

SHAKER INVESTMENTS

A RESEARCH-DRIVEN GROWTH APPROACH TO EQUITY PORTFOLIO MANAGEMENT

Volume 3 Issue 2



Note From Edward Hemmelgarn

To-date, 2002 has been a difficult and frustrating market environment, especially for growth investors. The Dow Jones Industrial Average, Nasdaq and S&P 500 have frequently been battered in unison, despite extensive economic data that shows sequential improvements in industrial production and corporate earnings.

In times like these, portfolio managers may be tempted to alter their investment approach. It is a temptation that must be resisted if it is a successful long term approach. Investors accept that markets are inherently unpredictable. However, they have a right to expect a money manager's investment process to remain consistent. This is especially the case if that process has proven its ability over the course of many years to deliver superior investment results.

Even the most disciplined and successful process will experience rough seas in a market as irrational and emotional as the one we've been faced with for more than two years. In addition to the usual investor concerns such as interest rates, earnings and consumer confidence, the market has focused nervously on serious questions regarding the accounting integrity of major companies, the Indian-Pakistani hostilities and the prospect of further terrorism in the U.S. and abroad. These are reasons for concern. However, it can be argued that investors have paid too little attention to the good news, including historically low inventory levels that no longer need to be cut, thus insuring production increases even if consumption remains flat, and the slow but sure improvement in earnings reports. Furthermore, productivity numbers are up, inflation does not appear to be an issue, and the weaker U.S. dollar should help to spur exports.

During this long market downturn, we have tried to identify and invest in those companies that are the leaders in areas that should grow much faster than the economy over the next five years. So far the stock market has been skeptical of future growth. But, as this growth becomes more apparent over the next 6-12 months, I expect that investors will respond to the improving fundamental results. ■



Manufacturing is Gaining Momentum George Raguz, Research Associate

Although U.S. manufacturing in 2001 experienced its worst percentage decline since 1982, production is now poised to rebound.

In mid-2000, consumer demand began to slow while production continued to grow. This mismatch quickly resulted in a build-up in inventories. By 2001, production decreased as companies scrambled to work off existing inventories. Indeed, production declined so dramatically that it created the largest inventory liquidation in memory. Capacity utilization data followed a similar pattern, falling to a 20-year low in late 2001.

Although consumer demand has continued to grow, industry production and capacity utilization has only recently begun to rebound. Given the current inconsistency between production and consumption, this rebound in manufacturing must continue in order to meet current demand, even if consumption remains flat.

Currently, the Specialty Chemicals industry offers attractive opportunities for investors who seek to capitalize on the impending rebound in manufacturing activity. This industry serves a broad range of customers with very different end markets, and its products are only moderately dependent on commodity price fluctuations. Shaker Investments is focusing on companies that exhibit sustainable competitive advantages and offer both organic and cyclical growth.

RPM, Inc., a leading consumer and industrial specialty coatings company, currently exemplifies these qualities. Rust-Oleum and Bondo are two examples of its household-name brands. These strong brands make RPM less susceptible to fluctuations in commodity prices, and enable the company to maintain market share better than its commodity-based competitors. In 2000, complications from an internal restructuring and overall weak economic conditions forced RPM to report its first decline in earnings in over 50 years of operations. The company has since beaten estimates each of the last 3 quarters, and we expect RPM to continue this trend of under promising and over performing.

PolyOne Corporation's story, while from the same tree as RPM, is cut from a different branch. PolyOne sells hundreds of value-added commodities and branded products to dozens of end markets. PolyOne's cost advantages and broad, global customer base reduces its economic sensitivity, and the company enjoys strong operational leverage. Born from the merger of Hanna Corporation (a public company) with Geon Corporation (a spin off from Goodrich), PolyOne is undergoing a massive restructuring to consolidate and improve its operations. The company is well positioned to benefit from the expected rebound in industrial production. Expanded margins and growing volumes will provide it with considerable earnings momentum in the next upturn.

(Continued on back page)

PORTFOLIO AT-A-GLANCE

As of May 31, 2002

TOP 10 HOLDINGS

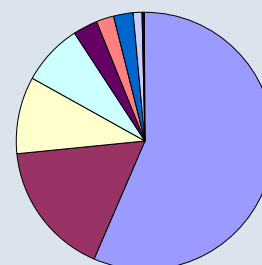
Brocade Communications
Eclipsys Corp.
Getty Images, Inc.
HNC Software
International Rectifier
Invitrogen Corp.
Microchip Technology
Retek Inc.
Royal Caribbean Cruises
Xilinx Inc.

AVERAGE PORTFOLIO CHARACTERISTICS

Number of Holdings	46
Wtd Forward P/E	30X
Wtd Sustainable Growth Rate	37%
Median Market Cap	\$1.6 bil
Price/Tangible Book Value	7.1

SECTOR WEIGHTINGS*

Technology	56.3%
Consumer Discret	17.1%
Health Care	9.7%
Financial Services	7.6%
Materials & Process	3.2%
Other Energy	2.3%
Utilities	2.3%
Auto & Transport	1.1%
Producer Durables	0.4%



*based on sector definitions by Frank Russell Co.

* The Technology sector as defined by the Frank Russell Company includes companies that produce semiconductors, networks and software for the telecommunications industry, semiconductors for industrial and consumer applications, as well as general software and computer services. Approximately a third of Shaker's technology investments are committed to semiconductors for industrial and consumer applications. Two thirds are in classic technology/capital equipment areas.



Executive Insights

W. David Wilson, CFO
PolyOne [NYSE:POL]

Q: *As the world's largest polymer services company, does PolyOne's size provide customers with any advantages?*

A: Our size enables us to bring to the marketplace an unmatched breadth of products and services. For the customer, the real advantage isn't simply a matter of magnitude, but our ability to offer unbiased solutions. With our access to such a broad palette of products, we don't need to favor one polymer over another to respond with an optimal solution to a customer's need. That provides us with a distinct advantage over suppliers who are compelled to fashion a solution from a limited product line.

Q: *Does PolyOne have any competitors of the same approximate size and scope?*

A: No single competitor approaches us in terms of breadth, but we have strong competition across our entire product spectrum from smaller companies as well as the divisions of some extremely large companies.

Q: *Considering the variety of PolyOne's products and markets, how does the company keep its focus?*

A: We achieve focus by dividing a complex company into its essential component parts. PolyOne is organized around six general managers, each of whom has a complete business team and the support of IT, Financing, HR and other functional resources. However, it's more than just a matter of creating the right organizational structure. We also pay considerable attention to ensuring that all of the businesses have clearly defined and measurable objectives, and that the right individuals and teams are assigned to meet these objectives.

Q: *In which operating units does PolyOne expect to see its greatest growth in the next three years?*

A: We expect the engineered materials and color portions of the Plastic Compounds and Colors unit to grow 1 ½ to 2 times the industry average in that time period, with the greatest gains in Europe and Asia. Another promising growth area is the Formulator unit, which custom-formulates and manufactures PVC and polyurethane liquid system products. Unlike the Plastic Compounds and Colors unit, the Formulator unit will see most of its growth in North America.

Q: *Are acquisitions included in PolyOne's growth plans?*

A: Especially in Asia and Europe, PolyOne intends to use acquisitions to supplement organic growth. We look for acquisition candidates that can readily fit into existing businesses and help augment our businesses by providing technology that fills an existing product gap or improves our service capability. At this time we're less interested in acquisitions in the U.S., but will consider attractive, strategic opportunities.

Q: *How important are PolyOne's customized products to the business, in contrast to off-the-shelf products?*

A: There are at least three reasons why customized products are very important to PolyOne. First, they help to differentiate us from the competition. Second, the customization process tends to result in stronger ties to our customer base. Third, customization is key to keeping our overall product portfolio ahead of the curve, because today's specialized product often becomes a general-purpose product within two to three years.

Q: *How does PolyOne sell its immensely varied product line? Does each product line or operating unit have its own, dedicated sales force?*

A: Today, each business has a dedicated sales force. One of our challenges is to train these separate sales teams to utilize our key competitive advantage, which is the ability to deliver unbiased solutions from a comprehensive product palette. This is not a minor initiative. We recognize that our goal will require extensive product and solution training as well as substantial technical support.

Q: *In the years ahead, will the percentage of resources devoted to PolyOne's research and development efforts grow?*

A: PolyOne plans to more than double its core research capabilities in the next five years, and will likely add \$20 million to \$30 million to the R&D budget. Product innovation is a major driver of our company, and it's an area we have to invest in if we wish to remain among the industry's innovation leaders.

Q: *What are PolyOne's biggest challenges in the years ahead?*

A: We have already discussed two of them – training the sales force and product innovation. Our third major challenge is to continually refine our product segmentation, in order to ensure that PolyOne's strengths and value propositions match up to our customers' needs.

Q: *Does PolyOne experience any difficulties finding qualified engineers and other specialists?*

A: That isn't a problem for us. PolyOne is an attractive company to work for, as demonstrated by our high retention rate. Young engineers appreciate that we represent a growth opportunity. We also are fortunate to have two of the top six polymer programs right in our own backyard, at Case Western Reserve and Akron University. We make a point of maintaining excellent relations with both institutions. ☒

(Continued from front page)

RPM and PolyOne have spent the last two years repositioning themselves to exploit their respective strengths. With the economic recovery still in question, operational execution becomes even more critical. Both RPM and PolyOne are prepared to outperform the competition in any economic environment. ☒



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