

**Hillcrest Asset Management, LLC.**

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**Form ADV Part II**

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*This brochure serves as a replacement for Form ADV Part II. Form ADV gives information about the investment advisor and its business for the use of clients. The information contained here has not been approved or verified by any governmental authority.*

## 1. Advisory Services and Fees

Hillcrest Asset Management, LLC (“Hillcrest”) is engaged in the business of providing investment supervisory services.

Investment Advisory Services fees are charged as a percentage of account assets. Fees are quoted on an annual basis. Account fees are computed and billed quarterly, in advance. The initial fee shall be based on the Account’s market value at the inception of the Advisor’s management and prorated for the number of days the Account was managed during the initial quarter. Subsequent quarterly fees shall be based on the Account’s market value as of the close of business on the last business day of the quarter preceding the quarter for which the fee is due. The percentage charged typically follows the schedules outlined below.

The standard advisory fees for the U.S. Small Cap Core product are as follows:

0.90% Annually	on the first	\$10 Million of Portfolio Value
0.75% Annually	on the next	\$20 Million of Portfolio Value
0.65% Annually	on amounts over	\$30 Million of Portfolio Value

Minimum Annual Fee of \$90,000

The standard advisory fees for the U.S. Small Cap Value product are as follows:

1.00% Annually	on the first	\$10 Million of Portfolio Value
0.90% Annually	on the next	\$20 Million of Portfolio Value
0.80% Annually	on amounts over	\$30 Million of Portfolio Value

Minimum Annual Fee of \$100,000

Our fees are generally non-negotiable; however, fees charged to any given client may be higher or lower than the stated fees or the fees charged to other clients with accounts of comparable size and investment objectives, based on the client circumstances or investment guidelines.

All assets in any form are considered in the computation of fees. Money invested in cash balances, money market assets, client-directed assets or notes will be included. If trades are unsettled and pending, the trade date balance will be used.

In computing the market value of any investment of a client’s account, each security listed on national securities exchanges shall be valued at the last quoted sales price on the valuation date of the principal exchange on which such security is traded. Any other security or asset shall be valued in a manner determined in good faith by Hillcrest to reflect its fair market value.

Either Hillcrest or the client may terminate an advisory contract at any time by giving the other party 30 days written notice. Advisory fees paid in advance will be prorated to the date of termination and any unearned portion will be refunded to the client.

## **2. Types of Clients**

Our clients will consist of individuals; banks or thrift institutions; investment companies; pension and profit sharing plans; trusts, estates or charitable organizations and corporations.

## **3. Types of Investments**

We offer advice on exchange-traded, over-the-counter and foreign-issued equity securities.

## **4. Methods of Analysis, Sources of Information, and Investment Strategies**

The Hillcrest philosophy for our U.S. Small Cap Core, U.S. Small Cap Value and U.S. Large Cap Enhanced Index products is the same. We believe a well-defined investment process starts with an overall philosophy of how stocks will outperform the market. Having an overall philosophy helps a manager make sure they are not exploiting random returns as skill.

Hillcrest's philosophy is based on the understanding that a portfolio of stocks with a combination of attractive valuations and good earnings growth will consistently outperform its benchmark. We utilize academic research, behavioral market theory, quantitative tools and fundamental research to find those stocks. We invest in companies that have superior valuations relative to the market and their peers, earnings growth greater than the market and their peers and strong financials.

The Efficient Market Hypothesis states that utilizing publicly available company information will lead to a fair value. It is clear that company information alone is not the only thing that affects the price of a stock. The fact that people buy and sell stocks affects the price because people have emotions and opinions about companies that are not always reflected in the data available. Due to these emotions, price will deviate from fair value. Hillcrest utilizes behavioral finance to take advantage of this. Our expertise comes from Brian Bruce's pioneering efforts in behavioral finance. He is a founding member of the Board of Directors of the Institute of Behavioral Finance, is the Editor of the Journal of Behavioral Finance and has spoken about behavioral finance at over 50 professional investor conferences and universities.

What sets Hillcrest's process apart is that our research shows which factors are important and when they are important. It is important to understand, for example, that

long term price momentum cannot be positive if you plan to buy at the bottom of the valuation cycle. Positive long term price momentum back tests very well and many managers give it a fixed weight in their model due to this fact. We understand that long term price momentum is a good factor to use when determining to hold a stock but it can keep you from buying when valuations are most attractive. We use our experience as portfolio managers and our investment philosophy to guide our models and will use long term price momentum only when it is important (which is not all the time).

Hillcrest seeks attractively priced stocks with strong financials. We buy those stocks when positive information changes perception of the company. We hold those stocks as they move from under-reaction to over-reaction. We sell them when the valuation is expensive and investors are losing enthusiasm. We run our strategy at a targeted 4-5% tracking error relative to the Russell 2000 for core and the Russell 2000 Value for value. We expect an excess return of at least 3% and an information ratio greater than 0.6.

The strategy's emphasis is stock selection. We do not engage in asset allocation, sector rotation or any top down techniques. We utilize quantitative techniques to identify stocks that we find attractive. Historical attribution shows that over 95% of returns come from stock selection.

Our investment process is based on our research into stock and sector related factors. We have found significant forecasting power in stock related factors. Sector related factors have tested much less significantly with far greater volatility. Based on this research, we focus our efforts where they will produce the best returns for the amount of risk. Our portfolios, therefore, are sector neutral to their respective benchmarks (Russell 2000 for Core and Russell 2000 Value for Value). We hold sector and key industry weights within 2% of their weight in the benchmark. Our process does not forecast sector returns. As our process is based on our philosophy about what causes stocks to outperform, we do not utilize continual historical regressions to vary the weights of our factors across sectors or across time.

The process starts when our investment management team meets on a weekly basis to review portfolios. In preparing for the meetings we are looking for sector imbalances, stocks outside of risk boundaries, low ranked stocks and poor performing stocks. Potential buy replacements are also brought to the meeting. The investment team then reviews the data and discusses each potential trade. Decisions are made and trading occurs that day.

### **Security Selection Process**

We start with a universe of benchmark securities plus any other holdings that may be in the current portfolio. We then rank all of those securities using a quantitative process. We have both core factors and adaptive factors in our process. Our goal is to re-create our investment philosophy through our process.

## **Sector Relative Rankings**

We rank stocks in each of the 10 S&P GIC sectors on a relative basis. Each factor is scored in standard deviation terms in order to facilitate combining the data.

In order to buy a security, we search for factors based on our philosophy. Our first core factor is attractively valued stocks. We then adapt the valuation factor in order to make it more powerful utilizing our experience and understanding of when and how factors are important. Our three core factors are equally weighted in our quantitative rankings. The weight of our fourth core factor cannot be described in the same manner as it is a qualitative analysis that looks for stocks that have issues or concerns that the data does not find. This qualitative analysis could have no effect if it finds no new information or it could be the deciding factor that keeps us from buying a stock.

### Core Factor 1 - Valuation

Our valuation is an equal-weighted combination of FY1 Earnings/Price, Book/Price, Cash Flow/Price, Sales/Price and Dividend Yield. Dividend yield is adapted based on the previous 12 months performance of the stock.

#### *Dividend Yield Adaptive Factor*

The dividend yield factor is adapted due to the need to adjust for 3 conditions. First, zero dividends are a positive contributor to future price appreciation and should not get the lowest score (which they would get if you ranked on dividend yield). Second, high dividend yields due to poor stock performance over the past year need to be adjusted downward as these yields are unlikely to be sustainable going forward. Finally, low dividends with strong 12 month performance need to be adjusted upward as dividend policy has not yet caught up.

#### *Valuation Dispersion Adaptive Factor*

The value factor is further adapted for dispersion. Besides looking at a composite valuation, we look at the dispersion in valuation metrics. Our research has shown that strong dispersion is a negative predictor of future returns and we adjust appropriately.

#### *Missing Data Adaptive Factor*

If there is missing data either in terms of valuation information or earnings coverage, our research done in the paper "Extreme Investing" shows this is predictive of future poor relative returns and we adjust the valuation factor to ensure that these stocks end up ranked in the fourth quartile.

#### *Bankruptcy Adaptive Factor*

We want to make sure that these attractively priced stocks will stay in business. The most powerful finding of our research is that small cap stocks with the most attractive valuations contain a number of stocks that subsequently go bankrupt. We calculate a modified version of an Altman Z score using balance sheet data like the debt/equity ratio to determine likelihood of bankruptcy. If a stock is in the bottom 3% of bankruptcy scores, the rank is forced to the bottom of the sector.

#### *Low Price Adaptive Factor*

Finally, we look for stocks with absolute low prices. Brian Bruce's research paper, "Extreme Investing" has shown that low price stocks are predictive of future poor relative returns. We adjust the rank of the stock based on this.

The next step in the process is to ensure that there is proper earnings growth relative to the valuation. Again, we calculate the core factor and then adapt it to be more powerful.

#### Core Factor 2 – Future Earnings Growth

After determining if a stock is attractively valued, we need to ensure that it will grow earnings appropriately. Many stocks with low valuations are cheap due to their poor future earnings growth. Our research and outside research finds that long term growth estimates from analysts are not accurate predictors of future earnings growth. Our internal research has found, however, that short term growth predictions and historical earnings growth are more predictive of future earnings growth. We equally weight 2 years of historical earnings growth, 2 - 3 years of future earnings growth and a non-consensus based long term growth rate to determine the future growth rate of earnings.

#### *Earnings Dispersion Adaptive Factor*

Like the valuation dispersion, we find that strong dispersion of the components of earnings growth is a negative relative predictor of performance. We adjust the earnings factor downward in direct proportion to the dispersion among the 5-6 years of earnings data.

#### *No Analyst Coverage Adaptive Factor*

When there is no analyst coverage, this is a negative predictor of future returns. Our research shows that analyst coverage is a positive informational variable.

So far in the process we have only discovered good value stocks. Next we need to ensure that we do not get caught in value traps. Most value managers will buy stocks based on valuation alone and then find that they need to hold them over a long period

of time before multiples expand. In Charles Lee's article "Fusion Investing", written when he was at Cornell, he shows clearly that multiples do not expand simply because stocks are attractively valued. Multiples expand because something positive happens at the company and that information gets conveyed to the marketplace. Only when this sentiment-changing information is disseminated to the market does the multiple expand. Hillcrest looks for this sentiment indicator to determine the proper time to buy.

#### Core Factor 3 – Positive Sentiment

In conjunction with strong valuations relative to earnings growth, we need improving sentiment (which we measure as positive information flowing into the marketplace) in order to have a security rank high enough for purchase. This factor also helps us to avoid value traps that will occur when behavioral biases cause investors to not react to stocks with attractive valuations. We look at a combination of earnings revisions, earnings surprise, changes in short interest and short term price momentum to determine if investors have turned positive on a stock.

These three core factors make up the quantitative part of our buy process. We next take a more fundamental look at potential buy candidates. We go through a number of data and news checks. Finally, we need to ensure that we understand where the growth is coming from as it is the key forward estimate in the process. For example, we would not want to own a retail store with 17% estimated earnings growth if it turned out that customer traffic had been down for 16 straight quarters. We do not look at every stock this way, only the 2-3 that rank highest in each sector where we are looking for a buy.

#### Core Factor 4 – Qualitative Buy Decision

A highly ranked stock can only be purchased if it passes our non-quantitative analysis. Liquidity is first determined. We only purchase stocks that can be held at 25% of average daily volume (ADV) at our stated capacity. Then the investment team reviews every stock that is a buy candidate for data integrity. Next, we look for news about a company that might not be incorporated into our quantitative factors. Finally, we need to understand how companies grow earnings to ensure that we invest in companies with the highest probability of obtaining their estimated future earnings growth. If we don't understand where earnings growth is coming from, or it seems too high based on the company economics, we will not purchase a stock regardless of its ranking.

Once a stock is purchased it is our expectation that there will be price appreciation. When this event occurs, we need to properly evaluate the stock and be able to compare it to potential buys. Too many managers sell stocks too soon based on their non-factor adaptive rankings. We have adaptive factors that allow us to properly compare current holdings and potential buys.

#### Held Stock Adaptive Factors

Once we hold a stock, our stock rankings are further adjusted using adaptive factors. Behavioral market theory tells us that once a stock is in favor and moving positively,

investors will continue that momentum to the point of over-reacting. In order to hold a stock through its entire cycle, we add in additional factors to account for this. For a held stock we will look at actual (not forecast) earnings momentum and price momentum. These factors are added to the forecast based on where a stock is in its valuation cycle as judged by our valuation factor relative to price. When a stock is close to its extremes in the valuation range, the long term price momentum factor contributes very little to the ranking. The closer a stock is to the middle, the larger its contribution.

## **5. Education and Business Standards**

At a minimum, Hillcrest requires all portfolio managers and equity analysts to have obtained a bachelor's degree. In addition, a portfolio manager and equity analyst is expected to have an MBA, be a Chartered Financial Analyst ("CFA") charter holder or be working towards a CFA charter. Hillcrest supports and encourages employees to pursue advanced degrees and other professional designations. Hillcrest considers one's business and educational background, prior investment related experience and past positions held of primary importance.

## **6. Education and Business Background**

Biographies of key personnel are as follows:

**Brian Bruce, CEO and President.** Brian, born October 22, 1955, received his M.B.A. from the University of Chicago, M.S. in Computer Science from DePaul University, and a B.S. in Business Administration from Illinois State University. He is a member of the Illinois State University College of Business Hall of Fame and is winner of the University of Chicago Graduate School of Business CEO Award. Brian is a professor at Southern Methodist University's Cox School of Business teaching both undergraduate and MBA classes which manage over \$6 million of the SMU endowment. Brian served as Chief Investment Officer in charge of equity management and research at PanAgora Asset Management, a \$23 billion institutional manager. Prior to joining PanAgora, he was a full time professor at Southern Methodist University and President and Chief Investment Officer of InterCoast Capital, a Dallas based subsidiary of a fortune 500 energy company. He previously worked at State Street Global Advisors, the Northern Trust Company and Stein Roe & Farnham. Brian has published numerous scholarly articles and books including *Analysts, Lies, and Statistics* which he co-authored with Harvard Business School professor Mark Bradshaw. He is also the Editor-in-Chief of Institutional Investor's Journal of Investing, Editor of the Journal of Behavioral Finance and Editor of the Journal of Trading. Brian frequently appears in the media including NBC, ABC, CNBC, Wall Street Journal, Bloomberg, Washington Post, New York Times, Associated Press, Reuters, Financial Times and Business Week. Brian also serves on many boards of directors including The Center for Investment Research, the CM Family of Mutual Funds and the Institute of Behavioral Finance.



**Mark Yancey, Managing Partner and Chief Marketing Officer.** Mark, born September 26, 1957, graduated from The University of Oklahoma with a Bachelors degree in Business (Finance). Prior to joining Hillcrest, Mark was co-head of Institutional Marketing and Senior Vice President of MetWest Capital Management, LLC in Newport Beach, California. He has 22 years of investment experience and managed client development for MetWest Capital out of the Dallas, Texas regional office. Prior to joining MetWest Capital, Mark was manager of client development at Palley-Needelman Asset Management. He also worked for Wells Fargo Bank and began his career with Mass Mutual Insurance Company.

**Deborah Trask, Managing Partner and Chief Operating Officer.** Deborah, born January 5, 1956, received her BA in Business from Northeastern University and her MBA from the University of Texas at Dallas. Prior to joining Hillcrest Asset Management, Deborah did operations and trading for RPF Equity Advisors. From June 1999 until she joined RPF Equity Advisors, Deborah was the Operations Manager and Office Manager for Dana Investment Advisors responsible for all of the trading and operations for its equity strategies. Previously, she was Senior Vice President in charge of operations for InterCoast Capital in Dallas, Texas. Before joining InterCoast, she was a member of the executive committee and responsible for operations of \$15 billion of domestic and international equities at State Street Global Advisors. She was a co-founder in charge of operations at India Wharf Associates. She is Managing Editor for *The Journal of Investing*, *The Journal of Trading* and *The Journal of Behavioral Finance*.

**Douglas E. Stark, Managing Director, Portfolio Management and Research.** Douglas, born December 22, 1960, received his BA from Arizona State University and his MBA in finance and international business from Columbia University, where he graduated with honors. He is a CFA charter holder. Prior to Hillcrest, he was Partner, Senior Vice President, and Director of Research at Martingale Asset Management. Prior to joining Martingale, Douglas was a Senior Vice President and Portfolio Manager at InterCoast Capital Company where he developed a stock selection strategy and created a risk management process for an active U.S. equity portfolio active international portfolio, and emerging markets portfolio. Douglas started his career at State Street Global Advisors in 1990, where he was a Vice President and management international stock portfolios and active currency overlays.

## **7. Other Business Activities**

Hillcrest's principal business is as an investment advisor providing investment advice concerning securities to clients.

## **8. Other Financial Industry Activities or Affiliations**

Hillcrest is not registered as a securities broker-dealer, nor is it registered as a futures commissions merchant, commodity pool operator or commodity trading advisor, nor

has Hillcrest made any arrangements that are material to its investment advisory business or its clients with a related person, nor does a related person act as a general partner in any partnership in which clients are solicited to invest.

## **9. Participant or Interest in Client Transactions**

Hillcrest currently maintains and adheres to a comprehensive Code of Ethics. The Code of Ethics covers many topics, including: the review and reporting of personal securities transactions, restrictions on investing in initial public offerings and private placements, prohibitions on the use of and trading on material non-public information, and the establishment of the position of Chief Compliance Officer.

All Hillcrest employees are restricted from engaging in any practices that would operate as a fraud or deceit upon Hillcrest or any of its clients. It is the policy of Hillcrest to prohibit personal securities transactions by access persons in all “restricted securities.” Hillcrest permits its employees to invest in securities that may also form a part of the client’s portfolios. Because Hillcrest permits its employees to deal in securities that clients may also deal in, every employee is required to obtain pre-approval on securities transactions and report quarterly transactions to the Chief Compliance Officer. Securities that are neither being considered nor are currently part of a Hillcrest investment strategy, but are still contained or are being considered for purchase in a client’s account are considered “held or to be acquired.” All other securities are considered non-restricted. Personal securities transactions by access persons in non-restricted securities do not require pre-clearance. The Chief Compliance Officer periodically reviews all personal securities transactions to ensure that employee positions and trades do not present a conflict of interest with the position of Hillcrest Clients. Hillcrest employees formally report their personal securities transactions to the Chief Compliance Officer quarterly. Annually, personal holdings statements for all access persons are also required to be given to the Chief Compliance Officer for review. Hillcrest provides regular updates and discussion regarding the firm’s Code of Ethics. All employees are then required to sign an annual statement acknowledging receipt, compliance with and understanding of Hillcrest’s Code of Ethics. A detailed copy of Hillcrest’s Code of Ethics is available to clients or prospective clients upon request.

## **10. Conditions for Managing Accounts**

Hillcrest does not have a minimum account size requirement.

## **11. Review of Accounts**

Certain members of the firm act as portfolio managers for client accounts. Each client portfolio is formally reviewed on a quarterly basis. However, triggering factors (buy/sell a new security, risk control parameters, sell discipline) will compel portfolio managers to

review accounts on a more frequent basis. In addition, portfolios are monitored daily on a composite basis.

Portfolio Managers meet weekly to discuss general investment policies and procedures as well as specific investment ideas. Hillcrest generates written analysis of portfolio performance based upon client needs. Hillcrest provides clients with a written annual performance analysis, including quarterly performance figures. In addition, performance figures can be requested at any time.

## **12. Investment or Brokerage Discretion**

Hillcrest has discretionary authority to buy and sell securities in the quantities that it deems fit without first obtaining consent of the client. Hillcrest determines which securities to buy or sell, the total amount of securities to buy or sell, the broker or dealer through which the securities will be bought or sold (unless directed by the client) and the commission rates at which the transactions are executed. Any limitations or restrictions with respect to the exercise of this investment discretion will be those established by the client in writing at the commencement of the advisory relationship or thereafter.

In selecting a broker-dealer through which to purchase and sell securities, Hillcrest will review the most favorable combination of transaction cost and proceeds available under the circumstances (Hillcrest Asset Management will seek best execution). In connection therewith, Hillcrest will consider a range of factors, including price and commissions, execution ability, clearance procedures, custodial and reporting services, and other brokerage services provided by the broker-dealer. Hillcrest does not use soft dollars and as such, research is not a factor in choosing a broker-dealer.

Subject to the above commitment to obtain best execution, Hillcrest will attempt to accommodate client requests to effect securities transactions through a particular broker-dealer.

Based upon the quality of the brokerage and/or other services provided, advisory clients may pay a brokerage commission or mark-up in excess of that which another broker-dealer might have charged for effecting the same transactions. Not all such services may be used by Hillcrest in connection with advisory clients who paid commissions to the broker-dealer providing such services. A written copy of Hillcrest's Soft Dollar Policy is available to all clients upon request.

When applicable, Hillcrest will take appropriate action and/or render advice with respect to the voting of client proxy statements. From time to time, Hillcrest may retain a proxy voting agent, who conducts in-depth research, monitoring, and provides comprehensive voting services. Hillcrest, to include any third party proxy voting agent, will vote all client proxy statements according the Proxy Voting Guidelines adopted by

Hillcrest. Utilizing formal proxy voting guidelines helps to maintain objectivity and fairness, and allows for resolving any potential conflicts of interest in a prudent manner. Hillcrest therefore believes that its proxy voting process resolves all issues in the best interest of each client. A written copy of Hillcrest's Proxy Voting Guidelines is available to all clients upon request.

### **13. Additional Compensation**

Currently, Hillcrest does not have any arrangements, oral or in writing, where it is paid cash by or receives some economic benefit from a non-client in connection with giving advice to clients or directly or indirectly compensate any person for client referrals.

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Hillcrest has adopted policies to protect personal information about its clients. A copy of Hillcrest's privacy policy is available upon request.