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MUTUAL FUNDS

MUTUAL FUND PROFILE

# Stratton Squeezes Growth Out Of Value

## He Bets On Recovery

Overlaying macro view on economic direction helps long-term record

BY KEN HOOVER
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The name is Stratton Growth Fund. But the strategy is still value.

"Despite the name, we are really a multi-cap value manager," said James Stratton, 68, who runs the fund and the management company that bears his name. "Our whole firm is oriented to value."

What makes his $64 million growth fund[STRGX] different than his value fund is that Stratton not only ranks stocks as undervalued based on traditional measures such as P-E and price-to-cash flow ratios. He overlays another ranking based on earnings and price momentum.

He's trying to pick stocks that are not only undervalued, but are growing. Morningstar places the fund in the mid-cap value category.

The strategy has paid off handsomely for shareholders.

Last year, Stratton Growth posted a 23.56% return vs. 17.9% for mid-cap value funds tracked by Morningstar.

For the past three years, it averaged 9.51% a year vs. 2.35% for the S&P 500. It cranked out 12.35% during the past five years and 2.34% for the S&P.

Stratton's record is even more impressive over the long haul. An investor who put $10,000 into Stratton's fund on its first day of business, Sept. 30, 1972, would have $394,623 on Dec. 31, 2004. That's $77,784 more than the investor would have had if the money were invested in the S&P 500 with dividends reinvested.

Stratton ranks stocks against others in the same sector, hoping to sort out the best in each sector.

### Goes With The Flow

Then, he thinks ahead, looking for a macroeconomic trend likely to move stocks and overweights or underweights sectors accordingly.

"We look at what we think will happen to the economy, monetary policy or tax policy," Stratton said.

Starting last May, just before the Federal Reserve started raising interest rates, Stratton and his team positioned the fund on the assumption rates would be rising.

They dropped companies that benefit from low interest rates, such as lenders Washington Mutual[WM], Countrywide Financial[CFC] and bought into those that benefit from higher rates, such as credit card issuer Capital One Financial[COF].

"We sensed that coming out of the crash in tech stocks and the Sarbanes-Oxley Act, two things happened. First, corporate managements got very conservative in making statements and forecasting earnings, and second, analysts got very conservative."

Companies and the analysts who cover them have moved from extreme enthusiasm in the late 1990s to extreme caution today. The result is that earnings forecast are way too low.

"Take a company that's just reported a good quarter. They'll tell you the reasons they can't do it again, and then they do," he said.

A good example is the fund's top holding, Parker Hannifin[PH], a Cleveland-based maker of industrial products, such as valves.

The stock gapped up dramatically Oct. 19 after the company reported quarterly earnings of $1.11 a share vs. analysts' estimates of 83 cents, according to Thomson/First Call.

At the beginning of 2004, analysts were looking for '04 earnings of $2.86. Now they expect $4.66.

For '05, analysts were looking for $4.17 in early July, but now expect $5.43.

"Analysts underestimated the earnings power, and the company did nothing to discourage them," Stratton said. "I'm not saying it's deliberate deception. Somewhere along the line, companies have learned its better to set the bar too low and then exceed it rather than set it too high and not get over it."

Many of Stratton's top holdings are industrial stocks he purchased because he sees a continued economic recovery.

"The economy has been improving faster and to a greater extent than people have been giving it credit for," he said.

### A Few Favorites

Among them are Deere & Co.[DE], Caterpillar[CAT] and Rockwell Automation[ROK].

To take advantage of the improving economy, Stratton wants companies with operating leverage. He has overweighted energy, capital goods and basic materials.

Stratton is underweight in consumer staples, financials, utilities and telecom.

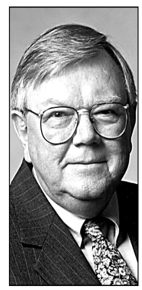
He sees the recovery continuing through '05 with the Fed raising interest rates a quarter point at every meeting until the fed funds rate gets to 3.5% from its current 2.25%.

Stratton has been in the securities business since 1960. He started his own company, Stratton Management in Plymouth Meeting, Pa. and his growth fund in 1972.

He also has a small-cap value and a REIT fund.

In all, he manages $1.6 billion, including money in institutional and high net worth accounts.

**Stratton Growth Fund**



- Manager (yrs.): James Stratton (32)
- Assets: $64 mil
- Ticker: STRGX
- Expenses: 1.28%
- Ph: (800) 634-5726

**Returns**
2004: 23.50%
3-yr. avg.: 9.51%
5-yr. avg.: 12.35%

| Top-rated holdings | EPS Rating | RS Rating | Acc/Dist Rating |
|---|---|---|---|
| D.R. Horton | 99 | 89 | B- |
| Valero Energy | 97 | 86 | C- |
| Lennar | 94 | 80 | C+ |

Stratton Growth Fund Inception Date: 9/30/72

| As of 12/31/2004 | 1 Year | 5 Year | 10 Year | 20 Year | 30 Year |
|---|---|---|---|---|---|
| Average Annual Total Returns | 25.53% | 13.18% | 14.91% | 12.97% | 14.27% |

**The performance data quoted represents past performance and does not guarantee future results. Total return calculations assume reinvestment of all dividends and capital gains distributions. Current Performance may be lower or higher than the performance data quoted. For performance data current to the most recent month-end, please visit our web site at www.strattonfunds.com. Investment return and principal value will fluctuate so that an investor's shares, upon redemption may be worth more or less than their original cost.**

As of 12/31/2004, the positions in the securities referenced in the article were as follows: Washington Mutual (0.00%), Countrywide Financial (1.00%), Capital One Financial (1.91%), Deere & Co. (3.37%), Caterpillar (3.10%), and Rockwell Automation (2.92%).

As the Fund is actively managed, the securities as presented do not represent the current or future composition of the portfolio. The securities referenced in this article do not constitute investment advice and is not intended as a recommendation to buy or sell any security. Investors should consult their investment professional regarding their individual investment program. Since the date of the article, economic factors, market conditions and the portfolio manager's views of the prospects of any particular investment may have changed.

Past performance is not indicative of future results.

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