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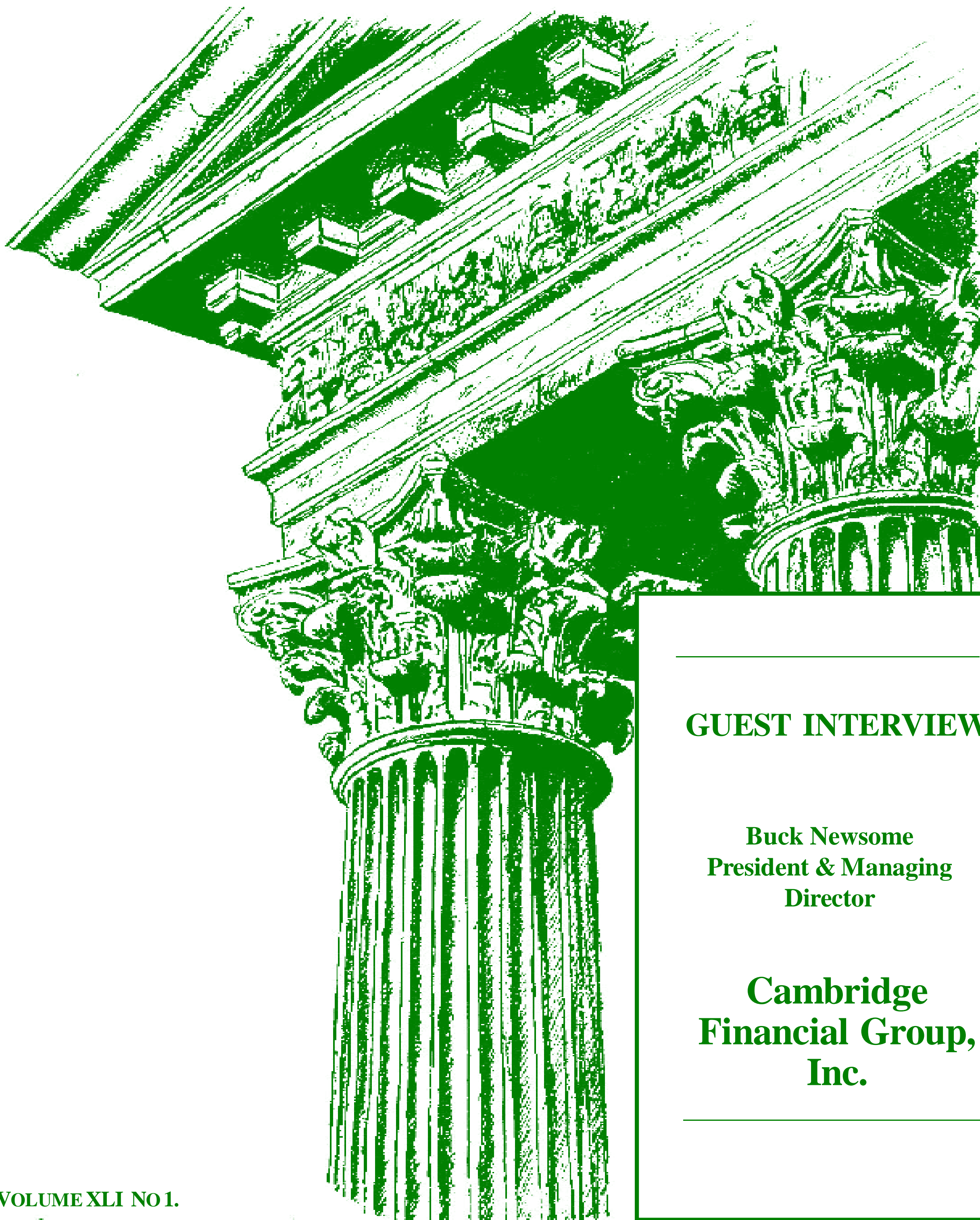
A Guide To The Nation's Leading Investment Managers



GUEST INTERVIEW

Buck Newsome
President & Managing Director

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VOLUME XLI NO 1.

Guest Interview:

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Buck Newsome
President & Managing Director

Q : Money Manager Review last interviewed Cambridge Financial Group in our Summer issue of 2004. Much has changed in the investment world since then. How has your firm changed while navigating these turbulent times?

Plenty of water has passed under the bridge since we last spoke in the summer of 2004. Since then, we've all grown a bit older and hopefully much wiser in the process. More than anything else, Wall Street has experienced the most significant change over the past six years versus any dramatic changes in the way we conduct business at our firm. Despite dramatic changes in the marketplace, our firm has proven nimble and resilient as we've negotiated the various and ever changing headwinds in the investment world on our way to where we are today. Fundamentally, Cambridge Financial Group is the same firm today that we were when we did the original interview with Money Manager Review nearly six years ago in 2004. We manage money the same way, we essentially employ the same people, and we've grown our assets under management as well as our distribution channels, albeit in a circuitous fashion as market conditions would allow. Much of our continued success, despite the volatile markets, can be directly attributed to an unwavering adherence to our time tested investment discipline.

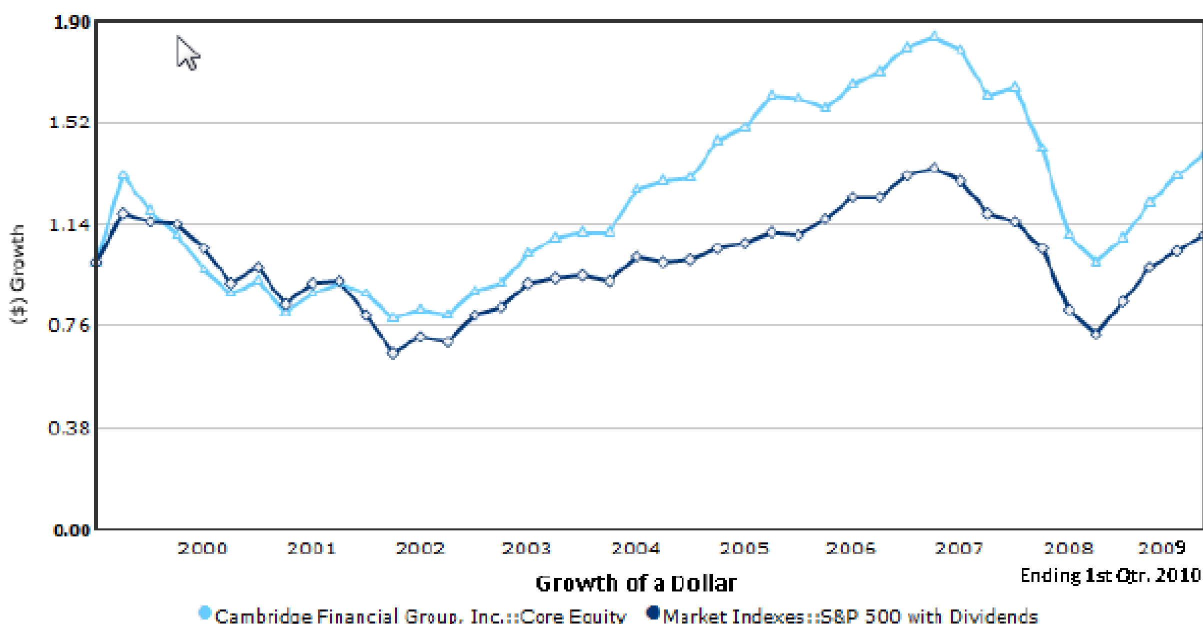
As a matter of review, in the summer of 2004, Cambridge Financial Group managed approximately $300,000,000 with around 1000 accounts. The investment world was still reeling from the harsh bear market suffered at the hands of the bursting of the technology bubble. Although the markets continued their ascent off the 2002 bottoms, uncertainty and fear continued to prevail. The Federal Reserve raised its target for short-term interest rates to 1.25% from 1% on the last day of the second quarter in 2004 initiating the climb back from a historic period of cheap money. This was the first time the Fed had raised the funds rate since May 2000 when it hit 6.5%. Over the subsequent three years the rate was cut 13 consecutive times to 1% - the lowest level in over 45 years. The good news was that after six of the previous ten rate-tightening cycles since 1950, stocks had posted double-digit gains in the next 12-months following the initial rate jump. Investors had reason to be optimistic.

By the fourth quarter of 2004, the DJIA was within striking distance of matching the all-time high of 11,722.98 it posted on January 14, 2000, a mere 27 months after setting a bear market low of 7286. Heading into 2005 this proved to be a major psychological boost to investors who had suffered through the most severe bear market since 1929. Simply put, the market had proven to be incredibly resilient at one of the most difficult junctures in our nation's recent history.

Q : Did Cambridge participate in the rally off the 2002 bottom?

Yes we did. As our Core Equity discipline gained traction off the bear market bottom, Cambridge Financial Group outperformed the S&P 500 by significant margin in 2004, 23.5% vs. 10.8%. As a result, our firm continued to expand distribution channels and grow assets finishing 2004 with approximately $400,000,000 under management in 1150 accounts. We entered 2005 with the stock market having posted consecutive yearly gains for the first time since 1999. The question on most investors' minds was whether the market could sustain its positive performance for a third straight year. In fact it could and did right up until the market peaked on October 7, 2007. The firm benefitted greatly from the favorable market environment over this time frame growing assets to over $1.3 billion in 3900 accounts by the conclusion of 2007.

Growth of a Dollar for Cambridge Financial Group's
Core Equity Composite Versus S&P 500 (2nd Qtr. 2000-1st Qtr. 2010)



Net returns provided reflect the deduction of transaction costs and advisory fees. Past performance is not indicative of future results.

Q : The second bear market of the decade was on the horizon entering 2008. How do you recall that time, and what effect did it have on your firm?

It was flat out frightening. The first half of the year was incredibly unsettling, but by September of 2008, it appeared as if the wheels had come off and the entire sky was falling. A welcome 5.3% rally for the S&P 500 on the final day of September could do little to salvage a horrendous month and brutal third quarter which saw the index finish down 9% for the period. After the initial nine months of 2008, the market had seen 20.8% in value evaporate into thin air. The deepening credit crisis sent shock waves throughout Wall Street causing events which could never have been foreseen when the new year began. On the heels of the difficulties experienced at various financial institutions in the first and second quarters, the once venerable Lehman Brothers was forced into bankruptcy while the nation's largest brokerage, Merrill Lynch, was sold to Bank of America. In addition, Fannie Mae and Freddie Mac were taken over by the government, AIG relinquished control to the government in return for a $150 billion loan, Washington Mutual was seized by federal regulators, and Wachovia was sold. Finally, Goldman Sachs and Morgan Stanley filed for commercial bank status in an effort to survive the current financial crisis. In short, the third quarter of 2008 was a flat out disaster for Wall Street. Since reaching an all-time high in October 2007, the S&P 500 had plunged an incredible 29.3% marking the index's sixth most severe bear market since World War II. The degree and severity of the sudden decline and demise of Wall Street's once invulnerable powerhouses was simply astounding. Unbelievably, the fourth quarter would prove even worse exacerbating what had already shaped-up at that point to be a very bad year. Mercifully, it ended.

When the story is told, 2008 will surely go down in history as a year that will live in infamy with markets producing the worst returns since the Great Depression. The sheer multitude as well as severity of financial disasters in 2008 was almost beyond comprehension. Troubles in the housing market were already well documented from the previous year, and they continued into 2008 as foreclosures hit new highs while housing starts hit new lows. The systemic toxicity and subsequent effect on the entire domestic and global financial system was terrifying. With credit markets seizing up, many firms holding these mortgage securities were unable to sell and began experiencing growing losses. Government "bailout" now became the popular watchword on Wall Street and in Washington. As if that weren't enough, a $65 billion Ponzi scheme was unearthed in December perpetuated by a Wall Street veteran and former NASDAQ Chairman Bernie Madoff. There seemed to be something going wrong all year, and investor confidence was crushed. The fear

and panic pervasive on both Wall Street and Main Street was almost palpable. The impact on investor portfolios proved devastating. The S&P 500 declined 38.5% for the year, the worst loss for the index since 1937. There had been no place to hide, and our firm performed in line with the index, certainly nothing to brag about. Mostly due to market deterioration, our assets under management fell to below $800,000,000. Although fear and panic ruled the day on Wall Street as evidenced by pay cuts, layoffs and widespread downsizing, we at Cambridge retained all our key personnel, continued to adhere to our investment discipline, and remained focused on better times we believed to be ahead.

Q : The market actually didn't crater until February 9th of the following year. Did that cause you or your partner to waver in your investment discipline or your beliefs in the financial markets?

No, but it was a significant challenge to keep clients calm and reassured that the world was not coming to an end. Despite the rocky road, 2009 ended with a bang as the S&P 500 posted its best annual return since 2003. Nevertheless, the market posted a loss for a calendar decade for the first time in history. The decade is now commonly referred to by Wall Street veterans as "Lost Decade". The only comparable time frame in history for such sub-par performance goes all the way back to the 1930's when the market ebbed out a miniscule average annual return of 1% with dividends reinvested. The upshot to such dismal performance over an extended period of time is the fact that stocks have historically rebounded in grand fashion in subsequent periods. The average annualized return in the 1940's, for example, was nearly 9%.

After posting a loss of 56.8% from the previous October 2007 highs through the March 9th 2009 lows (the worst such loss since the 1930's), stocks had retreated to 12-year lows. Then, to the dismay of the multitude of market skeptics, the S&P 500 promptly pivoted and proceeded to mount a massive rally off those bottoms to the tune of 64.8% thru 12/31/09. The key question now is whether that momentum can be sustained as we advance through 2010. We believe it can and will. We also believe in reversion to the mean which suggests that while the market on average should provide returns of 10% - 11% per year over time, in reality the 10 year return for the 2000–2009 time frame was essentially flat. If the theory holds true, returns should eventually revert back to their historical norms. Although Cambridge took a beating along with most of the rest of the investment world, we have remained committed to a time tested investment discipline that had yielded excellent long term results. We currently manage over $725,000,000 in 2600 accounts. Despite all the carnage of the past couple of years and since we last spoke in 2004, CFG has outperformed the S&P 500 by a margin of two to one from 1/1/04 – 12/31/09 (+4.26% vs. +2.09%). We have also added employees and ramped up our investment in technology. The firm has recently hired an Executive Marketing Director in our firm belief that there will be a reversion to the mean in the marketplace and relative out performance will follow. The good news is that we have survived and are still standing. After the S&P 500 posted annualized returns in excess of 20% for the 1980's and 1990's (the best consecutive decades in market history), the losses that followed in the 2000's helped to wipe out the excesses of the previous twenty years. We at Cambridge subscribe to the belief that patience and strict adherence to a time tested investment discipline will be the key to future investment success. Despite the difficulties of the past decade, we proceed through 2010 confident that the future for large cap S&P 500 stocks is very bright which will bode well for our investment strategy and for those investors who stay the course.

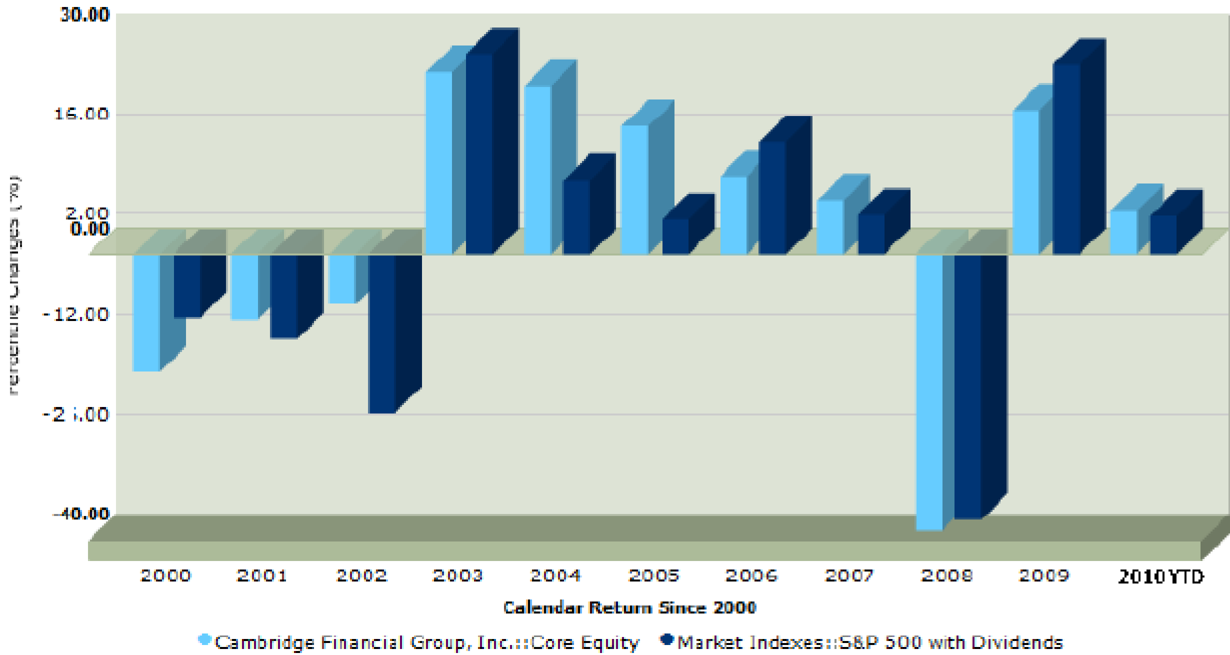
Q : How many products do you currently offer ?

Cambridge Financial Group offers three basic products to our clients: Core Equity, Aggressive Equity and Balanced accounts. The Aggressive and Balanced strategies are simply hybrids of our Core approach. If you understand the methodology behind the management of our Core accounts, you will easily understand our other two products. The Aggressive accounts utilize only the price momentum portion of the Core Strategy, while Balanced accounts combine the entire Core approach in conjunction with Treasury Notes no longer than 10 years in maturity. Core accounts represent over 90% of the entire asset base managed by CFG.

Q : In a recent radio interview you stated that CFG's equity approach combines investing in value and growth companies. How do you differentiate between value and growth?

Our Core Equity Management employs two complimentary strategies – price momentum, or growth, and value investing – in managing equity portfolios. The price momentum strategy focuses on those stocks that are performing the best relative to the rest of the market. The objective is to be invested in those stocks, which are exhibiting rapid increases in price. The stock that has advanced the furthest in terms of price percentage over the last 12 months is ranked #1, the 2nd best performer ranked #2, and so forth. At the other end of the investment spectrum, the value strategy selects those stocks which appear to be the most attractively priced relative to the rest of

Calendar Returns for Cambridge Financial Group's Core Equity Composite Versus S&P 500 (2000-1st Qtr. 2010)



Net returns provided reflect the deduction of transaction costs and advisory fees. Past performance is not indicative of future results.

the market, and which will appreciate over time as investors recognize their inherent value. The Core portfolio is comprised of 30 stocks when fully invested,selected as follows:

S&P Momentum

A 10-stock list is selected from the S&P 500 on the basis of price momentum. This list is adjusted on a quarterly basis.

CFGI Momentum

A 10-stock list is selected from the 100 company subset of the S&P 500 comprising the Cambridge Financial Group Industrials (CFGI) on the basis of price momentum. This list is adjusted on a quarterly basis.

CFGI Value

A 10-stock list selected from the 100 companies comprising the CFGI on the basis of value, and that have a history of raising dividends for 10 consecutive years. These companies are ranked based upon value measures such dividend yield, P/E ratio and dividend coverage. This list is adjusted on an annual basis.

Q : Do you try to index your growth and value portfolios, or do you invest in stocks using other criteria?

We definitely do not index. It is very difficult to beat the index if you look like the index, so we make no attempt in trying to mirror any index. Our portfolio is a by-product of the stock selection process.

Q : How does your asset allocation approach work?

Because there is no serial correlation between the top ranked stocks and the bottom ranked stocks in our portfolios, we simply equal dollar weight each position. Therefore, the target weighting in a 30 stock portfolio would be 3.3% for each position at the beginning of each calendar quarter. To maintain the integrity of those weightings, each position is reevaluated as of the close of every quarter. Assuming a position has survived our parameters required to be maintained in our portfolios in the subsequent quarter, we rebalance our positions to bring everything back towards our desired 3.3% weighting. Because of a long history of empirical evidence, the quarterly timeframe for rebalancing proves to be the optimal timeframe.

Q : What role does cash play in your asset allocation?

Our discipline is skewed to keep our clients fully invested most of the time. It is our opinion that no one can consistently and correctly time the market except for God and Liars. Therefore, we don't attempt it. There have been periods of time when the market has warranted higher than normal cash positions. Those times, however, are relatively rare (4 times since 1982). We typically remain fully invested with 1 ½ - 2% in cash.

Q: Tell us how you use price momentum in managing your portfolios?

Two of the three components in our Core portfolios, or 20 stocks, are purchased based upon relative 12 month price momentum. Ten stocks are selected from the S&P 500 at large based upon this characteristic, and an additional ten stocks are selected from the 100 stock CFGI based upon the same criteria.

Q : Why do you favor investing in stocks that are exhibiting rapid price increases?

It's really a Physics theory which says that "a body in motion tends to stay in motion." In terms of stocks, when a trend is in place, it tends to persist. Our system attempts to pick up those stocks that are exhibiting the most rapid increases in price in anticipation that stocks that are accelerating in price will continue to go higher. See table on page 6.

Q : How much deviation needs to take place between your value and growth holdings before you make adjustments?

Our Core portfolios are comprised of 30 stocks, 2/3 based upon relative 12 month price momentum and 1/3 based upon relative value. Ten stocks are selected from the "S&P Momentum" list, ten from the "CFGI Momentum" list, and finally ten stocks from the "CFGI Value" list. This allocation between growth and value is maintained at all times given full discretion. All positions are equal dollar weighted representing 3.3% of the entire portfolio. Evaluation and rebalancing of the portfolio is performed at the end of each calendar quarter in an effort to bring all names back to the 3.3% target thus eliminating names that have underperformed, trimming names that have outperformed, and adding to underweighted names that are still favorably ranked in order to bring them into balance relative to the entire portfolio.

Q : How does your aggressive equity compare to your core portfolio?

Our Aggressive Equity strategy is simply a subset of our Core strategy. We purchase 10 stocks from the S&P 500 based upon 12-month relative price momentum, so the Aggressive strategy is simply the S&P momentum list segregated off as a separate stand-alone entity. In other words, Aggressive portfolios are invested in 10 stocks only with sole focus on relative price momentum.

Q : How does your fixed income or treasury portfolio work?

The only treasuries that CFG manages are those found in our Balanced accounts. For those clients Cambridge employs a similar approach to that taken with our equity management. We continue to focus on momentum and value, but in the case of fixed income vehicles, it is momentum and value as it pertains to interest rates that will determine how far out on the yield curve we will invest.

Q : What criteria do you use to know when to buy or sell stock?

CFG consistently screens the S&P Momentum and the CFGI Momentum components of the portfolio quarterly based on their relative 12 month price momentum. Should a stock fall to below the 50th percentile of its respective universe, it is sold and replaced with the next highest ranked stock not already owned. The value component is reassessed on an annual basis. If a stock falls out of the top 10 of its universe it is sold and replaced with the next highest ranked stock not already owned.

Q : When you rebalance the portfolios, do you ever weigh one greater than the other?

Never. The integrity of all three components are maintained independent of one another and in equal weightings. Our investment discipline is not designed to make bets in one area versus another.

Q : How does CFG manage risk?

We manage risk by diversifying over 30 stocks while at the same time employing multiple strategies with a low correlation to one another – momentum & value – all in a single portfolio. Utilizing multiple strategies creates a "barbell approach" in the portfolio with the understanding that any investment style, be it growth or value, will invariably spend some time being out of favor and thus under-perform over a market cycle. When combined with the discretion to raise cash when it is deemed prudent, significant risk is extracted from the overall equation. Cambridge has always focused on minimizing that risk.

Q : Where does Cambridge obtain research ?

All of our research is proprietary and generated internally. Our system tells us what to buy, what to sell, and when to do it with the key being consistent implementation. Cambridge employs an investment system vs. an investment star.

Q : Please give us a general breakdown of your client base. Do you specialize in certain client types, or is your strategy appropriate for a broad range of clients?

Cambridge has a broad mix of client types, predominately small companies, institutions, and individuals, so there is no typical profile for a CFG client. References are available upon request.

Q : What are your account minimums?

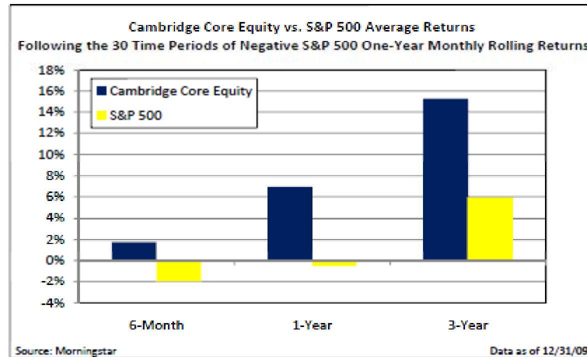
Minimum account size is $100,000 with fees starting at 1%. However, depending upon the size of the account, fees are negotiable.

The Case for Momentum Investing Now

The Cambridge Core Equity strategy has utilized a quantitative momentum investment style since 1992. The strategy has also been managed by the original principal owner of the firm since its inception, employing the same disciplined process for nearly 20 years, exhibiting a longevity in management rarely seen.

From 1992 through January 2007 there have been 30 time periods that the S&P 500 Index has had a negative one-year monthly rolling return. Following those 30 negative time periods, in every subsequent three-year time period Cambridge Core Equity has outperformed the S&P 500 by an average return of 9.36%.

The chart below illustrates the Cambridge Core Equity strategy and the S&P 500 Index's average returns over the six month, one and three-year periods following those 30 time periods of negative S&P 500 one-year monthly rolling returns.



Since January 2007 there have been 21 other time periods of negative S&P 500 one-year monthly rolling returns that we have yet to see the next three years of returns. As the market continues its post recession recovery, history indicates the Cambridge Core Equity strategy has had its best periods of performance in these types of markets.

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The performance for the CFG Core Portfolio is a composite figure for all accounts that are invested according to the specific equity strategy. Results are presented gross of fees. Returns are for the period ending 12/31/2009. Investing in securities is speculative and entails risk. There can be no guarantee that any investment strategy will be successful. Past performance does not guarantee future results. The S&P 500 is a composite index of 500 stocks compiled by Standard & Poor's Corporation that is used as a broad measure of stock performance. Please note that indexes are unmanaged and their returns do not take into account any of the costs associated with buying and selling individual securities. Individuals cannot invest directly in an index. Reference to the index does not infer any affiliation or endorsement by Standard & Poor's.

Q : Who are the other principals in the firm and what are their backgrounds?

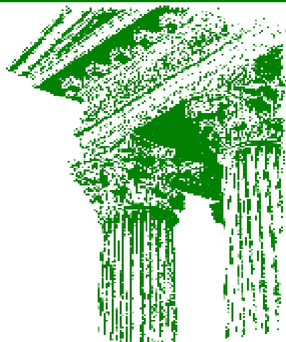
The other principal of the firm is Greg Bauer, who serves as the Chairman and Managing Director. Greg developed our investment disciplines and was the original founder of Cambridge Financial Group in 1986 starting out as a consulting firm dealing with individuals, banks & small institutions. In late 1991, I purchased 50% of the firm and joined Cambridge as the President & Managing Director for purposes of offering our investment services on a discretionary asset management basis only. Currently, Mr. Bauer and Mr. Newsome equally own 100% of Cambridge Financial Group.

Our investment discipline, however, got its start back in the early 1970's when Greg was managing equities for the Public Employees Retirement System (PERS) of the State of Ohio.

Over time, several of Greg's professional peers convinced him that he should hang out his own shingle and that he could build a firm around this approach to investing. Finally convinced, Greg did just that in 1986 and founded Cambridge Financial Group as an SEC registered investment advisor offering advice on a consulting basis in the form of a newsletter. In an effort to gain more control over the destiny of how this investment advice was implemented, a strategic business decision was made in late 1991 to go forward managing accounts on a discretionary basis only. I purchased half of the firm in October 1991 with an eye on starting our discretionary composite by 1/1/92. The rest is history. We started with a couple of million dollars under management and have been building ever since.

Q : I understand that you publish a quarterly newsletter and market commentary. How can I view these on a regular basis?

Both are published on a regular quarterly basis and available on our web site at www.cfginc.net, or by simply calling Brenda Caster in our Cincinnati office at 513-794-0002.



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