

BEHIND THE FUNDAMENTALS OF  
MILES CAPITAL'S EQUITY PROCESS



MILES *Capital*

RESULTS THAT MATTER

# INTRODUCTION

Our equity philosophy has three key tenets: Determining the appropriate allocation to equity markets is of paramount importance; diversifying across style, sector, size, and country exposure helps mitigate risk; and we focus on delivering positive risk-adjusted returns over a full market cycle.

Miles Capital's fundamental approach to equity management is focused on capturing as much of the market upside and as little of the downside as possible. We believe the foundation for achieving this consistent equity performance is driven through diversifying critical risks and selecting securities with strong fundamental characteristics.

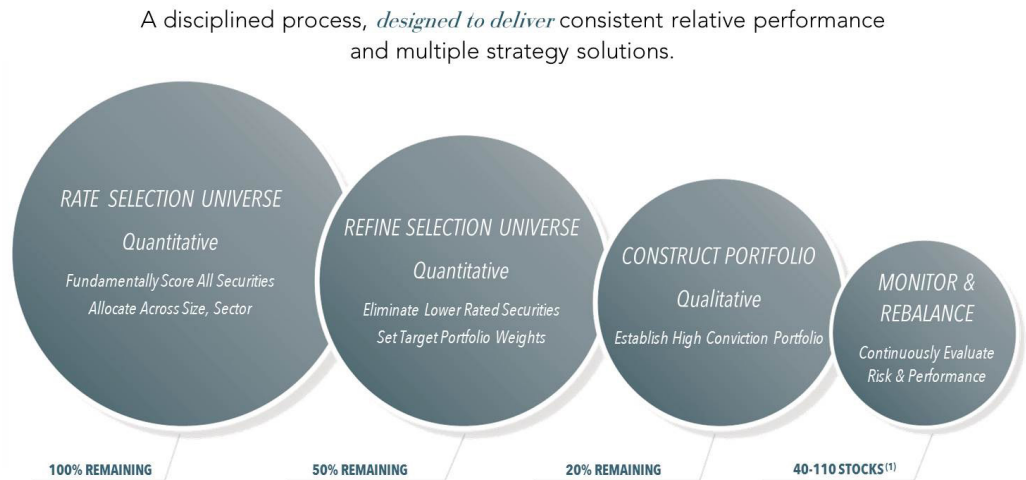
Our multi-step process (in Figure 1 below) starts by leveraging quantitative tools to rate over 3,000 equities across nine different markets, narrow the universe for fundamental analysis, then relies on our proprietary fundamental security-scoring methodology to ensure we select our highest-conviction stocks. Next we diversify across region, sector and market capitalization to minimize unintended risks, and finally we maintain a strong and ongoing focus on risk management.

Here's a closer look at each step of our approach.

## PROPRIETARY RATING METHODOLOGY

The first step we take when constructing a portfolio is to rate each security in the universe from which we are selecting for a given strategy, whether a U.S. index, global, or emerging market. Our proprietary methodology determines a fundamental rating for each stock on a scale of 1-5, with 1 being the worst and 5 being the best. We then automatically eliminate those stocks rated 3 and below. This allows us to concentrate our resources on what our process shows to be the best opportunities to identify securities that have historically outperformed and shown less volatility than lower-rated stocks.

FIGURE 1: MILES CAPITAL EQUITY MANAGEMENT PROCESS



For the three Miles Capital domestic strategies (large cap, small cap and dividend focused), the equities rated 4 and above outperform those below 4 about 55 percent to 60 percent of the time<sup>1</sup>, according to monthly data over the trailing 10 years. For all three domestic strategies (large cap, small cap and dividend focused), equities rated 4 and above have a lower standard deviation and downside deviation than those below 4, indicating they are less volatile and, in particular, less volatile in down markets.

<sup>1</sup> Analysis performed by Miles Capital using FactSet Analytics. Past performance is not a guarantee of future results.

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## SIZE AND SECTOR DIVERSIFICATION

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Most investors recognize that diversification across sectors is integral to risk management. A high concentration in one sector, such as technology, does not address industry or cyclical downturns. However, we have also found diversification across size within the market universe to be paramount for success as well. Many managers commonly ignore an opportunity for further diversification via investing in the smaller or lesser known names in an index. Research shows they typically focus on the largest names within an index, which may contribute to underperformance.<sup>2</sup>

With that in mind, once we eliminate the lower-rated securities through our ratings process, we then look across multiple sectors and determine our target weights on each sector – such as financials, energy or utilities.

Then we believe it's crucially important to diversify across the size ranges as well. The medium- and lower-market-cap names outperform the largest segment about two-thirds of the time, so having exposure to these stocks is important. A combination of external and internal research shows there is plenty of output to be generated by holding the lower-market-cap names, even just within the S&P 500. Over the past 20 years, the equal weighted S&P 500 outperformed the traditional market-cap-weighted S&P 500 about 65 percent of the time<sup>2</sup> due to the midsize or smaller groupings outperforming. That doesn't mean at all that we focus primarily on smaller companies, but rather that we take steps to diversify across all the size spectrum within the index.

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## HIGH CONVICTION PORTFOLIO CONSTRUCTION

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We then construct the portfolio, establishing allocations to our highest-conviction stocks, that we believe represent the best of the best in the given universe (See Figure 2). This will result in a model portfolio of between 40 and 100 stocks, depending on the strategy.

For example, our Small Cap Core strategy will typically hold a larger number of securities to 1) offer appropriate access to all areas of such a large (2000 name) index and 2) to help manage downside risk for a more volatile universe. But even in a larger portfolio, all securities purchased will have a rating of at least 3.5 and be the top names recommended by our analysts.

Our high-conviction portfolio seeks long-term capital appreciation, with the goal of delivering above-market upside and below-market downside (See Figure 3).

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## ONGOING MONITORING AND RISK MANAGEMENT

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The last component of our equities philosophy continues long after the initial construction of the portfolio. We perform ongoing portfolio surveillance by monitoring all holdings intraday and reviewing issuer news daily. We also perform a thorough analysis of trends on a weekly basis, a full portfolio and rating review monthly, and recalibrate our risk metrics on a quarterly basis. And we maintain a sell discipline that focuses on the deterioration of our stocks' ratings and performance relative to each holding's peers. There are three components to this process.

### First

If a price target (expected upside) is achieved we will review the position to identify whether a sell, trim or price target revision is appropriate. This is not an automatic trigger for sale, but rather an automatic trigger for review. If we believe the stock performance has run its course for now, we will evaluate better alternatives and trim or sell. However, occasionally there

FIGURE 2: SECURITY SELECTION

SAMPLE CONSIDERATIONS
<b>FUNDAMENTAL</b>
<ul style="list-style-type: none"><li>• <i>Structure &amp; Liquidity</i></li><li>• <i>Management</i></li><li>• <i>Competitive Position</i></li></ul>
<b>VALUATION</b>
<ul style="list-style-type: none"><li>• <i>Earnings</i></li><li>• <i>Cash Flow</i></li><li>• <i>Upside Potential</i></li></ul>
<b>TECHNICAL</b>
<ul style="list-style-type: none"><li>• <i>Volume</i></li><li>• <i>Merger/divestiture</i></li><li>• <i>Substitution</i></li></ul>

FIGURE 3: PORTFOLIO CONSTRUCTION

### RESULT:

- High conviction portfolio that seeks;
  - ✓ Long term capital appreciation
  - ✓ Seeks to deliver market upside and below market downside.

### ALPHA SOURCES:

- Size Distribution [10%-30%]
- Sector Allocation [20%-40%]
- Security Selection [50%-80%]

<sup>2</sup> Analysis performed by Miles Capital on the S&P 500 holdings for trailing 20 years. Source: Bloomberg, Miles Capital.

Diversification does not ensure a profit or protect against market loss.

Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Past performance is not a guarantee of future results.



is new information and the price target must be revised upward. We are not short-term investors, but we review as we want to help ensure we lock in gains for our clients if holdings appreciate quickly.

Second

We feel our ratings methodology is very powerful, but even securities rated 4 or 5 can deteriorate, so we are continually reviewing our holdings’ ratings. We will automatically sell a holding whose rating has dropped below 3. In addition, any significant deteriorations (for example, from 4.5 to 3.5) especially compared with the other opportunities in our selection set, trigger automatic review.

Third

The final component of the sell discipline is a review of performance for the stock over different time frames relative to its peers within the same sector. The performance of a utility stock compared to a technology stock is relatively meaningless. Rather, we observe how the utility stocks we have perform relative to the other utilities in the selection set. If a stock depreciates more than 25 percent relative to its peers, it is automatically sold.

FIGURE 4: ONGOING MONITORING AND RISK MANAGEMENT

We monitor portfolios on a continual basis, performing a daily contribution to return analysis of the entire index.

DAILY <i>Surveillance</i>	WEEKLY <i>Trend Identification</i>	MONTHLY <i>Portfolio Review</i>	QUARTERLY <i>Portfolio Recalibration</i>
<ul style="list-style-type: none"><li>• Contribution to Return Analysis on Entire Universe</li><li>• News Alerts</li><li>• Earnings Announcements</li></ul>	<ul style="list-style-type: none"><li>• Relative Portfolio Performance</li><li>• Patterns of Stock Behavior</li><li>• News or Ranking Trends</li></ul>	<ul style="list-style-type: none"><li>• Attribution Analysis<ul style="list-style-type: none"><li>✓ Sector</li><li>✓ Market Cap</li><li>✓ Rating</li></ul></li><li>• Research Rating Changes</li><li>• Assess Performance and Risk Contributors</li></ul>	<ul style="list-style-type: none"><li>• Recalculate Entire Investable Universe</li><li>• Assess Market Cap Movements</li><li>• Realign Shifted Sector Weights (<i>Within Client Specific Needs</i>)</li><li>• Re-evaluate Bottom Contributors</li></ul>

We use our disciplined approach to avoid any style or holdings drift. It also helps remove emotion from the decision-making process.

CONCLUSION

The two primary aspects that make our equity strategies unique are the efficient and automated ability to rate over 3,000 stocks and a unique focus on diversification of size within each strategy. This disciplined process is designed to deliver consistent relative performance and multiple strategy solutions for a wide range of investor types.

We employ our equities philosophy consistently across the five strategies we offer: large cap, equity or dividend focused, small cap, international and REITs. The process is largely the same for all five strategies that we manage, although there are regional and international nuances in certain instances.

We strongly believe intelligent portfolio construction is the foundation for consistent equity performance – and our philosophy and process have proven an effective route to helping achieve that goal.

## ABOUT MILES CAPITAL

At Miles Capital, we offer customized investing and relationships directly with portfolio management to help meet your objectives and needs. We take a holistic view of our clients' needs, and build strategic partnerships that help support their broader goals.

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## Contact Us

We would be honored to bring our trusted guidance, purposeful portfolio design and delivery, and proactive client service to bear for you.

**CONTACT US TODAY AT 800.343.7084 FOR MORE INFORMATION.**