, that can be difficult. And certainly in the current market environment, the volatility does create some stress. For example, there are three companies in our portfolios right now that we've been spending a lot of time doing additional research on trying to understand what's driving their short-term performance over the last two to four weeks, because these three companies have been pretty substantial laggards even on a sector-relative basis. Yet, if we look at the underlying businesses in terms of the earnings they've been able to generate — in terms of what their management is guiding, in terms of what they've been able to deliver relative to expectations, the trends on margins and revenue — they are as solid as any company. I think part of their performance is tied to the market volatility.

I'd say that's the biggest thing that the volatility introduces for us: trying to distinguish when poor performance is reflective of some unseen company-specific risk as opposed to some short-term trading effect. We try to stay consistent to our process and the ideals that we're looking for in terms of our companies. Poor performance is often a great flag for us to move away from companies, and there are a couple holdings that we've replaced recently because of performance. But for three of our current holdings we just cannot identify a real catalyst for the performance. A lot of it may be tied to market volatility, but I guess until the market starts moving in a less volatile fashion or starts heading north again, it will be difficult to really know that. So we continue to analyze these companies to see if there is a reason that we need to sell them. It's always been a part of our process that if we can't understand what's driving poor performance, we will sell. At some point, if these stocks continue to be punished relative to their peers, we'll acknowledge that we're missing something and move to alternatives.

TWST: Please tell us about your background.

Mr. Roberts: My academic background is electrical engineering, mathematics and statistics. But even in the electrical engineering degree, there was an underlying theme of probability and statistics. Within electrical engineering, most of my emphasis was on communication theory, which is based heavily on probability. So probability was the common thread. As I got out into the real world, I spent over a decade writing commercial software. I was working for a small software company and became involved in managing our own finances, including investments and seeing the process of a sister company go public. As I educated myself more on investment management, I saw portfolio management as thinking about things that are probabilistic in nature. So while it sounds very different, investment management does come back to the common thread that existed in my academic background and my career in electrical engineering.

The probability and statistics background helps with data analysis, which we do a lot of. My software development background also helps, because more and more of what goes on in the investment management world, even if you are not a quantitative portfolio manager, involves computerized processing of large amounts of data. In my opinion, engineering problems are all about making trade-offs to try to achieve or optimize some desired result. Really a lot of our portfolio construction is engineering in that sense. So I see portfolio management as just being an extension of things that I studied and then practiced in the professional world, before switching over full time to financial services.

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TWST: Is there anything you'd like to add?

Mr. Roberts: If you look at our historical performance, our excess returns come almost 100% from the individual security selections. That's where we are going to add value, but we try to do that in a risk-controlled way. Historically, we have generated excess returns that we are very proud of, but I'm always more proud of the fact that we've done it in portfolios that have shown below-market risk. The beta of our portfolios on a since-inception basis is about 0.88. It actually had been lower until the last year or so. If you look at the standard deviation of our daily returns, our 50 to 55 stock portfolios have lower volatility than the S&P 500, which is a 500 stock index. So our attractive historical returns are even more attractive on a risk-adjusted basis.

We are not always ahead of the market over short time periods, but we manage to beat the S&P 500 two out of three times on average on a quarterly basis. When you build that up to an annual basis, it's actually a much higher percentage. Our goal is to generate excess returns with below-market risk on a fairly consistent basis. We think by focusing on security selection as we do, our success can be replicated in a way that leads us to that consistent performance.

Disciplined adherence to our risk controls also contributes to consistent relative performance. As I mentioned before, we are sector neutral, so we are not going to make so-called sector bets. Instead, we are looking for the best health care names, the best technology names and the best names in every sector. As a result, we tend to get much more even performance over time. We don't get the swings in performance that tend to come with sector bets.

Another factor I'm proud of in terms of our results is the success of our security selection across economic sectors. If you look at the 10 GICS economic sectors — technology, utilities, materials, etc. — since inception we've been able to add positive excess returns in nine out of 10 sectors, and in the one sector where we lagged the market we trailed by just a small amount. In our SRI product, we've actually outperformed in all 10 sectors. That consistency of performance is driven by our security-selection process. Our relative value approach to individual security selection on a sector-by-sector basis appears to work, judging by the historical data, and is part of why we feel that our past success can be replicated in the future.

Certainly, there were times in the past where we had very large excess returns, and we don't necessarily expect to see those types of outsized returns again. But we do believe we can consistently generate reasonable amounts of excess return over time. We believe our process of disciplined risk controls, combined with strong security selection, guided our past success. This gives us confidence in what we are doing and what we can expect to achieve in the future.

TWST: Thank you. (LMR)

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