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THE WALL STREET
TRANSCRIPT
Questioning Market Leaders For Long Term Investors

Investing with Multiple Strategies

EARL V. NEWSOME JR. is Managing Director and co-owner of Cambridge Financial Group, Inc. As a registered investment advisor, CFG was founded as a consultant to institutional investors. Services were expanded to include discretionary asset management in late 1991. Prior to founding the firm, Mr. Newsome was a Vice President – Investment Consultant for Renaissance Investment Management, Inc., from 1987 to 1991. From 1986 to 1987 he was a Vice President – Marketing for Legg Mason Capital Management. Mr. Newsome managed individual client portfolios as an Account Executive for E.F. Hutton, Inc., from 1983 to 1986 and was an Account Executive for Merck & Company from 1978 to 1983. He earned a BA degree at Gettysburg College in 1978.

TWST: Would you please start with an overview of Cambridge Financial Group?

Mr. Newsome: We're a discretionary asset management firm based in Ohio, with offices in Columbus and Cincinnati. Cambridge was founded in 1986 as a consulting firm by my partner, Greg Bauer. I purchased half of the firm in October 1991 with the idea of pursuing future business on a discretionary asset management basis only, and did so beginning on January 1, 1992. We started with about $8 million under management and ended this past year with just over $1 billion under management. The profile and the history of the firm have obviously not changed since the last time we spoke.

TWST: What was 2006 like for your type of investing? What is the outlook for 2007?

Mr. Newsome: It started out with a bang with an excellent first quarter. In the second quarter, we came back to earth a little bit, but we were still ahead of our benchmark, the S&P 500. More specifically, the last two quarters for our particular investment style were rather difficult. We invest solely in S&P 500 stocks. A predominant portion of the portfolio is based on 12-month price momentum, and in July, the market really started to grope for leadership, as stocks would break out and then fall back to the pack rather than just continue to run as they usually do. The market was looking for leadership, and it still has not been found. The final two quarters of 2006, especially the third quarter, were rather difficult for us. In the fourth quarter, we were pretty much even with the S&P. I think the S&P with the dividend was up 6.7% or 6.8%, and we were up 5.7%. So we have no complaints there, but in the third quarter, our particular discipline was definitely out of sync.

The bottom line is that by the end of the year, we trailed the S&P 500 total return by about 500 basis points. It was a difficult year for growth managers in general, and we were no exception. The S&P recently published a report that stated the S&P 500 Index outperformed almost 70% of all large cap growth managers, so we were not alone.

As we go into 2007, we're seeing a shift. More of the large cap growth stocks are coming back into favor, and if that persists and the market gets back into sync in doing what it usually does, stocks will break out and accelerate to the upside. That momentum tends to continue for quite a while and should bring us back into step with the market.

It's not the first time that this particular phenomenon has occurred in our history. If you examine our quarterly returns as far back as 1996, 1997 or 1998, we've had two or three quarters at a time where we've gotten out of sync with the market. After a certain period of time, the market will adjust and we'll get back into sync. The key is that we're long-term investors. If you can stick with the discipline and ride through some of those periods of time when you're not in step with the market, the three-, five-, seven- and 10-year numbers will speak for themselves.

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TWST: Is that helped by your barbell approach of growth and value that allows you to change according to the different markets?

Mr. Newsome: We don't change, but the three components tend to perform independently, and your observation is exactly right. In the fourth quarter of 2006, the 10 value stocks that we hold in our portfolios were up almost 10%. So when you get into a market where growth or price momentum isn't working, theoretically that's when the barbell approach is supposed to work. The value approach should tip up and be in favor, and that is exactly what happened.

In fact, we had five names in the portfolio that were no longer value stocks by the end of the year when we took our value composite snapshot, so they were sold. In other words, they performed so well that their p/e ratios and dividend yields were such that they no longer qualified as value stocks. The value end of the portfolio toward the second half of the year actually was the best performing component in our portfolios.

TWST: You use multiple strategies in your investment approach. Would you describe some of those strategies that you utilize?

Mr. Newsome: As mentioned, we use the barbell approach. The first thing we do is rank every stock in the S&P 500 based on 12-month price momentum. Price momentum as we define it is the percentage change in price of a stock in the S&P 500 over the past year. In other words, the stock that has appreciated the greatest amount in terms of price over the last 12 months is ranked first, the second greatest amount is ranked second, and so forth down the list. The whole theory is based on physics. A body in motion tends to stay in motion; in this case, when momentum is in place, it tends to persist for quite a while.

The first leg of the stool is to buy 10 stocks from the S&P 500 based on 12-month price momentum. The second thing we do is slide down the investment spectrum. We have a proprietary universe of stocks that we call the Cambridge Financial Group Industrials. In our literature or on our Website (cfginc.net), you will see this universe referred to as the CFGI. Basically, it's a 100-stock subset of the S&P 500, and it's very similar to the S&P 100. They are 100 of the largest stocks in the S&P 500, and we diversify based on industry and sector weightings.

The rationale for the second universe of stocks is that collectively they have a much more palatable risk profile than the S&P 500 — lower standard deviation, lower beta and less volatility. What we do next is overlay the exact same algorithm as we did with the first leg of the stool. Again, we look at 12-month price momentum. The stock in that universe that appreciated the greatest amount over the past year would be ranked first, the second greatest amount ranked second, and all the way down to 100. Then we buy 10 stocks from that list.

The last thing we do is go all the way to the other end of the investment spectrum using that same second proprietary universe of stocks, or CFGI. We again rank from top to bottom, but this time based on value criteria. We use very pedestrian, very vanilla value criteria. We look at things like dividend yield. With that 100-stock list, we'll rank from the highest yielding stock to the lowest yielding stock. Every stock gets a score based on that parameter. We look at p/e ratios, and rank from lowest to highest. We look at things like price to sales and price to revenues, with every stock getting a score. We make sure the direction of earnings for the next 12 months is positive and then go to the right hand side of the page and come up with a value composite score for each stock. We buy 10 stocks from that list.

When fully invested, which we are most of the time — right now, we actually own 28 names instead of 30 — CFG owns 10 from the S&P 500 based on price momentum, 10 from the CFGI based on price momentum, and 10 from the CFGI based on value criteria.

TWST: So you generally have 30 stocks in your portfolio.

Mr. Newsome: Most of the time we will have 30 stocks in the portfolio. As I mentioned, we currently have 28 names — nine on the S&P momentum list, nine on the CFGI momentum list, and 10 on the value list. There are only nine in each of the first two because the stock that was at the very top of each list was so stretched out that when we adjusted our trading this month, my partner decided it was probably not the best time to buy those names. We attempt to get them at a cheaper price with the possibility of a pullback. So we have an eye on being fully invested, but right now, the top-ranked stocks are just too far ahead of themselves in the momentum lists. Therefore, we currently have 28.

TWST: Has the portfolio shifted in emphasis from last year? Last year, you were turning toward energy and technology stocks.

Mr. Newsome: I sure would hope so. We have no energy exposure now, the reason being that price momentum turned against those stocks. We had **Halliburton** (HAL), **Valero Energy** (VLO) and **Baker Hughes** (BHI). They still have price momentum, but it is negative. When price momentum reverses, we exit those stocks.

So the answer to your question is that what we're seeing flow back into the portfolios now tends to be a lot of the technology stocks. We hadn't seen much of a technology exposure since the late 1990s and early 2000, and now we're seeing a lot of those themes show up once again. We own stocks like **BMC Software** (BMC), **DIRECTV** (DTV) and **AT&T** (T). In our middle list, we've got **Comcast** (CMCSA), **Hewlett-Packard** (HPQ), **Oracle** (ORCL) and **Cisco Systems** (CSCO), which just entered the portfolio. An area that hadn't emerged as a leader — in fact, it went completely the other way after the start of 2000 — is now starting to flow back to the top of the list.

TWST: You mentioned you were looking at technology last year too.

Mr. Newsome: That phenomenon started to occur last year, but it's really picking up some steam now. So where nobody wanted to touch those stocks for several years, now all of a sudden they're being bid up. **IBM** (IBM) is also a stock that's in there; we hadn't owned **IBM** for a long time.

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1-Year Daily Chart of Cisco Systems

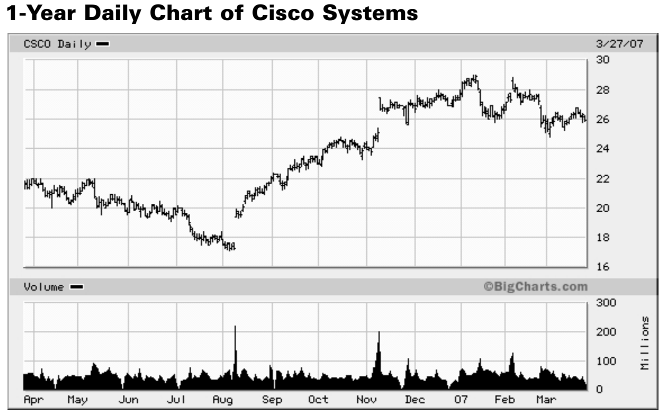

Chart provided by www.BigCharts.com

TWST: Since they're all coming from the same pool, are any of these companies in two of your baskets?

Mr. Newsome: We haven't had a double weighting in quite a while, but if you're drawing stocks from that same universe for all three components, there is a very good chance of a name showing up twice. We've had many double weightings in our history; right now we don't have any. If you think about it, theoretically you could possibly have a triple weighting since they're all coming from the same pool. For that to happen, a stock would have to start as a value stock, the market would recognize that value, start to buy, bid it up, and then it would show up on the other momentum screens. If that happened, we would triple weight. It has never happened in our history, and this work goes all the way back to the 1970s, but there have been several double weightings along the way — none in recent history, but it can and will happen again.

We have 30 stocks in a typical portfolio. We equal dollar weight with each holding. When we rebalance at the beginning of the quarter, every stock will make up 3.3% of the overall portfolio. If a name shows up twice, we simply will double weight, and it will be 6.6%.

TWST: Would you give us some examples of the different types of stocks that you have in your portfolio and the reasons why they're in that particular sector?

Mr. Newsome: In the S&P momentum list, every stock is in there for the exact same reason. It's not because we are making a play in a certain sector or a certain industry — it's because when we run our rankings and something fails, the next highest ranked name not already owned comes into the portfolio based on 12-month price momentum. The S&P momentum list, which tends to be the most volatile and aggressive list, also tends to be the best performer of the three components over time. **AT&T**, **Big Lots** (BIG), **BMC Software**, **CSX Corp.** (CSX), **DIRECTV**, **Kohl's** (KSS), **Monsanto** (MON), **Pactiv Corp.** (PTV) and **Terex** (TEX) are in there now. So there are nine names, and the other 3.3% that would typically go into that S&P momentum component is sitting in cash equivalents waiting to be put to work.

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When you move over to the CFGI momentum list, **Allegheny Technologies** (ATI), which has just been a stellar performer for us, continues to do what we want it to do. We just trim it back at the beginning of every quarter and bring it back to 3.3%, but I think that stock was up about 45% in the fourth quarter. It has been a great performer for a long time. **Boeing** (BA), **Cisco Systems**, **Comcast**, **General Motors** (GM), **Goldman Sachs** (GS), **Hewlett-Packard**, **OfficeMax** (OMX) and **Oracle** all went into the portfolio for the same reason when we ranked the CFGI momentum list from 1 to 100. When something would fail, we'd go back to the top of the list and purchase the next highest ranked name not already owned. It's a very simple, straightforward process.

On the value side, we own **Archer Daniels** (ADM), **Caterpillar** (CAT), **Emerson Electric** (EMR), **IBM**, **General Electric** (GE), **Lehman Brothers** (LEH), **Pfizer** (PFE), **R.R. Donnelley** (RRD) and **Wal-Mart** (WMT). I think you will notice that the capitalization in our portfolio is shifting as well. We have had some significant exposure to mid-cap stocks recently because there are plenty of mid-cap stocks in the S&P 500. Now we're seeing a shift back toward the larger cap stocks and even the mega cap stocks. We define the large cap stocks as $10 to $40 billion in capitalization. Anything in excess of $40 billion would be considered a mega cap stock, and right now, that is where the price momentum is showing up — in these larger names. That hasn't been the case for a long time.

1-Year Daily Chart of BMC Software

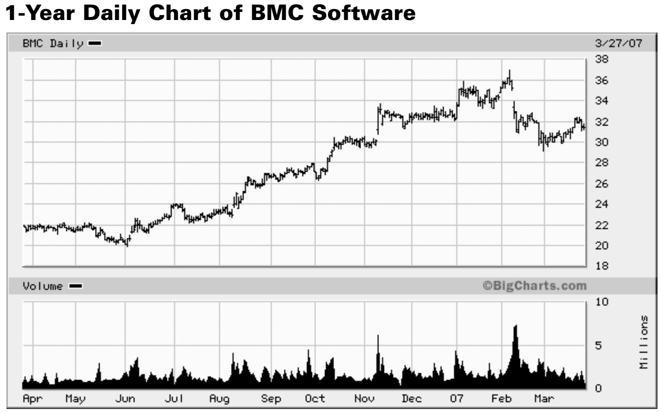

Chart provided by www.BigCharts.com

TWST: You are really buying the stocks, not the companies.

Mr. Newsome: No question, and the same is true on the sell side. When we're selling something, we're selling the stock — we're not selling the company. It's not any indictment of the company at all. It still may be a very good company, but at that point of time, the opportunity in their stock is not the best place to be. We may come back and buy that stock again at some point in the future.

TWST: What stocks have been surfacing in recent weeks or months that have gained your attention?

Mr. Newsome: The new ones are in there. We bought the ones that surfaced and got our attention. As I mentioned, we own 28 names right now. **Big Lots** just came in as a momentum stock. **BMC** just came in as a momentum stock, as did **PTV** and **TEX**. In the CFGI list, **Cisco Systems** just showed up as a momentum stock. Because the value component had performed so well in the third and fourth quarter of last year, when we ran the value composite snapshot at the end of the year, several of those stocks weren't value stocks anymore. Therefore, they were sold. The names that replaced those as value stocks were **Archer Daniels**, **Emerson Electric**, **GE**, **Lehman Brothers**, **Pfizer** and **Wal-Mart**.

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TWST: You just mentioned your sell process. Is that the same process for each of the three relative rankings?

Mr. Newsome: The momentum portfolios are adjusted quarterly. In the case of the S&P 500, we take our snapshot at the end of each calendar quarter. Most recently, we did this as of the last day of business in December. If a name has fallen below the midway point of that universe (below number 250) based on relative 12-month price momentum, that is our indication that the one phenomenon we're looking for, price momentum, no longer exists. We will sell the stock, go back to the top of the list and buy the next highest ranked name not already owned.

The second universe obviously is the 100-stock CFGI list. In this case, we employ the same methodology. If the name falls to below the midway point (number 51) based on relative 12-month price momentum, we sell it and go back to the top of the list and buy the next highest ranked name not already owned.

The sell discipline for the value component works very differently. We will buy those stocks in January of every year. That whole philosophy of value is that we're buying discounted merchandise, spending 50 cents for a dollar's worth of merchandise, but it might take some time for the marketplace to recognize this and bid it up to its fair value. So we will give the value stocks more time to work. We will hold those names for an entire year and do the entire re-ranking as of the close of business the following December. We then implement any changes in January. Based on our value composite, if a name falls out of the top 10, it's sold and we proceed back to the top of the list. So five of the 10 names at that end of the investment spectrum as of the close of business in 2006 had fallen to number 11 or below, based on value ranking. This is why there was higher than usual turnover in that end of the portfolio at the beginning of this year — because we implement it in the subsequent quarter.

1-Year Daily Chart of Big Lots

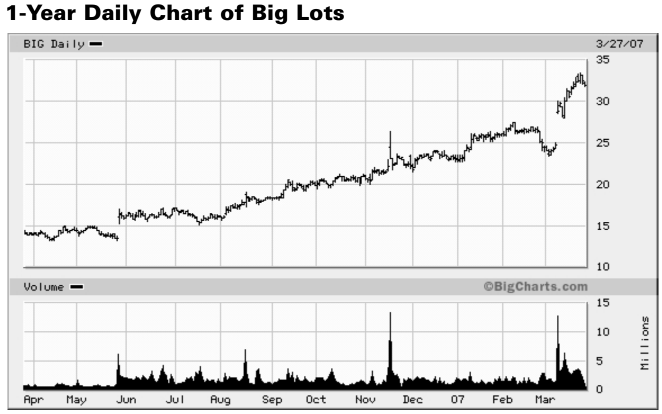

Chart provided by www.BigCharts.com

TWST: How do you attempt to control risk in a portfolio?

Mr. Newsome: There are a couple of ways we attempt to control risk. The first is simply through diversification. We are buying 30 names as opposed to 10 or 15, which spreads our risk. We're also employing multiple strategies. We're using a fairly aggressive momentum strategy, coupled with a less aggressive growth strategy from the CFGI momentum list. We add the value side, which has a low correlation to relative strength or price momentum. When the growth sectors fall out of favor as they did at the end of last year, the value discipline or philosophy is there to act as a counterweight or barbell.

We also use cash. We are currently about 8% in cash and were ahead of the market in January. This is a relatively large cash component for us.

TWST: If the market tends to underperform, you will raise cash.

Mr. Newsome: Yes, we will, but it has been a long time since we've ever gone to any extreme. If the market really turns against us and our market indicators go negative, we will actually sell the entire S&P momentum list. We can go to as much as 33% cash. I don't like to talk much about that because it hasn't happened in a long time — 1997 and 1998 was the last time it happened. In between, we've been anywhere from 1% or 2% cash, up to as high as 15% cash if the environment dictated it.

TWST: Would you give us a profile of your typical investor?

Mr. Newsome: There isn't one. Somebody who wants to accomplish multiple goals with one account is the type of client that comes to us. Specifically, our clients can be individuals, a relatively large endowment or a company's pension plan. The profile really is spread across the board. There is no typical profile. We tend to be a good core strategy for somebody who doesn't have millions of dollars to hire 10 or 15 managers. If the client can only hire a couple of managers, we're a good fit because we're buying some value, some aggressive growth and some less aggressive growth, with the ability to utilize cash as a tool.

TWST: What is your tax management philosophy? Is tax efficiency an important consideration?

Mr. Newsome: We don't like to pay taxes any more than anyone else, but we're investing for investment reasons. We will minimize taxes as much as we possibly can. We will offset a gain with a loss where possible. We will defer a short-term gain to a long-term gain, but I would not hold us out as a tax efficient manager. My partner says that he hopes all of our taxable clients pay some taxes. One way to pay no taxes is to make no money. So you will pay taxes when investing with us. We do not manage these portfolios based on tax reasons — it's all based on investment reasons.

"What we've seen historically, though, is that when there is no leadership, it tends to correct itself in a relatively short period of time — usually two to three quarters — and then new leaders will emerge, even in a flat market. As long as you possess a methodology that can pick those up, you can add some relative value."

TWST: That shows a lot of flexibility in your investment process.

Mr. Newsome: We have a strategy for all seasons. Our particular discipline tends to perform well over a variety of market environments. If you are purely a large cap growth manager, the last six or seven years have been tough. Just look at the Index; the five-year return on the S&P 500 is 6.2%, which is a less than stellar return. If you look at historical norms, which are 11% to 12% for the market, the S&P 500 is performing at about half that rate. Large cap growth has been dramatically out of favor for six or seven years.

We believe that is going to change; it invariably does. Value was so out of favor at the end of the 1990s that a lot of people were throwing in the towel and hired growth managers. They were doing this at absolutely the wrong time, because when the market hit the skids in 2000, 2001 and 2002, value stocks were the best place to be and have been for a while now.

TWST: What is it that distinguishes or differentiates this multi-strategy approach of yours from that at other firms? What do you bring to the table that others might not?

Mr. Newsome: Most managers tend to be a growth manager of large caps, small caps or mid-caps, or a value manager of large caps, small caps or mid-caps. We have a couple of strategies employed in the same portfolio. We're utilizing philosophies that have a low correlation to one another. We're not going out on a limb with one pure strategy alone where, if it's out of favor — as large cap growth has been — you can be out of favor for long periods of time.

So by utilizing a couple of strategies plus cash, it makes us a bit unique in this business. That's probably the biggest factor that sets us apart from most managers. If you're living and dying with small cap value, for instance, which has been a great performer, you should realize that this strategy might have had its day. It will come back in favor again, but it has been in such good favor over the last several years that invariably, the cycle will shift. We insulate ourselves from being way out of favor at any one period of time.

TWST: Are there any possible problem areas or challenges to your type of investing?

Mr. Newsome: Sure. Let's say the S&P in general goes down. If you're only buying S&P 500 stocks, you're probably going to go down as well. If leadership doesn't evolve in this universe of stocks, we could be out of sync for a while. What we've seen historically, though, is that when there is no leadership, it tends to correct itself in a relatively short period of time — usually two to three quarters — and then new leaders will emerge, even in a flat market.

As long as you possess a methodology that can pick those up, you can add some relative value. Right now, that's not happening. Most of the money in the last two quarters of last year flowed into large cap safe havens. There really has been nothing breaking away from the pack. As long as that's the case, we'll struggle to keep pace with the S&P 500. Historically though, that usually fixes itself within a relatively short period of time.

TWST: What advice would you give to people about coming into the market? Can they still make money in this current market?

Mr. Newsome: I think people can and are. The indices had double-digit returns last year, and that was an excellent time. There is always opportunity. The trick is finding a well thought-out investment discipline that has been proven over time, and make sure it's with a good solid money manager. Just stick with the game plan.

The whole key is discipline. Too many people invest and then run if it doesn't work for a couple of quarters. That's when they shoot themselves in the foot. If you invest with the right time horizon and the right tolerance for risk and commit for three to five years with a solid discipline over a market cycle, you will like the results. Don't look at one quarter, don't look at one year and don't even really look at three years. Look at five, seven or 10 years because that's what you're really investing for — the long term.

There were some great managers out there in the past year that fell on their swords. Some have been phenomenal over the years but really struggled last year for the first time in a long time. Does that mean the manager became stupid all of a sudden? I don't think so.

TWST: Is there anything that you would like to add?

Mr. Newsome: I would just recommend to anyone, whether they choose us or someone else, to make sure they're buying a solid, well thought-out sensible investment discipline that you're going to commit to and stick with over time. Give the manager a chance to go through some volatility or even be out of favor for periods of time. Use the time horizon of five or seven years, but stick with the discipline. It's a game plan; all you're buying with any money manager is a game plan. As long as that manager sticks to that well thought-out game plan, you should be okay at the end of the day.

TWST: Thank you.

Note: Opinions and recommendations are as of 3/26/07.

EARL V. NEWSOME JR.
Cambridge Financial Group, Inc.
8280 Montgomery Road
Suite 302
Cincinnati, OH 45236
(513) 794-0032