



The Rainier philosophy is simple. We invest in quality growth companies at prices that make sense. We believe that rewarding stock performance comes from companies with superior growth, attractive relative valuations, competitive strength, and financial integrity. Our decisions are based on fundamental analysis, which emphasizes bottom-up stock selection by sector specialists. We invest in all major market sectors because we believe that investment opportunities are found in industries that are frequently overlooked.

## Sector Insights

### Focus: Materials & Processing

Materials & Processing sector specialists: James R. Margard, Peter M. Musser, Carlee J. Price

**Q: How does Rainier use its sector experts to manage a diversified portfolio?**

A: Sector teams consist of two to four people, with each person acting as both analyst and portfolio manager. These are sub-groups within the greater nine person equity team, in which each portfolio manager serves on multiple teams. We maintain a research focus in every area of the market, with a view that growth opportunities exist in all sectors and that market leadership shifts over time. Our sector teams seek to capitalize on that phenomenon. Different nuances exist for companies in different sectors related to the keys to growth, sources of profitability, and appropriate valuation metrics. Our sector teams specialize in understanding the most important factors that will influence price movements of stocks in their areas.

**Q: What are the major industries within this sector?**

A: The materials & processing sector is diverse, containing a large number of relatively small industries. While the sector was a larger component of the market indices in the 1980s and 1990s, the market cap of the sector has diminished since then.

The largest industry within the materials & processing sector in the Russell 3000 Index is chemicals. Two of the largest stocks in the sector are from this industry: Dow Chemical Co. and E.I. DuPont de Nemours & Co. Industrial metals is the second-largest industry and includes basic steel and copper stocks such as Freeport-McMoran Copper & Gold Inc.

Within industrial metals is the specialty metals industry which includes companies that produce unique metal alloys that are highly engineered and used in very specific end markets, such as energy or aerospace. Chemicals and industrial metals represent over 60% of the materials & processing sector. Other notable industries within the sector include paper and packaging, fertilizers, building materials and gold. The forest products industry has evolved in recent years as some companies, including Weyerhaeuser Co. have decided to convert to real estate investment trusts (“REITs”), and have been reclassified by many indices into the financial sector.

**Q: What is Rainier’s approach to buying stocks in the materials & processing sector?**

A: The materials & processing sector is different from most other sectors in that many of the companies within the sector produce goods that are essentially commodities. The majority of commodity-oriented companies rely on economies of scale and size to gain profit margin advantage, as they do not have the competitive advantage that comes with product differentiation. However, the key determinant of profits for these companies is the price of the commodity. In times when the commodity price is not high or rising, the results are low overall profit margins and few catalysts for future growth. At Rainier, we seek to identify companies that are able to meaningfully grow production – in the case of pure commodity companies – or differentiate their products or services from competitors’ in order to have a competitive advantage in the marketplace. In certain areas of

materials & processing, scarcity creates opportunity. Companies that can produce more in an environment where limitations exist have the potential to grow earnings faster than peers. While some growth investors give little attention to this sector because it has not traditionally been associated with growth, we believe that investment opportunities with an earnings growth component can be found in stocks with these characteristics.

**Q: How does the sector typically react during economic cycles?**

A: Historically, the materials & processing sector has been quite cyclical, with sub-industries within the sector reacting differently depending on the distinct dynamics of each. Because many of these companies produce materials that are inputs in the production of other goods, the economic cyclicity of this sector is quite diverse as well. Many commodity chemicals are related to residential and commercial construction. Paints and coatings are tied to the housing and automotive markets, and building materials, such as roofing and wallboard, are also closely tied to the housing market. Industrial metals such as steel and copper are dependent upon industrial production since, for example, they are inputs for the automotive industry.

Highly engineered metal alloys tend to be less correlated to the overall economy and more correlated to their specific end market uses, which may or may not coincide with the general economic cycle. Many such alloys are especially important as inputs into commercial aircraft or oilfield equipment. The commercial aerospace industry, a component of the producer durables sector, more often than not has been a late-cycle industry, strengthening well after an overall economic recovery has taken root, as aerospace companies typically commit capital for purchasing new planes and equipment after clear signs of an economic recovery are evident.

**Q: What areas within the sector do you currently view favorably?**

A: Within our portfolios, we have identified stocks in the specialty metals and specialty chemicals industries where we see opportunity for growth. A key driver for above-average earnings growth is pricing power, whether through limited supply or price based upon value to the customer. Because of rising demand and supply limitations, opportunities exist for many specialty chemicals companies to widen margins and accelerate profit growth. Refined lithium is an example of one of these opportunities, serving as a key input for electric car batteries. It is also not widely available as a commodity. The supply/demand relationship now appears to be favorable. Thus firms positioned to capitalize on this dynamic should have pricing power.

Related to the theme of investing in companies that are able to differentiate, we also see opportunities for companies in the production of highly engineered metal alloys. Metals and other components used in the production of energy and commercial aerospace products have a “mission critical” characteristic that makes their requirements for quality and performance extremely high. Buyers of these metals are most concerned with purchasing a strong but light product that will perform at a high level in variable conditions. This level of customization and specificity generally gives companies producing these materials greater pricing power, and potential opportunities for future earnings growth.

**Q: What major themes do you see in this sector going forward?**

A: There has been a trend within materials & processing in the last decade for companies to increase in size through mergers and acquisitions, with a focus on removing competition, growing larger, and cutting costs to achieve economies of scale. In businesses that are commodity-oriented, scale is vital to success. We believe this consolidation is occurring in part because it is becoming increasingly difficult to add economic value in this sector of the market.

An agricultural “revolution” is underway, which is advantageous to many companies in the agricultural chain. Demand in the emerging world in particular is providing new opportunities for companies to grow revenues. Strong growth and urbanization in India, China, and South America have increased demand for protein, which in turn stimulates demand for proportionally higher quantities of grains required to ultimately produce that protein. The principal crops used for feed are corn and soybeans. Companies such as DuPont are able to capitalize on this dynamic by developing seeds that increase yields, due to their resistance to herbicides and certain crop pests. This demonstrates the ability of technological innovation to add value to a sector that is generally commodity-oriented, as these companies have engineered seeds genetically.

Another related industry poised to capitalize on growing populations and crop demand in emerging markets is fertilizers. The use or increased use of fertilizer increases crop yields. Among fertilizers that assist in crop growth, potash appears to be the most attractive over a full cycle, as it is a mineral which is less abundant than phosphates and is not manufactured from an abundant commodity, such as nitrogen fertilizers, which are derived from natural gas. Supply constraints should provide companies that produce potash an economic advantage over peers that tend to be more vulnerable to over-supply at times during a business cycle

*Next edition: Health Care*

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