



FundAlarm ANNEX

Know when to hold 'em, know when to fold 'em, know when to walk away, know when to run

Fund name: Nakoma Absolute Return (no ticker yet)

Objective: The fund seeks absolute returns with low volatility independent of equity market conditions. In particular, it attempts to provide protection when both stock and bond markets are declining through a long/short equity strategy. The fund may invest in bonds (though that's apt to be rare) and may invest up to 25% of its portfolio in foreign stocks traded through US exchanges.

Adviser: Nakoma Capital Management of Madison, Wisconsin. Nakoma is an SEC-registered investment advisor managing approximately \$70 million in separate accounts and hedge funds. One of its three hedge funds, Nakoma Partners, uses essentially the same investment strategy as does the mutual fund.

Manager: Dan Pickett and Mark Fedenia. Pickett is responsible for the daily operations of the fund. Mr. Pickett has been the Adviser's Chief Investment Officer since joining the Adviser in 2003. From 1997 - 2002, he served as Managing Director and Director of Research for Southridge Capital Management, a Connecticut hedge fund firm. From 1988 to 1997, he was Portfolio Manager and Director of Research at Columbus Circle Investors, a multibillion-dollar institutional money management firm. Mr. Fedenia has been Managing Director of the Adviser since joining it in 2003. He is also a tenured member of the Finance Department at the University of Wisconsin-Madison and, since 1986, Director of the Applied Security Analysis Program at the University. From 1998 to 2000, Mr. Fedenia was a portfolio manager for PFP Management Company LLC.

For the past six years, they have co-managed hedge funds which used the same investment discipline embodied in the Absolute Return fund. From 2000 to 2002, they ran the fund for Southridge Capital and, from 2003 to the present, they ran it as part of Nakoma Capital.

Inception: December, 2006.

Minimum investment: \$1,000 for regular accounts with or without an automatic investing plan. I don't believe they're set up to do IRAs yet.

Expense ratio: 2.39% after waivers, divided between annual operating expenses (capped at 1.99%) and an estimated 0.40% cost for shorting. The expenses are high, in part, because of the cost of shorting stocks. The first step

in shorting stocks is to borrow shares from a current owner but you owe that owner a fee, the return of his or her original shares, and repayment of any dividends the stocks may have paid while you held them short. The extent of those costs depend on the size of the fund's short position (their hedge fund has averaged about 40% short, though that number has varied a lot). As with funds such as Wintergreen, you're paying the management fee typical of a hedge fund and access strategies typical of hedge funds, without surrendering 20% of your profits as well.

Comments: I've liked living in the Midwest since I arrived here from Massachusetts in the mid-1980s. I was drawn, first, by the friendliness of the region. The people seemed to pay attention to each other, to care, to participate, to engage. With time, my simple-minded affection was supplemented by an appreciation for the often amazing, under-publicized achievements of some of the institutions here. By way of a simple illustration, there's Augustana. Who would have imagined a little college in the Midwest would be in the top ten, among all colleges and universities in America, in qualifying teams to the national debate championships? Or top five, among all colleges and universities, in the number of Academic All-American athletes? Or in the top 50 (out of perhaps 3000 schools) in the number of its students who go on to earn doctorates?

By way of a more complex illustration, there's ASAP—the Applied Securities Analysis Program at the University of Wisconsin. Never heard of ASAP? You're not alone: the program's success far outstrips its publicity. ASAP and its predecessor program has trained over 500 money managers, 80% of whom are now working on Wall Street. They include some of the investing world's best and brightest (Mr. Nygren at Oakmark, Mr. Nicholas of the Nicholas funds, Mr. Freiss at Brandywine, Mr. Sekelsky at Mosaic, Mr. Petersen at Fidelity Equity-Income, and several of the managers of Harvard's massive endowment). By all reports, the program is hands-on (they're responsible for over \$40 million in the university's endowment), supportive and enormously challenging.

All of which bears on Nakoma Absolute Return, a mutual fund modeled after a hedge fund. Both the mutual fund and the hedge fund draw deeply on ASAP's analytic tradition and human resources: the lead manager, Mr. Pickett, is a graduate of the program, teaches in it and serves on its strategic advisory board. His co-manager, Dr. Fedenia, has been the program's director since 1986. Likewise, Nakoma's analysts are all Wisconsin graduates and all experienced (hedge) fund managers.

After running this strategy through a hedge fund for the past six years, the folks at Nakoma have opted to make it publicly available. Their goal harkens back to the earliest days of hedge fund operations in the late 1940s: to make money consistently, regardless of the overall gyrations of the stock and bond

markets. They describe three processes which conspire to arrive at that outcome:

- Dynamic asset allocation, in which a number of quantitative indicators help them determine the market's overall direction and, hence, their level of equity exposure.
- Fundamental stock selection, which appears to be driven by their assessment of the extent of the mismatch between a stock's fundamentals and investor expectations of the stock.
- Risk management, which helps adjust the portfolio so that its risk profile helps match their view of the market. That might involve hedging specific positions, stop-loss orders, limiting maximum position sizes, shifting the portfolio's interest rate sensitivity, and so on.

The fund is designed to produce consistent, positive returns regardless of market condition and there's some evidence that it's capable of doing so. The fund is modeled after two hedge funds co-managed by Messrs. Pickett and Fedenia between 2000 and now. The first fund, Southridge Partners II, prospered during the 2000-2002 bear market: it returned 21% during a time when the S&P500 dropped 37%, it had less than half of the market's volatility and actually achieved a negative correlation (-7%) to the US stock market. The second fund, Nakoma Partners, has operated during the subsequent bull market: it returned 28% between the start of 2003 and the present, with less than half the market's volatility and a still-negligible correlation to the stock market.

It is possible to be misled by Nakoma Partner's total return record, which is available to Morningstar's premium members. The long term record for the fund is weak, which reflects the fact that it operates with an entirely different management team and investment strategy prior of Pickett and Fedenia's arrival in 2003. While they had the option of starting an entirely new fund to avoid being saddled with Nakoma's weak track record, but Mr. Pickett reports that move "didn't seem worth the expense and wouldn't have been fair to legacy investors with carry forward losses (shielding performance fees until they'd been earned back)."

At about 7% per year (presumably after fees), their absolute return strategy is clearly not a get-rich-quick scheme. It is, however, a remarkably powerful diversifier since it operates with essentially no correlation to the stock market. Combined with its low volatility and reasonably high tax-efficiency, the fund might well substitute for the bond component of a long-term investor's portfolio. Alternately, it might be a core holding for a reasonably conservative equity investor who is more interested in making money steadily, even in the face of a bear market, than in trying for triple digit returns.

Bottom line: Nakoma Absolute Return offers small investors a chance to access, almost exactly, the strategies and talents offered by a long/short equity hedge fund accessible only to the extremely wealthy. There's an interesting speculative question about whether investors will embrace the idea of a high probability of modest returns, in lieu of the wild ride typically offered by the stock market. Approached with eyes open, it seems to offer an extremely valuable tool in an increasingly uncertain market.

Company link: [Nakoma Funds](http://www.nakomafunds.com) (www.nakomafunds.com)

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<http://www.fundalarm.com/nakom01.htm>