

THE RESERVE REPORT®

IT PAYS TO KEEP MONEY IN RESERVE™

Third Quarter 1999

Letter from the President

WE SUSPECTED AS MUCH



Bruce Bent
President,
The Reserve Funds

Last quarter, I spoke to you about the dangerous practice many other money funds employ of investing in commercial paper. I also reassured you that The Reserve Funds has never invested in such speculative

and potentially hazardous securities. The timing of that warning turned out to be eerily prophetic.

Case in point: General American Life Insurance Company (GenAm), a little-known St Louis-based insurer, which issued a form of commercial paper known as a funding agreement, a contract between GenAm and institutional investors. Some of these investors were among the nation's largest money fund managers.

The funding agreements had a potentially lethal linchpin: investors had the right to demand full repayment from GenAm on just seven days' notice. And when Moody's Investors Service downgraded the paper to non-investment grade, it precipitated an avalanche of demands for repayment from suddenly panic-stricken money fund managers.

At The Reserve Funds, we know with commercial paper investments, things like this are inevitable. We watched the unfolding events with interest, secure in our policy of avoiding portfolio time bombs like insurance industry funding agreements.

As money fund investors clamored for their money back, GenAm found themselves with nearly a \$7 billion shortfall, and was swiftly put under administrative supervision by Missouri insurance regulators. As reported

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in the August 23, 1999 issue of *Barron's*, "Of the 37 holders of the funny funding agreements, 30 were money funds on the hook for about \$5 billion."

Barron's continued, "Who'd have imagined money funds would have laid so deeply into the illiquid and oddly structured guaranteed-investment contracts..?"

Indeed. For years, I have been speaking to anyone who would listen about the inherent dangers of money funds holding inappropriate investments such as commercial paper and derivatives in their portfolios. I have penned dozens of articles in investment, financial and trade journals on the topic. Some in the industry have accused me of overreacting, but in light of events in recent years, it seems many of my critics had their head in the sand.

Every major loss or failure suffered by a money fund has been the result of commercial paper or some form of derivative investment that defaulted. The question you as an investor should be asking is, "What happens if I invest in a money fund that defaults and decides not to bail me out?" The answer is unclear, but why would anyone take such a risk for what typically amounts to perhaps three or five hundredths of a percent increase

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Reserve Small-Cap Growth Fund

A CONVERSATION WITH VROOM & WEISMAN

We recently interviewed the Sub-Advisers of the Reserve Small-Cap Growth Fund, Edwin G. Vroom and Adele S. Weisman. The two are principals and portfolio managers at Roanoke Asset Management Corporation in New York, NY.

Mr. Vroom and Ms. Weisman have managed the Reserve Small-Cap Growth Fund, one of six no-load funds that comprise the Reserve Private Equity Series, since its inception in November, 1994.

The Fund's performance, as compared to the Russell 2000 Growth Index, has been impressive, to say the least. Through September 30, 1999, the Reserve Small-Cap Growth Fund has generated a twelve-month return of 100.57% vs. 32.06%, and an average annual total return of 27.34% vs. 11.77% since inception.*

What is the Fund's objective?

The Reserve Small-Cap Growth Fund's objective is to seek long-term capital appreciation through investment in a portfolio of smaller-sized U.S. companies whose outstanding shares have an aggregate market value of \$1 billion or less at the time of purchase. Any production of income is secondary.

The Fund seeks to achieve its objective by investing in equity securities issued by companies with investment characteristics such as:

- Accelerating rates of revenue and earnings growth, market dominance or a strong defensible market niche.
- Unit growth coupled with stable or rising profit margins, a sound balance sheet.
- Skilled management with an ownership stake.

How did you compile such an enviable investment performance, particularly in the last year?

A year ago, we were dealing with crises in Southeast Asia and Russia. Although many investors were uncertain about the future, we believed that the correction was not a signal to get out of the market but an opportunity. We were even ahead of others who believed as we did. We foresaw the market turn and by early September, 1998,

we were fully invested. By the time most others recognized the turn (in early-October), we already had a full house in the telecommunications, specialty retailing and technology areas.

In terms of industry sector concentrations, we were extremely well-positioned coming out of the correction last year. And our portfolio has been dynamic, not stagnant, since, so that we have continued to have significant commitments in the leadership segments.

Can you describe the key investment strategies you executed over the last year and how they translated into a winning portfolio?

Some of the key strategies we executed in the last twelve months were outside the consensus thinking at the time. These strategies, namely technology and telecommunication sectors have reaped significant rewards for our investors, particularly in the last six months.

One of those strategies was to remain invested and, in fact, increase our investment in the enterprise software area.

In the telecommunications area, we were very early in identifying that fiberoptic technology would be vital in building out the broadband networks being created worldwide. The telecommunications sector has done well for our shareholders.



Edwin G. Vroom & Adele S. Weisman
Portfolio Managers,
Reserve Small-Cap Growth Fund

The final segment of our technology/telecommunications strategy was in the semiconductor and related areas where we hung on through the dicey part of the cycle, concentrating on several companies which make components for or are otherwise linked to telecommunications equipment. These issues have also turned around and have become strong performers.

What kind of research enabled you to separate the reality from market perception?

The answer to this question really defines who we are. We tend to be more strategic, digging deeply into the core of what a company does, what its business is all about, versus the short-term price action of its stock. So after we review a company's financial reports, interview its management and competitors, and can find no evidence of weakness, that's when we see an opportunity. That's where, as strategic investors, we can separate ourselves from those who focus exclusively on stock price action and a series of numbers to make investment decisions.

QUARTERLY FUND PERFORMANCE

