THRIVENT MUTUAL FUNDS

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TRACKING ROIC HELPS UNCOVER QUALITY STOCKS AND AVOID RISKY ONES

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Return on invested capital (ROIC) can be a helpful tool in uncovering quality stocks and, when combined with valuation, could provide above average shareholder returns—while also helping to bypass companies that may face return challenges in the future.

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Executive Summary

- ROIC shows the returns a company's management earns on the total capital it invests, including borrowed capital.
- ROIC aids comparison between firms by including both their equity and debt in the analysis.
- Shareholder return in a stock is created when the outlook differs from the expectation built into the stock price. Using ROIC in the fundamental analysis process can help investment managers determine that potential difference.
- ROIC can help find stocks with potential for above average returns by identifying cheap companies with low returns that may improve, cheap companies with high returns that may hold when others expect them to erode, and fairly valued or slightly expensive companies that have the potential to invest at high incremental returns.
- ROIC can also help avoid companies that may be a value trap—a cheap stock that stays cheap—a high earning company that may not be able to sustain that level of earnings, and growth companies that may face stiff competition in the future.
- Thrivent uses the ROIC strategy as part of the process to analyze stocks for its mutual funds—particularly the Thrivent Large Cap Value Fund (TLVIX) and the Thrivent Small Cap Stock Fund (TSCSX). We perform detailed fundamental research on companies we analyze to determine if ROIC for those companies can improve to a level greater than investors' expectations.
- The final step of the ROIC strategy is to identify a catalyst that could unlock value, such as announcement of a new product, new strategy, cost initiative, restructuring or other significant action.

ROIC—"return on invested capital"—is essentially net income divided by total capital. But it's more than just a calculation. It's a stock analysis process that can help analysts identify quality stocks and steer away from risky ones.

We use ROIC extensively in our stock analysis process for both the Thrivent Large Cap Value Fund and the Thrivent Small Stock Fund. We believe focusing on ROIC combined with valuation provides a greater opportunity for outperforming in the stock selection process.

The premise underlying ROIC investing is that a company with high return on invested capital and the ability to reinvest at that rate (or a rate above the cost of capital) deserves a higher valuation.

Why is ROIC important?

In short, ROIC shows the returns management earns on the total capital it invests. Otherwise, GAAP (generally accepted accounting principles) reporting can distort real returns. If management borrows at its cost of capital (generally higher than 8%) and invests at less than its cost of capital, it destroys value. In other words, if you borrow money at 8% and reinvest it at 4%, that will ultimately drive down real returns and value.

While we feel that focusing on ROIC helps produce high quality research, it should not be the only factor considered when making investment decisions. Like all valuation methodologies, results from the application of ROIC analysis can vary based on economic and market factors, and a company's historical ROIC may differ from its future ROIC.

One of the key advantages of ROIC analysis is that it improves comparability across firms by essentially putting all companies on an equal playing field by accounting for both their debt and their equity. And ROIC better aligns with a company's economic strengths rather than just its accounting returns, which also improves comparability.

Without a focus on ROIC, a growth investment manager might focus solely on a company's earnings growth, while a value investor might focus on companies that are cheap relative to current cash flow. In contrast a value investor focused on ROIC understands there is a tradeoff between a company's value and its operating performance or returns.

Drilling Down on the Process

Academic literature tries to hold things constant—for example, assuming a company with a high ROIC will always have a high ROIC—but that doesn't always hold true in the real world. As a result, a portfolio manager cannot just buy a list of cheap stocks with high returns and expect to outperform.

Many high-return companies might be over-earning at the current time and unable to re-invest at high levels, so future incremental returns will come under pressure.

Other value investors may just buy cheap stocks without considering the companies' return history and potential outlook for those returns. A cheap company with low returns will stay cheap unless it develops an improvement strategy that is eventually reflected in future economic returns and cash flows.

Finally, many value investment managers may also overlook those companies that are not outright cheap on current cash flows but earn a ROIC at a premium to the market and have the ability to invest at a high incremental level of return. A company might deserve to trade at an even higher premium to the market given the ability to generate a consistently high level of returns in excess of the market.

As a result, a portfolio manager utilizing ROIC in an investment process needs to understand the level of returns priced into a stock. The portfolio manager then needs to complete a detailed fundamental analysis of the company's ROIC and determine if the company has ample future opportunities to invest at a high level of ROIC. Shareholder return in a stock is created when the outlook differs from the expectation built into the stock price.

For instance:

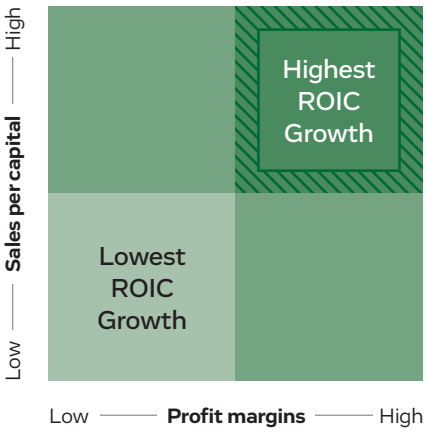
- Revenues generated relative to capital invested and profit margins drive ROIC (high levels of revenue per dollar of capital invested and profit margins will result in a high ROIC).
- Research helps determine the sustainability and direction of the drivers.
- Companies with higher ROIC should have higher valuations.
- Breaking down the two levers of returns help portfolio managers analyze and study how a company can improve its ROIC—through new products, better pricing, cost cutting, eliminating non-productive assets, and other similar actions.

Achieving Success Using ROIC

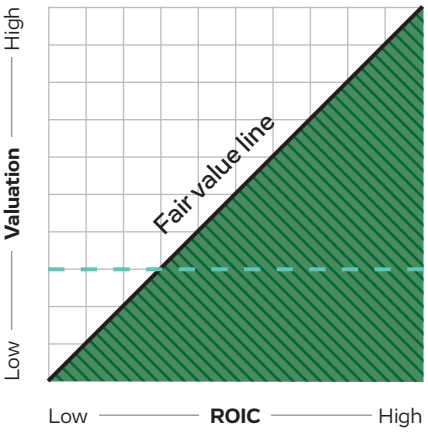
Here are the key ways to improve the chances of success with an ROIC-based approach:

- Invest in a cheap company with low returns that improve.
- Invest in a cheap company with high returns that hold when others expect them to erode. (Investors are expecting future returns to erode but if a company can hold those high returns, investors will reward it.)

KEY RETURN LEVERS



CRITICAL ANALYSIS



Return on invested capital (ROIC) is a measure of operating performance—a ratio of a company's profitability over capital. It measures how well the company utilizes capital.

Management seeks opportunities in the green striped space below the **fair value line**, while other value managers may only focus on low valuations below the teal dotted line.

Charts are for informational purposes only and do not reflect the performance of any specific fund or security.

- Invest in what appears to be a fairly-valued-to-slightly-expensive company but earns high return with the ability to invest at high incremental returns. (If a company is trading at a slight premium to market, it might look expensive on current cash flow or earnings. However, if the company's returns are 30% greater than the market with the ability to invest at these high incremental rates, then an even higher premium is justified.

Using ROIC to Avoid Pitfalls

Here are some pitfalls investors try to avoid by focusing on ROIC valuation tradeoff:

- **Value traps—cheap stock that stays cheap.** This refers to a company or industry that is structurally challenged, and thus unable to improve its ROIC. Under those conditions, the company would be destroying value with every incremental investment.
- **Over-earning and not cheap on future returns.** This refers to a stock that looks cheap based on current numbers but cannot sustain a high enough level of returns to justify its current valuation.
- **Growth investor competing away profits.** In certain cases, the market might provide a tremendous amount of growth opportunity for a company, which then attracts the excitement of other companies and investors. If too much capital—through too many companies—chases this opportunity, then there will be no returns left for the shareholders of the original company. Competing companies can drive down great growth potential and ROIC.

How Thrivent Uses ROIC

How does Thrivent implement the ROIC strategy? The Thrivent Large Cap Value investment process requires our analysts to rank companies based on valuation, operating performance and catalyst. Analyst research must consist of a thorough review of ROIC and valuation tradeoff among a litany of other analytics.

Our experienced and tenured analysts have also developed specific investment frameworks on how to make money in a given company or sector. An overlaying of the analyst investment framework with the Value team's trade-off between valuation and ROIC provides for greater opportunity for outperformance.

Analysts perform detailed fundamental research on a company to determine if ROIC can improve to a level greater than investors' expectations. To aid this analysis, we dissect the components of ROIC and then do a thorough fundamental bottom up analysis to estimate the future level of those components.

ROIC can be broken down into net operating profit and invested capital, and then broken down further into profitability (net operating profit after tax—"NOPAT"—to sales), sales productivity (sales to capital) and capital efficiency (asset to capital.) Each of the components of returns is examined over time to understand the drivers behind their performance.

Using detailed company models, we look at the historic trends of these components and the operating factors influencing them over time.

The hard part begins as the analyst does a detailed analysis of the company's strategy, core competency and competitive advantage to understand where the analyst expects profit margins, sales productivity and capital efficiency will be in the future. The beauty of this process is that it forces the analyst to look out into the future rather than to be overly swayed by short term issues. Execution of this analysis is the most important part of the process but the ROIC concept helps keep the analyst focused on the important drivers.

Finally, the detailed ROIC process must uncover or lead to an outlook that differs from other investors' expectations of future returns.

Uncovering Valuation Variations

We must begin by understanding what ROIC is priced into a stock. Since this is more of art than a science—or a combination of both—analysts are encouraged to look at analyzing the valuation and operating performance tradeoff in many ways.

For instance, one approach might be using a historic charting tool that examines the relative returns of the stock and valuation over a long period of time relative to a specific industry of companies or the broader market.

To dive more deeply into what is priced into a company an analyst would build a detailed discounted cash flow (DCF) model with a certain level of future return expectations driving the cash flows. The difference between the DCF value for the company and the current

stock price can provide insight into what other investors are expecting of incremental returns and the ability to reinvest.

The last part of execution is identifying the catalyst for unlocking value. When we find a company, whose stock is not valued properly in terms of our expected ROIC relative to what the market expects, we still need a catalyst to unlock this value—announcement of a new product, new strategy, cost initiative, restructuring, or other significant action. How will the market show us whether our assessment was correct? Usually, we have to wait for the financial numbers to come in above investor expectations and more in line with our expectation—which should drive up the price of the stock.

While ROIC is just one part of the stock analysis process, it can help investment managers avoid value traps and identify stocks in which the growth outlook differs from the expectations built into the stock price by uncovering valuable insights into the sustainability of a company's growth—and the potential long-term performance of its stock.

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Mr. Lauber joined Thrivent Financial in 2004. He has previously served as an associate portfolio manager.

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Disclosures

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