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Fund-amentals

Quarter 4 - 2006

capital at work
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Contrarian Equities *at* Work

Market Review

Stock markets all over the world experienced a strong rebound in the second half of 2006 on the back of lower bond yields, lower commodity and energy prices, continued worldwide growth and strong company earnings.

As we have argued early july, equity fundamentals remain solid. Cash generation is important and balance sheets are healthy. The significant spread between cash-flow yield and the still low cost of debt is the driver behind the continuing M&A boom.

In a globalizing world, with emerging economies as an important driver of economic growth, our corporate-wide strategy is to own superior businesses which will benefit from this globalization, both on the revenue and on the cost side.

So far in 2006 ...

At the end of 2006 our portfolio is up 14.77% in Euro for the full year, which brings our long term (Sep98) avg. ann. return to 12.30% in Euro which is in line with our avg. expected return and above our avg required return.

Our international exposure is as follows, 60% Europe, 35% Americas and 5% Asia. Our currency exposure is 70% Euro, 5% CHF & GBP, 25% US and 5% Asian currencies. We own approximately 60 stocks of which 13 above 3% which represent a total of 53%. Taking into account our defensive option strategies, our portfolio has a 96% delta-adjusted equity exposure.

Most significant recent additions: Barnes & Noble, GBL, Austrian Post, Viacom, Omnicare, Compucredit, Capital One Financial and 3M. Most significant recent reductions: Realogy (LBO), Inbev, Sotheby's, Géophysique, Saipem, Bulgari, Mediobanca and Citigroup.

What next?

We are maintaining our value-based investment strategy of owning supposedly undervalued companies until reappraisal, irrespective of current or future market trends.

If the global economy continues to grow and globalization gathers pace, we believe our fund will do very well with its sizeable exposure in multinational industrials.

We have no position in telecom stocks, and minor positions in defensive consumer segments, commodity businesses in general and integrated oil companies in particular.

Valuation

We are still completely out of telecoms, very light on commodities with only 1.7% oil-related and light on consumer defensives with only 1.2% in Inbev. Currently, our main investment theme remains 'Globalization at Work', which means significant ownership of global industrial groups, which should continue to benefit from global growth and from capex by cash-rich corporations.

Top 10 holdings		
1.	**Vinci**	6.3%
2.	**Schneider**	4.2%
3.	**E. On**	4.2%
4.	**Mittal Steel**	4.0%
5.	**LVMH**	4.0%
6.	**Siemens**	3.7%
7.	**United Technologies**	3.3%
8.	**Saint Gobain**	3.2%
9.	**Grupo Televisa**	3.1%
10.	**Lagardère**	3.0%

Ivan Nyssen, *Fund Manager Contrarian Equities at Work fund*

22 years investment experience
Master in Economics

Between 1987 and 1994, Ivan worked for Lehman Brothers as an Institutional Business Developer. In 1994 he joined Capital*at*Work where he holds the positions of CEO and CIO. Ivan also manages the Contrarian Equities at Work fund.

European Equities *at* Work

Market Review

European equities continue to find support from abundant cash flows and low interest rates. M&A business is helping boost the flow of good market news. Many companies are experiencing returns on free cash flow that are well above the very low cost of debt (between 3 and 3.5% after tax for investment grade issuers). Companies themselves are competing with private equity funds in corporate purchase operations.

The published results for the third quarter have also played a part in the good market performance. Although investors in the US are still concerned about the possibility of the market correction in the residential construction sector affecting the rest of the US economy, observers continue to be positively surprised by the eurozone economy. The most recent IFO, which is a true barometer of the German business climate, shows healthy investment and industrial output. There are signs of improvement on the labour market in Germany and France alike, and this is boosting consumer spending. Finally, the strong growth in emerging markets continues to bolster up the sales and results of European companies with a strong international presence (Siemens, Saint-Gobain, Schneider Electric, LVMH and WPP).

Performance and Analysis

The fund has posted a return of 17,09 % since 1 January. The portfolio benefited from its exposure to the construction sector (Vinci, Bilfinger Berger, Lafarge and Saint-Gobain), the oil services sub-sector (Acergy, Saipem and Compagnie Générale de Géophysique), and the steel sector (Arcelor-Mittal).

Strategy and Outlook

As a result of the steep market rise since the beginning of the year, we reduced our positions in companies that are no longer significantly undervalued as compared to their intrinsic value. We took some profit on Inbev, Bulgari, Saipem, Acergy and Allianz. We disposed of our positions in Fiat and Compagnie Générale de Géophysique. We remain underweighted in Financials, where we do not believe the current levels of profitability to be sustainable. We took a new position in GBL (discount of 27% against its net asset value, stakes in Total, Suez, Lafarge and Imerys), and increased our positions in Publicis (withdrawn from the CAC 40; disappointment on the occasion of the publication of the quarterly results) and Dassault Systèmes following a private meeting.

Valuation

The fundamentals for European equities remain very sound. Although we cannot rule out a temporary correction (Weak USD? New tension on the energy markets? Geopolitical tension?), we believe the current valuations provide real opportunities for investors who are prepared to wait. The strong free cash flow generation will enable companies to reward their shareholders by paying generous dividends or undertaking fresh stock buy-back programmes. Many of the positions in our portfolio should offer dividend yields of nearly 3% in 2007. Dividends are becoming an important component of the expected return on the equity markets.

Top 10 holdings		
1.	**Vinci**	5.7%
2.	**Schneider**	4.1%
3.	**Saint-Gobain**	4.1%
4.	**E. On**	3.8%
5.	**Siemens**	3.4%
6.	**Lafarge**	3.1%
7.	**Novartis**	3.0%
8.	**GBL**	2.7%
9.	**Bacou-Dalloz**	2.6%
10.	**AGF**	2.6%

Dominique Marchese, *Fund Manager European Equities at Work Fund*

14 years investment experience
Master in Mathematics
Bachelor in Actuarial Sciences

Dominique started his career as a Trader and worked as a Portfolio and Fund Manager for both private and institutional clients before joining Capital*at*Work in 2002. Since 4 years he has been managing the European Equities at Work Fund. He is also member of the Board and director of the Asset Management Department, together with Erwin Deseyn.

American Equities *at* Work

Market Review

The North American stock market started to rally at the end of the summer, and this continued into Q4. Many market pundits had advocated prudence ahead of the mid-term elections, but their caution proved misplaced. Cash remained on the sidelines for too long in the summer and most fund managers felt compelled to chase the year-end rally. The S&P500 is set to increase by more than 7% in the course of the quarter. Earnings at the end of Q3 and through Q4 showed continued double-digit YOY growth compared to 2005. Consumer spending held up well through the buoyant pre-Christmas shopping season, and the Democrats - now in control of Congress - have yet to announce policies viewed as detrimental to Wall Street's consensus scenario of a soft landing for the economy.

Performance and Analysis

The American fund rose by over 8% during the quarter in USD terms. Oil prices failed to fall below 55$/barrel and the energy sector joined in the rally, pushing our energy holdings higher. The benign interest-rate scenario caused the housing sector to rally strongly. The Consumer Discretionary sector also experienced a strong rally. Our positions in energy and in consumer stocks such as Nike, DR Horton, Home Depot and Interactive Corp. surged. Healthcare stocks have continued to lag and industrials put in a mixed performance according to the sector of operation. Lastly, large global financial stocks - such as AIG, Berkshire and Citigroup - finally delivered on their value appeal after many quarters of below-par performance. We have trimmed or sold holdings whose valuations have reached our target levels. Many of these are in consumer sectors. We have also reduced our Pfizer positions after management withdrew Torceprabip from commercial development.

Strategy and Outlook

Our strategy will continue to focus on companies with sustainable, quality business models whose future cash flows can be discounted to provide a quantifiable valuation. We continue to find value in large companies whose global exposure will help them reap the benefits of increasing consumer demand in the Emerging Markets. Citigroup, AIG, Viacom, United Tech, Tyco, Johnson&Johnson and Intel are some of our largest holdings. In addition, cash on corporate balance sheets and private equity will support further M&A activity. Underleveraged, cash flow generating companies provide a good hunting ground for the fund. Finally, many R&D driven companies in America are releasing new products that should reinvigorate earnings growth subject to successful product launch.

Valuation

Market valuations appear to be in line with historical averages. S&P500 is trading below 16X 2007 earnings, which are expected to increase by just under 10%. The net dividend yield for the index hovers around 1.5%, regardless of the massive stock buy-backs. As a matter of fact, many companies are awash with cash, enabling management to orchestrate releveraging through stock buy-backs or acquisitions. Using cash in this way results in higher ROIC than mere interest on cash in the bank, but is also testimony of slower growth prospects in core operations. Provided 10-year interest rates stay within 50bp of their current levels, equities will continue to trade in parallel with slower, but rising earnings growth.

Top 10 holdings		
1.	**Berkshire Hathaway**	4.7%
2.	**Citigroup**	4.7%
3.	**AIG**	4.6%
4.	**Viacom**	4.2%
5.	**Capital One Fin.**	4.0%
6.	**Intel**	4.0%
7.	**Liberty Media**	3.8%
8.	**Oil Service**	3.6%
9.	**CVS**	3.6%
10.	**Home Depot**	3.6%

Frederic Winssinger, *Fund Manager American Equities at Work fund*
16 years of investment experience
MBA, Wharton School at the University of Pennsylvania, BA, Claremont McKenna College

Frederic worked as a financial analyst and portfolio manager in Los Angeles between 1990 and 1993. He graduated from Wharton in 1995. After graduating Frederic held various positions as an analyst and portfolio manager in London, where he managed a long-short equity fund between 2001 and 2006. He joined Capital*at*Work at the beginning of 2006 and has been managing the American fund since.

Asian Equities *at* Work

Market Review

Asian equities rose this year to the end of April, in a period of rising global interest rates, making them rather vulnerable to a correction. The reason for this was increased investor risk aversion (due to concern about a possible economic slowdown in the US) and some profit taking. However, valuations were not extreme and economic growth in the region remained robust, leading us to anticipate a sound recovery. Several Asian markets had fallen by more than 20% since the beginning of the correction, but most rebounded well during the remainder of the year. Asian stocks rose to their highest level in more than six months after the US economy posted higher than expected growth last quarter, and the South Korean government increased its 2006 forecast for exports. Asia received a further boost from strong capital inflows and lower oil prices.

In Japan, our major investment region, domestic demand remains firm, partly because households are feeling the positive impact of improved labour-market conditions and an upturn in bank lending. Company profits are on the rise, and deflation is a thing of the past. Against this backdrop, the Bank of Japan decided to abandon its policy of quantitative monetary easing introduced five years ago and announce an official inflation target, signalling a desire for increased transparency. These were all welcome developments that bode well for the stability of the Japanese economy and Japanese companies.

Performance and Analysis

Our fund is up 8,40 % (year-to-date), with the weakest performance coming from our investments in Japan and South Korea, and our investments in Hong Kong, China, India and Indonesia putting in the best performance. However, the euro appreciated substantially against all Asian currencies, which weighed heavily on our fund's performance. We took the May sell-off as the opportunity to boost our positions.

Strategy and Outlook

Our fund remains underweighted in Energy and Materials. We still have concerns about the sustainability of the results of companies in these sectors and their valuations. In contrast, we have a significant overweighting in Consumer Goods and Financials, which account for two thirds of our portfolio. Generally speaking, we prefer companies focusing on their home economies, which continue to post strong, stable growth, and provide our portfolio with a buffer against a slowdown in the US. Our policy on currency exposure remains unchanged: there is no hedging, as we are increasingly convinced that these currencies are undervalued.

Valuation

Asia presents attractive opportunities for long-term investors. Economic growth in the region continues to outpace Europe and the US. Asian companies in general continue to post high earnings growth, and there is little risk of margin contraction in the companies in the portfolio. Most importantly, current valuations do not fully reflect the positive long-term domestic outlook for Asian companies.

Nevertheless, investors' long-term orientation is key. Asian equity markets are inherently more volatile, as liquidity is lower and we invest in a wide range of currencies. We reduce the risk by diversifying among countries, sectors and companies, and by buying sustainable top-rate stocks at attractive prices.

Top 10 holdings		
1.	**HDFC Bank**	2.6%
2.	**S1 Corporation**	2.5%
3.	**Housing Dev**	2.4%
4.	**Telekom**	2.3%
5.	**Taiwan Semicon.**	2.2%
6.	**Woolworths**	2.2%
7.	**KT&G**	2.0%
8.	**Goodman**	1.9%
9.	**Genting**	1.9%
10.	**Hankook Tire**	1.8%

Tom De Backer, *Fund Manager Asian Equities at Work Fund*

4 years investment experience
Master in Economics
Master in Banking and Finance

Tom joined Capital*at*Work in 2002. After working as a financial analyst for 3 years, he became manager of the Asian Equities at Work fund in 2005.

Growth Equities *at* Work

Market Review

At the beginning of the year, we expected equities to outperform bonds and cash, based on a combination of high corporate profits, continued low interest rates and reasonable valuations. And this has been the case. Equity was again the asset class of choice, returning almost 10% in 2006 in EUR terms (MSCI World Index). So, after the strong performance in 2006, what can we expect from the equity markets in the months to come? We expect equity returns to be positive in 2007 for the following reasons: (1) reasonable valuations; (2) profitability should remain high, despite some pressure expected in the short term; (3) the wave of mergers and acquisitions, which has supported the markets in 2006, is likely to continue. **In conclusion, the combination of all these factors will continue to underpin the equity markets.** In terms of investment style, "Value" companies outperformed "Growth" companies by almost 10% in 2006.

Performance

During the last three months, the fund has benefited greatly from the market rebound. It increased by 2,47%. In year-to-date terms, the fund posted a performance of 7,3 %.

Outlook

Value has outperformed growth for five years. We now believe it is time to opt for growth. There are three reasons why **investors should look to growth at this time**:

Global economic growth is slowing. This means that companies will get less support from the cycle and structural growth will be rewarded;

Earnings momentum is rolling over from last May's record level. In an environment where earnings growth is becoming scarcer, high growth should, in our view, command a premium;

Valuations have compressed. The P/E spread across markets is at its lowest for nearly 10 years. This suggests that investors are havingThe P/E spread across markets is at its lowest for nearly 10 years. This suggests that investors are having to pay a lower premium than usual for companies with a superior growth outlook.

Strategy

Thematic approach

We do not believe that growth is necessarily available at sector level. Instead, we focus on a thematic approach. The Growth fund always strives to identify major actual demographic, economic or political trends in our society. We believe that companies that are well placed to take advantage of those powerful trends should grow faster than average and make growth more consistent and sustainable. Some of our main themes are: leisure, youth and fashion, technology, healthy people, security, the environment and energy.

Globalization

The growth fund is an international equity fund. Our geographical exposure is currently as follows: 50% Europe, 35% United States and 15% Emerging Countries. We overweight European stocks. Valuation remains supportive, and both economic activity and profitability continue to provide pleasant surprises. Elsewhere, we retain a modest overweighting in emerging markets, where selective valuation and growth opportunities make sense. We underweight the United States.

Large Caps vs Small Caps

We continue to prefer large caps to small caps. Small caps are still more expensive. The outperformance of recent years has left these stocks trading with a significant P/E premium. Moreover, in an environment of less tolerance for risk, we think that the risk/reward profile of small caps looks less attractive.

Valuation

With a total implied growth rate of 2.5% for the growth fund, we believe that the fund is attractively valued with regard to the growth outlook of companies in the portfolio. The actual expected top-line growth is above 12% for 2007, and just above 10% for 2008.

Top 10 holdings		
1.	**Sanofi-Aventis**	3.1%
2.	**Flir Systems**	3.0%
3.	**Carbone Lorraine**	3.0%
4.	**Dassault Systemes**	3.0%
5.	**Anglo-Irish Bank**	3.0%
6.	**Manitou**	2.9%
7.	**eBay**	2.8%
8.	**Commerce Bancorp**	2.7%
9.	**ITT Corp**	2.6%
10.	**Foncia Groupe**	2.5%

Florence Debloos, *Fund Manager Growth at Work Fund*

7 years investment experience
Master in Economics
Master in Tax Law

Florence was a Private Portfolio Manager before joining Capital*at*Work in 2000. Since 2003 she has been managing the Growth at Work fund.

Bonds *at* Work

Market Review

In summary: the following list indicates some of the harsh realities witnessed in fixed income markets over the past 12 months:

- 10-year EU rates rose 60bp from 3.33% to 3.93%
- 2-year EU rates rose 100bp from 2.90% to 3.90%
- the 3-month Euribor rose 125bp from 2.45% to 3.70%
- The euro appreciated by 11% against the dollar (from 1.1845 to 1.3145)
- The ECB hiked up its refinancing rate 5 times, taking it from 2.25% to 3.50% during 2006
- The US FED raised the Fed Funds 4 times, taking it from 4.25% to 5.25% during 2006 and decided to take a breather on 8 August (the cycle of rate hikes that started in June 2004 saw 17 consecutive rises, taking the rate from 1% to 5.25%)
- The Bank of Japan put a halt to its policy of quantitative easing and increased rates from zero to 0.25%

  Performance of the:
  - EUGATR index, comprising all European government bonds with maturities of more than 1 year ended the year at -0.27%
  - JP Morgan Global Government Index Unhedged year-to-date: - 4.76%
  - JP Morgan Global Government Index Hedged year-to-date: +1.07%
  - Citi Euro high grade index (hedged) returned 0.90% (AA: +0.76%, BBB: +1.98%)

An aggressive reversal in rates took hold in early December, driving 10y rates to 3.93% - up 25bp since the beginning of the month. The credit markets held steady over the quarter, with spreads tightening by 5 to 15 bp in high-grade bonds and around 25bp in cross-over (BB) credits.

Performance and Analysis

The total net return for Bonds at Work during 2006 was +0.82%. The government bond reference index on which we aim to provide added value stands at -0.58%. Alpha creation was 1.40% (after management fees). Our allocation of 20% in FRNs (CMS) linked to 10y rates has provided the desired buffer in our tactical portfolio construction. We repeat that our credit selection has performed in line with the benchmark, and the inclusion of hybrid bonds and emerging market bonds has strongly boosted the performance since July 2006.

Strategy and Outlook

With the global bond markets consolidating and showing low volatility, our stance on rates in developed countries remains neutral to bearish (higher rates). Our position in corporate bonds remains high, although it has been reduced since the beginning of the year. We have only maintained our position in issues with solid FCF visibility and management that does not focus solely on rewarding equity holders. Around 10% of the fund is invested in hybrid bonds which still offer value (between 2.00% and 2.60%) above 10y government bond rates by lowering the capital structure of highly rated companies. Our new positions in four carefully selected 'emerging' bond markets (Brazil, Mexico, Turkey and Poland) has offered, and continues to offer, our investors a sound risk/reward profile for 2007. A further tightening of monetary policy in Europe, Japan and other developed countries has put us in defensive mode, as a result of which we are maintaining our allocation of 20% in floating rate notes.

Valuation

Bonds at Work offers its investors a running yield of 6.00% for a duration of 6.00 years, as against a running yield of 5.2% at the beginning of the year. Consequently, current investors are holding or buying into a higher nominal return over a holding period equal to the duration of the fund – 6 years. Our global diversification among fixed-income sectors delivered the targeted added value and is maintained at the start of 2007.

Peter De Coensel, *Fund Manager Fixed Income Funds*

15 years investment experience
Master in Economics
Master in European Economy

Between 1991 and 1996, Peter worked as a Fixed Income Trader in Belgium and in France. After working as a Hedge Fund Manager from 1996 until 2003, he worked in financial consulting for a couple of years. Peter joined Capital*at*Work in 2005. Together with Erwin Deseyn he is managing the Bonds and Inflation funds.

Inflation *at* Work

Market Review

The comments in our summary of nominal bond markets for 2006 also apply to inflation-linked bonds. At the beginning of the year, inflation expectations (break-evens, the difference between nominal and real rates) stood at 2.33% in the US and 2.08% in Europe. At the end of the year, we were back to around the same levels. Whereas the threat of inflation pushed up business earnings during Q1 and Q2, it dissipated entirely in Q3 and stabilized during Q4. The concern about inflation during the first half of the year switched to anxiety about growth in the last two quarters. Capital*at*Work does not share this concern about growth, because we believe that lower real growth rates in the US will only have a minor impact on real global growth. Central banks will want to see solid evidence of recession in the economic data before they start to consider an end to the upward rate cycle (EU) or before lowering the cost of borrowing (US). The market stress during May and June offered clear value in inflation linked bonds in emerging markets. Once the worst of the correction had occurred, we bought in Brazilian and Mexican linkers, offering real yields of 10% and 4.5% respectively.

In a nutshell, real rates tracked nominal rates in 2006.

Performance and Analysis

The total net return for Inflation at Work during 2006 stands at -0.52%. Our inflation linked government bond reference index stands at -1.71%. Alpha creation equals +1.20% after management fees. Our allocation of 24% in FRNs (CMS) linked to 10y rates, as an implicit inflation hedge, has acted as a buffer in an environment of rising real rates. Our selection of emerging market real rate bonds underpinned our performance during Q3 and Q4. In Q3 the fund performance stood at +3.03%. Q4 generated +0.29%.

Strategy and Outlook

Diversification will be a key driver of performance. Our strategic exposure to EU and US real rates has decreased. After a fundamental analysis of emerging markets (Brazil and Mexico) and peripheral European markets (Iceland and Poland – EU member) we will maintain a neutral exposure (i.e. with a positive risk/reward profile) in 2007. The outlook for inflation expectations entails further consolidation and 'low volatility' in break-even readings. As rates fluctuate around the central banks' inflation targets, any sudden movement in either direction could have a disproportionate impact on market psychology. NB: there is still a good case for adopting Inflation at Work in a balanced portfolio. The fund offers a real return and a total return that will be in line with our Bonds at Work fund as long as inflation expectations remain within the target range.

Valuation

Inflation at Work offers our investors a real running yield of 2.83% for a duration of 8.16 years. Core EU linkers account for 20% of the fund. Our 24% position in the FRN (CMS) sector linked to 10y yields bottomed out at the end of the summer and recovered slightly in Q3 and Q4. This allocation offers an extremely high embedded value due to the current flatness of the European yield curve. The inclusion of emerging markets adds risk-adjusted performance to the fund. At the same time, this exposure to linker markets outside the US and Europe (Japan, Iceland, Poland, Mexico and Brazil) reduces the correlation risks substantially. As pure inflation returns converge globally (i.e. US inflation: 3.8%, Brazil and Mexico, 3% to 4%), our fund offers investors exposure to global real rates.

Erwin Deseyn, *Fund Manager Fixed Income Funds*

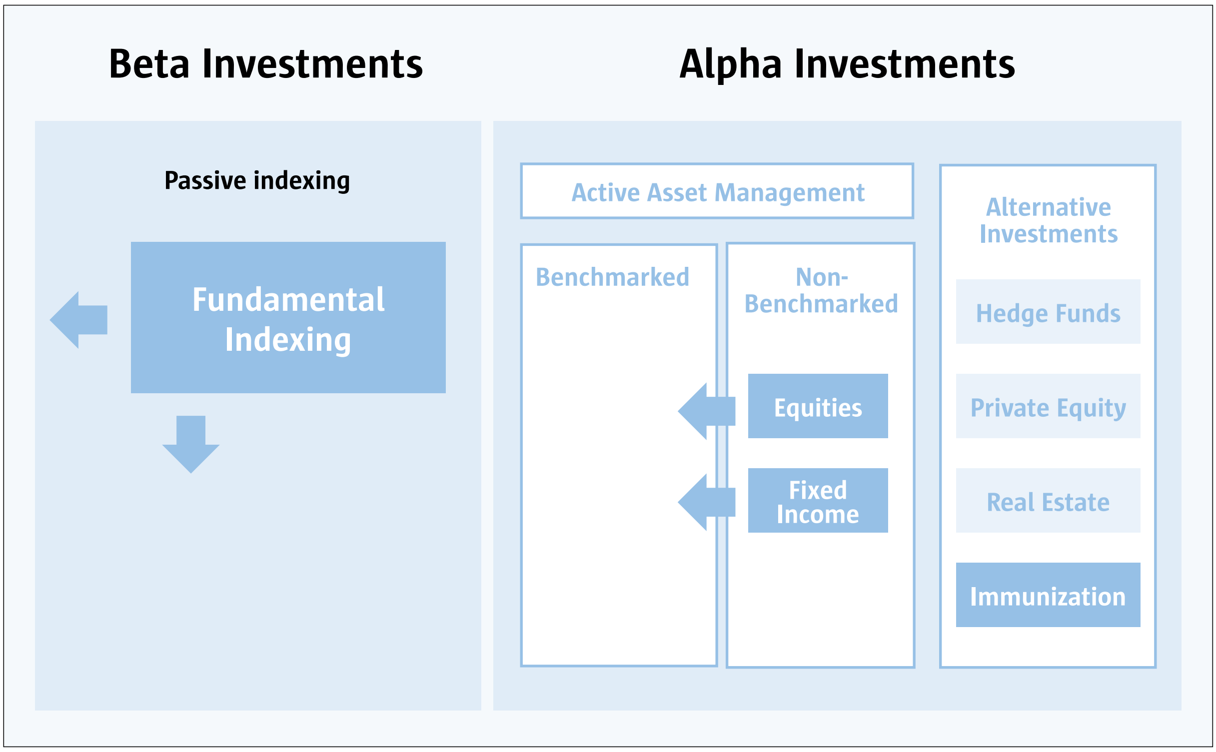
15 years investment experience
Master in Economics

Before joining Capital*at*Work in 1999, Erwin worked as a Fund and Portfolio Manager and co-directed a Family Office for 2 years. At Capital*at*Work Erwin is a fund manager for fixed income funds Inflation and Bonds. He also is a member of the Board and directs the Asset Management Department, together with Dominique Marchese.

Funds sheet

	Equity					Bonds	
	Contrarian Equities	European Equities	American Equities	Asian Equities	Growth Equities	Bonds	Inflation
Fund Manager	Ivan Nyssen	Dominique Marchese	Frederic Winssinger	Tom De Backer	Florence De Bloos	Erwin Deseyn & Peter De Coensel	Erwin Deseyn & Peter De Coensel
Asset Class	Global Equities	European Equities	American Equities	Asian Equities	Global Equities	Global Bonds	Global Inflation Linked Bonds
Date of Creation	01/09/98	15/04/99	17/11/97	19/07/05	01/09/98	15/09/00	09/10/03
Assets under Management	320.44 €	220.13 €	76.63 USD	72.65 €	65.19 €	308.96 €	291.80 €
Management Fee	1.00%	1.00%	1.00%	1.25%	1.00%	0.6%	0.6%
ISIN Code	LU0090697987	LU0078275129	LU0078275558	LU0216386259	LU0090697631	LU0116513721	LU0175696946
Bloomberg Ticker	CAWCOEC	CAWEUEC	CAWAMEC	CAWAEQCLX	CAWHGECLX	CAWHGECLX	CAWINFW
Annualized Performance							
1 Year	14.77%	17.09%	13.81%	8.40%	7.30%	0.73%	−0.77%
3 Years	15.48%	17.55%	7.94%	–	8.11%	3.45%	-
5 Years	6.17%	5.91%	5.40%	–	−2.72%	5.57%	-
Annualized Return since inception	12.30%	3.23%	4.73%	12.55%	2.25%	5.12%	3.84%
Total Return since inception	163.11%	27.82%	52.52%	18.73%	20.42%	36.90%	12.93%

Active Management and/or Passive Management?



It was in 1975 that "Vanguard", under the leadership of the legendary John Bogle, launched its first index fund linked to the S&P 500. It subsequently grew to the biggest mutual fund in the United States. Since those early days, passive asset management has, for some good reasons, conquered the world of investments. The Vanguard website still offers a wealth of information on passive investing.

http://www.vanguard.com

The reason why indexing works has to do with simple mathematics. As a group, investors earn the market's return. For every investor that beats the market, another one will be beaten. On average, investors can earn no more than the market return – before costs. After costs, the average investor must lag the market. The higher the costs, the greater the shortfall. Costs do matter. Indexing succeeds by seeking to match the market's return, while keeping cost low.

Two other points of argument that are debated in the active versus passive discussion are turnover and diversification. Some researchers argue that the extraordinary dynamics of the world economy will increase the turnover of index funds. This is because the composition of the indexes changes more rapidly than before. This will increase the costs of running passive strategies. Others argue that indexes do not offer broad diversification. The overwhelming importance of financial stocks in today's indexes leaves investors vulnerable to a specific sector, just as it was the case with technology stocks at the end of the nineties. **A great article on these topics was written by Peter Bernstein in the Financial Analysts Journal in 2003.**

The debate between active and passive management will probably never end. Even stronger, there is no clear-cut answer. The world of asset management is just not that simple. Capital*at*Work therefore wants to offer expertise in both worlds. The red boxes in the scheme on top of the article, indicate the possible added value of Capital*at*Work for institutional clients:

1. **Our active asset management capabilities derive directly from our investment philosophy, and the consistency in its application over time, without regards of trends, hypes, and hyperboles.**

   Capital*at*Work is a value manager. Value investing is an investment technique that searches for firms that have not been, to the investor's mind, fully valued by the market and might be due for a re-rating. The manager of a portfolio will not want to pay too highly for stocks, unlike a growth manager, who will pay more for uncertain growth prospects of a firm. The lines between the two camps, value and growth are more blurred than these definitions would suggest.

2. **We fully recognize the ever bigger importance of costs in asset management. This is why we strive towards 100% transparency with regards to costs:**

   In our actively managed mutual funds (bonds and equity) this means that the only cost charged to the client are the management fees. Transactions in our funds are executed at cost through state of the art execution programs. Our challenge is to strike a balance between the cost of our in-house research and the extra performance that research can offer. We believe that our investment philosophy creates a win-win situation for us and our clients.

   We are in the process of developing a new breed of low-cost mutual funds (equity). They are passive in the sense that they are linked to indices, but active in their construction. It is our answer to passive investing. This new approach is called Fundamental indexing. Fundamental indexing tries to give the best of both worlds to the investor: the low costs and broad diversification of passive management in combination with our in-house research. Fundamental indexing is a new weighting format that suggests to weigh stocks in an index according to their fundamentals, which are non valuation linked parameters, such as sales, dividends, book value, net income, total employment… This new weighting scheme has been created to avoid faddish overvaluations and fear-driven undervaluations that occur with a market capitalization weighted index.

3. **Our goal with our Fixed Income Investments is to generate alpha using various complementary strategies.**

   Our approach to generating this alpha is by investing where we see value, without being constrained by benchmarks. The ultimate goal is to deliver extra return above the nominal risk-free rate and this over a medium-term horizon. In this respect we use duration not only as an indicator of sensibility to movements in yields. The reason being that it is almost impossible to predict what interest rates will do over a short-term horizon. We prefer to use duration for immunization purposes. It allows to express a clear-cut view of what our investors can expect over a medium-term horizon, and what the value proposition of our portfolio is today:

   If the duration of the fund stays constant over a time-period (see Fig. 1), then the annualized future return over that time-period for an investor who invests in our portfolio today will be the current yield to maturity of the portfolio. And, this will happen, indifferently of intermediary interest rate movements (see Fig. 2)

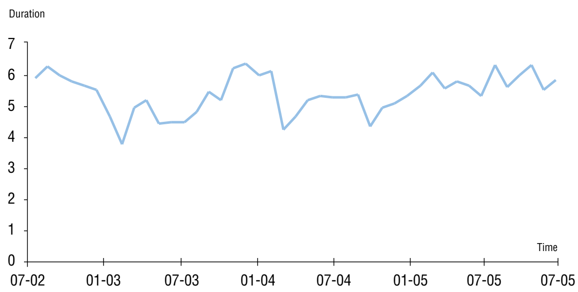


Fig.1: 90% of the time the duration of Bonds at Work evolved within a 4.5 to 6 year range

Interest rate changes	Evolution in time			
	1 year	**3 years**	**5 years**	**10 years**
+200 bp	–3.85%	3.22%	4.63%	5.69%
+100 bp	0.45%	3.98%	4.69%	5.22%
0 bp	4.75%	4.75%	4.75%	4.75%
–100 bp	9.05%	5.52%	4.81%	4.28%

Fig. 2: Return of a Bond Portfolio with a running yield of 4.75% and with a constant duration: indifference for intermediate interest rate changes

This specific use of duration, in a way, can be viewed as an Absolute Return Strategy. It gives you an absolute return, not over one year, but over a medium-term horizon.

What makes us really unique is that we use the same valuation methodology for our active investment process as for our passive investment process. Our valuation methodology which is based on in-depth research of Enterprise Value and Free Cash Flow of the companies we invest in, is used for all our investments:

- active and passive investments
- bond and equity investments

Erwin Deseyn, *Fund Manager Fixed Income Funds*

Colofon

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