ticker

Quantitative Analysis in a Non-Quantitative Fund

Selecting stocks from a pool of 3,000 small- and mid-cap companies, requires a quantitative and disciplined process. Thomas Vandeventer, portfolio manager of the Tocqueville Opportunity Fund, has developed a selection approach which combines fundamental analysis with multi-factor screening to discover companies generating superior quantitative results to peers and to identify undiscovered and undervalued companies.

Thomas Vandeventer, is a Portfolio Manager at Tocqueville Asset Management L.P. Vandeventer joined Tocqueville in 2006 and is the portfolio manager of the Tocqueville Opportunity Fund. Prior to joining Tocqueville, Vandeventer was Senior Managing Director and head of the Institutional Large Cap Growth group at Clearbridge Advisors (Legg Mason) and Citigroup Global Asset Management (CAM); he was responsible for the investment of pension, foundation and endowment funds. Vandeventer also managed portfolios for high net worth clients and trusts in equity and balanced accounts. Vandeventer remained with the same investment management group for twenty years, having joined Shearson Asset Management (American Express Company) in 1986. He worked in Real Estate Finance as an Associate at UBS from 1983 through 1985. Vandeventer earned his B.A. from the University of Virginia and an M.B.A. from Columbia University.

What is the history of the Fund?

I started managing institutional money in 1992 with a focus on large-cap growth stocks. The framework for the Fund structure and the investment approach, in terms of security selection and portfolio construction, comes from this experience.

Small-cap investing was an exciting, new challenge and an opportunity I seized in 2010. Since the early 1990's, I had followed academic work in our field and became keenly interested in predictive variables in growth stock investing. Some of this research involved analyzing whether certain investment factors were correlated to investment performance. My work gradually led me to meet and work with a number of people on Wall Street who were doing work in this area.

My approach was not developed as a substitute for fundamental work, but rather as a complement. I had realized that many of the ways in which investors organized and processed research, was due to the bias mentality of research departments and not necessarily because of independence or objectivity. Some investors used sell-side research, some prided themselves on using only buy-side. Both approaches always seemed to contradict a more objective approach in which there was no analyst, portfolio manager or salesman bias with regard to what company was being emphasized.

With thousands of companies out there, I have always been more worried about the potential of companies we didn't own and/or didn't have the manpower or time to explore. How would one identify those companies before their big stories and the upside were recognized? Waiting for overburdened research departments and their internal politics with strained resources or sell-side efforts clearly wasn't the answer.

The whole process just begged for a solution. Investors understand that it is often not what you own that ends up hurting you, but the ones you didn't own—the big winner that you never saw coming which got away. There just had to be a better way to remove emotional, structural, and organizational bias by finding an approach to identifying and comparing all companies with a similar yardstick.

Multi-factor analysis was the answer to make the process efficient. Computing power offered an elegant, efficient and almost unlimited potential to leverage the search and identify process.

What factors are involved in this process?

From a fundamental standpoint, understanding and evaluating small-cap stocks is an easier task compared to large caps; the capital structures have fewer moving parts and putting one's arms around the business model, products and services is just a less challenging task. One can work

"I have always believed that companies can only sustain their competitive advantage and growth if they are able to reinvest at a comparable or higher return on capital. Our approach is oriented to investing in companies which realize superior returns on investment capital."

through that universe a lot more rapidly than if you were looking at Johnson & Johnson.

However, the universe of small cap companies is large and is impossible to fully analyze unless one has an army of analysts, which nobody has or can afford or could actually manage!

I think the multifactor-based quantitative approach is a reliable tool to apply to such a massive universe of names in the small-cap segment. It is a systematic method of generating a constant pipeline of new investment opportunities—a way to refresh investments productively. The key point here is that this approach identifies the companies where we should focus our research because the highest ranking securities are the most attractive on growth and valuation and historically have outperformed the small-cap universe.

Value investors are generally surprised to hear that valuation is a critical tool for a growth investor, but valuation and momentum are the two most critical measures. There are investment cycles when valuation measures are in fact weighted more heavily than growth measures in a particular ranking algorithm. Valuation always matters. Momentum may have a bad name at times, but momentum is a broad measure – it's not just price change or relative strength.

What is your investment philosophy and what are your views on portfolio concentration?

The Opportunity Fund has from 200 to 250 issues. Empirically, it has always seemed that the money managers I had worked with or observed over the years had made the biggest mistakes when they ran concentrated portfolios.

This is undoubtedly a seductive approach—fewer names that you know deeply; fewer eggs in the basket; watch the basket —but over the years there have been plenty of shipwrecks due to concentration and many shops have closed down because their concentration in the Fund led to overwhelming losses.

Money managers have big egos, but those egos should never obfuscate the fact that we are fiduciaries managing somebody else's money—somebody's retirement perhaps. Concentration is simply an unnecessary risk for the investor to take; particularly when there are so many wonderful investment opportunities.

Does the number of names you hold depend on sectors?

There is no cap on the number of names in the portfolio. That being said, there are certain sectors of the market where we can run relatively concentrated and there are other sectors where it can be quite dangerous to do so. We take the portfolio itself and think of it broadly as diversified before we start narrowing it down into particular sectors.

From my experience over the last four and a half years, we want to run a diversified portfolio in sectors such as healthcare because we always have product development risks. And there are so many interesting new therapies. We are currently living through a renaissance period in healthcare thanks to the genomic revolution. However, many viable companies working on new solutions to unmet needs have no operating history as of today; they are somewhere between clinical trials and approvals and they have great science.

Unlike prior times in healthcare sciences, many of the targets are rare and orphan diseases -small addressable markets and many of today's drugs are rifle shots- aimed at particular mutations and unique disease states. Just because they are small companies doesn't mean we can neglect them.

The incidence of diseases like cystic fibrosis, Huntington's or Duchenne Muscular dystrophy is limited, but the diseases are devastating and the needs of the victims are not being met. We owned a position in a tiny company called Pharmasset Inc, purchased by Gilead, and now has the number one drug for Hepatitis C.

By the way, these young healthcare companies can't be identified through quantitative approaches — there are generally no sales or earnings and no operating histories — we only find them through basic, old-fashioned research.

We look for companies working for solutions, and frequently our investments positions in the beginning are quite small. Yet, we recognize that with success the smallest player on the board often becomes one of the largest. At one time, all our top healthcare investments were small for the portfolio.

What drives your investment process?

We are not a quantitative fund but we use quantitative analysis. The heart and soul of the process is really fundamental analysis. That harkens back to what I have practiced my entire investment career, which is a very simple investment approach.

I have always believed that companies can only sustain their competitive advantage and growth if they are able to reinvest at a comparable or higher return on capital. Our approach is oriented to investing in companies which realize superior returns on investment capital.

In terms of market share, in terms of profitability, and in terms of return of capital, they tend to be leading companies because they have the best management, the clearest investment strategies, and they tend to have a differentiated business service and products. They tend to generate competitive returns that are higher than their peer group. Consequently, these companies become core positions within the portfolio.

There is no secret to this approach, but it can require commitment and patience as you go out to find the best of breed, invest, and let management work for you. And you have to stick to your guns.

How do you look at companies from a fundamental perspective?

From a fundamental standpoint, there are a lot of ways to analyze companies. To begin with, competitive analysis and understanding the importance of market share and market strategy are critical. We spend a lot of time on the business model and ask ourselves if it is sound and will it put the company into a leadership position.

We also focus on the income and cash flow, on profitability and margins, and reinvestment. But balance sheets are no less important, and capital allocation turns out to be most important.

Many investors are just looking for a quick bird in the hand—a company that can recapitalize or repurchase a ton of stock—providing an overnight, one-time hit, a trade. We love those too, but we are really investing in companies which take their cash flow and reinvest it to grow.

Dividends are great, but I would always prefer a 15% return on equity to a 2% taxable dividend that I then need to reinvest.

How is your research and portfolio team organized?

There are three of us on the strategy and I am the lead portfolio manager. Two analysts who work with me and each of us has specific responsibilities. Ideally, some of those responsibilities tend to overlap. Most importantly, we work as a team and we want to share responsibility in what is a democratic and respectful approach.

How long do you like to hold your stock picks?

In general, we want to invest with at least a three- to five-year time horizon. Small- and mid-cap investing tends to be more volatile in terms of particular name price movements, so there are periods of time where you take profits or you are moving money out of a name that has done really well, or you have simply identified another name.

We have had nearly 50 takeovers in just over four years, so we need to replace names. We have many names that have appreciated many times over. Yes, we have had 'ten baggers,' and sometimes we need to trim them down because they go up too much in market cap.

We use every tool in the book so I do not have a bias towards either buy-side or sell-side research. Over the years, I think it is important to be objective towards your sources of knowledge and research. We use the sell-side and we do a lot of modeling on core names that we own. Additionally, we attend a lot of conferences and we use management as much as we possibly can.

The one thing we target in everything we do outside of making an appraisal of the competitive position of the business is that, from a valuation perspective, we like to try to frame what our expectations are through discounted cash flow analysis and then build relative valuation.

What kinds of companies have met your research criteria in the past?

Alnylam Pharmaceuticals, Pharamcyclics (just taken over by Abbvie), and Regeneron, are some of the top names that we have owned over a long period. They have premier drugs and these companies have taken their drugs from development stage into sales that are growing rapidly.

Moreover, some of our holdings have been acquired; Allergan, Forest Labs, NPS Pharma, Onyx Pharma, Salix Pharma, Prosensa and Cubist are few companies that make that list.

Tocqueville Opportunity Fund

Company	Tocqueville Trust
Symbol	TOPPX
Address	40 W. 57th Street, 19th Floor New York, NY 10019
Phone	800-697-3863
Website	www.tocqueville.com

Source: Company Documents

About Ticker Q&A

Our research staff analyzes and selects funds based on their consistency in performance and durability of investment style.

You can find more fund profiles and view our other publications on Ticker.com and TickerFunds.com

In technology, the names would include Manhattan Associates, ServiceNow and Palo Alto Network. We have had plenty of takeovers in tech over the years: RightNow Technology, Success Factors, Taleo and Concur Technology.

In consumer discretionary, we have Hanesbrands, which has been in the Fund for three and a half years. We have had some good acquisitions in the consumer space as well, including Peet's Coffee, Beam, and Petsmart.

In financial services we have some really interesting growth companies. Pinnacle Financial, is a bank in Nashville, Tennessee which executes consistently and we have owned it in the Fund pretty much since day one.

We look to invest in cornerstone holdings which have unique business models coupled with the best management teams in the business. When and if we find them, we stick with them as long as they execute.

How do you apply your sell discipline?

I have never believed in automatic triggers to sell an investment.

The sell decision is really just the inverse of a buy decision – we sell when margins erode, competition intensifies, market shares are given up, execution fails and/or there are legal or accounting irregularities.

We listen to every quarterly report on the conference calls. We want to hear management's explanation and discussion of what happened during a quarter. It is critical to be actively engaged with our investments. We scrutinize the quarterly report cards for every company. For us, execution is the critical difference between the kinds of companies we want to own and the kinds of companies we want to reduce or sell completely. In short, it boils down to leadership and execution.

We want to understand if everything is working the way we thought it was going to work, if the sales are growing the way we expect, it is a continual process. Just like we do with every other holding, we will consistently check back in to see how that name is doing on a quarterly basis.

The Opportunity Fund is focused on small- and mid-cap growth stocks, but we have the leeway to maintain investment in positions which gain appreciably in market capitalization and which would exceed the standard cap size definitions applied by small-cap and mid-cap only fund managers. We aren't compelled to sell out of our successful names in order to fit into a somewhat arbitrary, marketing style/cap box. We think this is a competitive advantage of the Fund.

The names that I quoted as examples tend to be the largest holdings in the portfolio. Apparently, the top ten tend to be the largest cap companies because they have grown; they may have doubled, tripled, or quadrupled since we originally bought them.

How do you structure the portfolio?

The smaller names in terms of capitalization tend to feed in at the bottom. The way we structure the portfolio is like a big pyramid, with the top of the pyramid representing 15% to 17% of the Fund.

The top 25 names are somewhere between 25% and 30%. The top 50 names are at about 55%, and the next 150 names comprise the next 50% of the portfolio. At an individual level, we are thinking about quite small initial positions of 25 to 35 basis point positions.

These are the seeds in the Fund and they are the names we think are riskier; they are less well developed than the larger companies. But they are also the names which are most likely to be the doubles and the triples in two to three years.

One of the key aspects of what we do in terms of the portfolio construction is that when we cannot analyze the basis of profitability, we watch the sequential sales growth. Young companies aren't always throwing off profits—if you are looking for earnings you are missing the forest through the trees. From a valuation standpoint, all we can do is look at the proportionate growth rates in sales and valuation relative to other names. There are certain segments of the market where it is impossible to do the traditional valuation calculation, the discounted cash flow analysis. That is where execution becomes very important. That is why these stocks can be highly volatile.

The one thing I have learned in over 25 years is that many names at early stages of development just do not fit into traditional valuation frameworks. For example, most healthcare investments are valued on their milestones and their successes until the financials come into focus. Again, diversification mitigates the risk of any one investment.

How many total holdings do you average and how do you allocate among sectors?

The correct paradigm at present is anywhere between 200 and 250 stocks. The active share in this Fund at the end of the year was around 65% and our benchmark is the Russell 2500 Growth Index. We only overlapped the benchmark with one third of the portfolio. The reason why this is a very active portfolio is because we own a large number of positions that are not in the benchmark.

The largest holdings are generally in the 2% arena. Typically, in the top ten we might have one name at 2% to 2.5%, and the rest of the names will be somewhere between 1.5% and 2%. Again, the top ten generally total only 15% to 17.5% of the Fund.

The largest weightings right now on a pure sector level are in healthcare and technology. Healthcare is about two and a half times the benchmark while technology is about two times the benchmark. We are equal weight in the cyclicals, which we treat as one group including - financials, auto transportation, consumer durables and materials. And,

we are equal weight in the consumer staples and discretionary names as well. We have been significantly underweighted in energy for two years, and we own no utilities.

The portfolio turnover has been 98% for the past 14 months. That is a lot less than most of my competitors but it is probably normal for this market segment. In today's world where information is widely available and distributed evenly, you have to have some lever or tools to get ahead of your competition.

With our quantitative robot, I believe that we have that and that allows us to build the portfolio out in terms of the construction process, not from just a bottom up investment decision-making, but also how we layer in the names collectively against each other.

How do you define and manage risk?

The classic definition of risk is portfolio volatility relative to your benchmark. Taking that into consideration, I do not structure the portfolio from that classic standpoint against the benchmark because I want to outperform the benchmark through active weightings and through fundamental security selection.

There is the classic economic definition of risk, being the volatility of a portfolio relative to something, to its benchmark or its peer groups, but at the most basic level I have always felt that volatility ultimately should be taken to the fundamental level of the risk of a particular company that you own.

That can be measured in a lot of different ways, not just through the balance sheet. Stock prices go up and down, but a great company will invariably come back and go to a higher price as its value increases.

Volatility may capture price changes but it doesn't do a good job of capturing fundamentals.

Please see important disclosures on the following page.

TOCQUEVILLE

Thomas Vandeventer
Tocqueville Asset Management L.P.
June 2015

Disclosure: *This article reflects the views of the author as of the date or dates cited and may change at any time. The information should not be construed as investment advice. No representation is made concerning the accuracy of cited data, nor is there any guarantee that any projection, forecast or opinion will be realized.*

The Tocqueville Opportunity Fund may be offered only to persons in the United States and by way of a prospectus. This literature should not be considered a solicitation or offering of any investment products or services to investors residing outside of the United States. Please consider the investment objectives, risks, and charges and expenses of the Fund carefully before investing. The prospectus contains this and other information about the Fund. For more complete information on this Fund, including its charges and expenses, please obtain a free prospectus by downloading a copy from the Tocqueville website below, by contacting an authorized broker/dealer, or by calling 1-800-697-3863. Please read the prospectus carefully before you invest or send money. Past performance is no indication of future results.

There are special risks associated with investing in small and mid-cap stocks, including: small companies rely on limited product lines, financial resources and business activities that may make them more susceptible than larger companies to setbacks or downturns; and small and mid-cap stocks are less liquid and more thinly traded which make them more volatile than stocks or larger companies.

References to stocks, securities or investments should not be considered recommendations to buy or sell. Securities that are referenced may be held in portfolios managed by Tocqueville or by principals, employees and associates of Tocqueville, and such references should not be deemed as an understanding of any future position, buying or selling, that may be taken by Tocqueville. The Tocqueville Opportunity Fund is distributed by Tocqueville Securities, L.P.

The average annual total returns and top ten holdings for The Tocqueville Opportunity Fund ending June 30, 2015 are as follows:

Average Annual Rates of Return	
1 Year	23.16%
3 Year	21.82%
5 Year	20.78%
10 Year	9.26%
Expense Ratio	1.30%

Top Ten Holdings	
Bluebird Bio, Inc.	1.84%
Alnylam Pharmaceuticals, Inc.	1.76%
Manhattan Associates, Inc.	1.66%
Signature Bank	1.60%
Splunk, Inc.	1.47%
Palo Alto Networks, Inc.	1.38%
Pinnacle Financial Partners, Inc.	1.35%
Tableau Software, Inc.	1.30%
Bank of the Ozarks, Inc.	1.29%
Regeneron Pharmaceuticals, Inc.	1.27%
Total	**14.92%**

Past performance is no indication of future results*. Performance for periods before 10/12/10 is for The Tocqueville Small Cap Fund, which was renamed The Tocqueville Opportunity Fund on 10/12/10. The Tocqueville Small Cap Fund had different Portfolio Managers until 7/1/10 and different investment objectives and strategies until 10/12/10. Performance data quoted represents past performance and does not guarantee future results. 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 performance assumes reinvestment of capital gains and dividends and does not reflect the redemption fee. If deducted, the redemption fee would reduce the performance quoted.* ***Please note that effective July 1, 2015, the redemption fee for the Fund listed above has been eliminated.*** *Fund performance current to the most recent month-end may be lower or higher than the performance quoted and can be obtained by calling 1-800-697-3863 or visiting www.tocqueville.com/mutual-funds.*