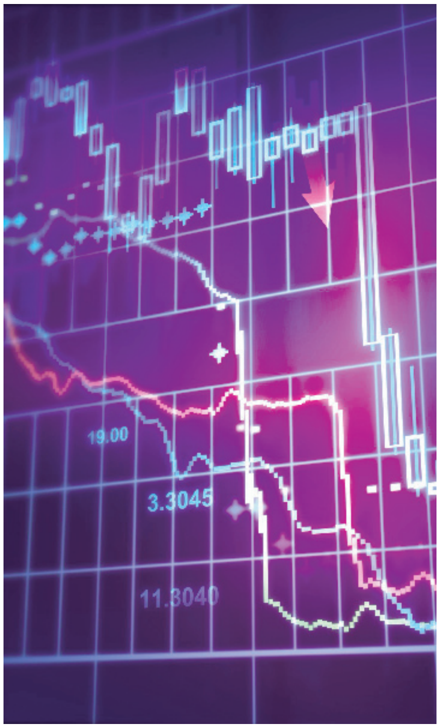
EVENTIDE FUNDS
Values-based investing

Eventide Asset Management, LLC
60 State Street, Ste. 700
Boston, MA 02109
877-771-EVEN (3836)
WWW.EVENTIDEFUNDS.COM

Bad Profits versus Good Investing



Too many companies can't tell the difference between good profits and bad . . .

Customers resent bad profits -- but investors should, too, because bad profits undermine a company's prospects. Like the addicts they are, enterprises dependent on bad profits have no future until they can break their habit.

Fred Reichheld
The Ultimate Question
Harvard Business School Press, 2006

Profit is the lifeblood of business -- and of business investing. Without profit a business fails, and increasing profit makes a business increasingly valuable, including for its shareholders. Yet the importance of profit in business often leads businesspeople, and business investors, badly astray. Businesspeople come to the corrupting conclusion that profit is the overriding purpose of business. Investors embrace the perilous belief that increasing profits are necessarily evidence of a healthy, sustainable business. But as the recent meltdown in the American financial sector so dramatically demonstrates, both these conclusions, widespread as they are, are dangerously, even fatally, false.

In 2006 the Harvard Business School Press published a book by Fred Reichheld entitled *The Ultimate Question*. The book was based on years of research at Bain & Company, one of the world's premier management consulting firms. It focused on a key question: what really differentiates healthy, sustainable business growth from growth that, in the end, proves unhealthy and unsustainable?

Reichheld and his colleagues at Bain determined that value creation -- not profit -- is the essential distinction between healthy and unhealthy businesses. Healthy, sustainable businesses are, of course, profitable -- but they make their profit by creating real value for customers. They consider profit the byproduct of serving well the needs of customers (and of employees and society). For many other companies, however, profit maximization, not value creation, is their highest purpose. As a result, these companies increasingly make their profit at the expense of their customers. Instead of creating value for customers, they end up extracting value from their customers.

Reichheld argues persuasively -- and proves empirically -- that profits generated at the expense of customers are, in fact, "bad profits:"

> *Too many managers have come to believe that increasing (profits and shareholder value) requires exploiting customer relationships. So they raise prices whenever they can. They cut back on services or product quality to save costs and boost margins. Instead of focusing on innovations to improve value for customers, they channel their creativity into finding new ways of extracting value from customers . . .*
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> *In short, companies regard the people who buy from them as their adversaries, to be coerced, milked, or manipulated as the situation permits. The Golden Rule -- treat others as you would like to be treated -- is dismissed as irrelevant in a competitive world of hardball tactics. Customers are simply a means to an end -- fuel for the furnace that forges superior profits.* ***This view is utter nonsense. Companies that let themselves be brainwashed by such a philosophy are headed into the sinkhole of bad profits, where true growth is impossible.***

Strong words. Does the evidence back them up?

Reichheld and his colleagues developed a conceptual framework called Net Promoter Score (NPS) that measures the ratio between Promoters and Detractors among a company's customers. Even more importantly, NPS ends up serving as an empirical measure of the degree to which companies create value for, or extract value from, their customers. Using the NPS metric, Bain surveyed over 150,000 customers in more than two dozen business sectors. What they learned is striking, including in its implications for investors:

- ✓ On a scale of -100 to 100, the large majority of American companies had NPS scores of 5 to 8. In other words, these companies practiced business in ways that turned almost as many of their customers into Detractors as Promoters.

- ✓ In fact, some entire sectors had negative NPS scores, i.e., taken together, all the companies in the sector were creating more Detractors than Promoters.

(In light of those facts, it's not hard to understand why for the entire period 1994-2004, 80% of American companies failed to achieve annual growth rates of even 5%.)

- ✓ However, in sector after sector, if one or two companies had noticeably better NPS scores than their competitors, then these companies displayed decidedly superior rates of growth and profitability.

- ✓ In fact, Bain demonstrated that, on average, a twelve point increase in NPS translates to doubling a company's rate of growth.

Bain's research has dramatic implications for investors. For most investors (or their portfolio managers), attractive rates of growth and profitability are their first and foremost investing criterion. Yet Bain's NPS research demonstrates that many companies achieve growth and profitability at the expense of their customers -- an approach that is inherently unsustainable. For investors, bad profits mean bad investing -- and the subprime mortgage debacle provides a dramatic lesson in just how bad the investing outcome can be.

Fortunately, companies who create real value for customers create good profit -- profit that is sustainable and scalable for the long-term. These companies prosper by doing good. So do their investors.

Eventide Asset Management, LLC, has a distinctive -- in fact, quite probably a unique -- investment philosophy, guided by an appreciation of the great potential for good, but also for harm, inherent in the activities of business.

Eventide believes that companies that prosper best over the long-term are those that best serve the needs of others. Accordingly, Eventide invests in companies that operate with integrity and excel at creating value. In so doing we enlarge the capacity of these businesses to create still more value, including for our shareholders. Just as importantly, Eventide avoids investing in companies that engage in predatory behavior or seek profit at all costs -- practices which harm customers, society, and eventually shareholders.

The result is "values-based investing" and it not only gives Eventide the potential for outperformance, it also provides a unique opportunity to invest in companies whose products and practices help create a better world.

We think of this as "business as blessing" and it is the cornerstone of our investment philosophy. Toward that end, Eventide has committed to donate a portion of its profits from managing the Gilead Fund to charitable organizations that are serving the world, especially the global poor.