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Creating a Resilient Portfolio of Small-Cap Stocks

ALBERT GROSMAN, CLEARBRIDGE INVESTMENTS, LLC

ALBERT GROSMAN is the Co-Portfolio Manager of the ClearBridge Small Cap Fund, the related Small Cap Strategy for institutional investors and the All Cap Value Strategy at ClearBridge Investments, LLC. He has 23 years of investment industry experience. He joined ClearBridge, LLC — formerly known as Legg Mason Capital Management, LLC — in 2007. Prior to joining the firm, he worked as an equity analyst specializing in small- and mid-cap companies with Long Trail Investment Management; Phinity Capital; Cyllenius Capital Management, which was acquired by BlackRock Inc.; and Fidelity Management & Research. He has a BBA in business administration from Emory University and an MBA from Columbia Business School.

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SECTOR — GENERAL INVESTING

(AHJ500) TWST: Could you tell me a little bit about the ClearBridge Small Cap Fund and the firm?

Mr. Grosman: The fund has been around since 1985 and has gone through a few iterations. I joined the fund in 2011, and in early 2014, we transitioned it from a midcap fund to a small-cap fund. I joined the predecessor firm in 2007, and in 2009, I started a small-cap strategy that was a separate account that I've managed since inception. In 2014, the small-cap product merged with the fund so that it and all separate accounts are now managed under the same strategy and same portfolio management team of three people — two co-managers and a dedicated portfolio analyst — and support from ClearBridge's central research department.

TWST: And does the fund have a unique philosophy?

Mr. Grosman: Our goal is to create a resilient portfolio that has a chance of outperforming the wide variety of market conditions over the long term. We are valuation-driven, using economically sound discounted cash flow models. Our process focuses on market expectations for a stock, i.e., what growth rate and return on capital the company needs to generate for how long in order to be worth what it's trading for.

Then, we use competitive strategy to determine what variant perception we may have compared to the market. For example, do we think margins will improve more than the market expects due to the recent consolidation in the industry? Or perhaps we think that returns on capital will be better than expected because of a recently finished investment cycle. These explicit, falsifiable variant perceptions form the crux of our investment case.

Throughout that process, we seek to closely understand the risks that we take. The team is designed to be diverse and to ask a lot of questions, ultimately trying to make sure we're asking the right questions. We also think probabilistically about valuation, acknowledging that many unexpected outcomes will occur, but ideally, we will have more ways to win on the upside than to lose on the downside.

We keep our investments within the confines of small cap. It is our benchmark, the Russell 2000, and this is designed to be a

Highlights

Albert Grosman discusses ClearBridge Investments, LLC and the ClearBridge Small Cap Fund. Mr. Grosman's goal for the fund is to create a resilient portfolio that has the potential to outperform long term across various market conditions. The process is valuation-driven and uses discounted cash flow models. Mr. Grosman focuses on what the market expectations are for a stock and what his variant perception is compared to the market. Using the Russell 2000 as the fund's benchmark, Mr. Grosman invests across the small-cap universe and achieves diversity by investing in deep-value, steady as well as high growth businesses. Mr. Grosman also aims to understand the risk he is taking. By utilizing a probabilistic approach, he is able to determine where an invest lies on the continuum of risk.

Companies discussed: AVG Technologies N.V. (NYSE:AVG); Planet Fitness (NYSE:PLNT); CSG Systems International (NASDAQ:CSGS) and TAL International Group (NYSE:TAL).

core small-cap product. We do look and invest very broadly across the small-cap universe. We apply the same process to all the types of companies that we invest in, ranging from the traditional very deep value to steady businesses to high growth businesses. We believe the same process is applicable across the board, and to be able to achieve our goal of resilience, we need to have that diversity.

"We do look and invest very broadly across the small-cap universe. We apply the same process to all the types of companies that we invest in, ranging from the traditional very deep value to steady businesses to high growth businesses. We believe the same process is applicable across the board, and to be able to achieve our goal of resilience, we need to have that diversity."

TWST: And did you want you tell me a little bit about the firm and its history?

Mr. Grosman: ClearBridge has been an affiliate of Legg Mason after being acquired in 2005 from Citigroup. Today, ClearBridge manages over $100 billion in assets, mainly in equities, with offices in New York, Baltimore, Wilmington and San Francisco.

TWST: And did you want to highlight a stock that you might find interesting?

Mr. Grosman: I would like to highlight **AVG Technologies** (NYSE:AVG). **AVG Technologies** is a company that provides security solutions for computing devices, people and location services. Basically, it protects your data, your devices, and it also allows for control/management of wireless family plans and location services. We've owned the stock for about a year and a half.

When we bought **AVG**, we concluded that the price was discounting very little growth in the long term. Since then, **AVG** has shown underlying growth in subscribers, revenues and profitability. However, the growth has been masked by **AVG's** decision to exit some legacy. One important key to long-term growth is **AVG's** mobile platform of security, data management and location services. Additional upside exists from the opportunity to serve the data security needs of small/medium-sized businesses, which is an area where security is not very well-addressed today.

AVG has produced strong margins over time and has high incremental margins as a result of the low cost to acquire new customers. Today, on a traditional accounting multiple basis, **AVG** trades at less than 10 times earnings and less than 6 times EV to EBITDA based on 2017 consensus estimates. This is a high-free-cash-flow-generative company that has used a portion of profits for very strategic, growth-enhancing and long-term value-creating acquisitions, like the location-based services offering. In sum, **AVG** is a company with a strong base business with a great outlook for growth, profitability and value-creating growth that is not reflected or being discounted in its stock price.

TWST: And what's going on within the technology sector that's allowing it to grow?

Mr. Grosman: AVG benefits from the security risks posed by the digitization of our daily lives. Its products and services are mostly for personal use. The original offering was an antivirus protection solution but has been expanded to protect data and devices.

One example is **AVG's** virtual private network — VPN — offering. If you use a public Wi-Fi at your favorite coffee shop or elsewhere, your devices and data are potentially exposed to hackers. By subscribing to the **AVG** VPN solution, you can protect your devices and data from such attacks. Another example is the ability to monitor and manage the usage of family cellphone plans or location-based solutions. Both examples are sold by the major wireless carriers in the U.S. to their subscribers, which also creates additional marketing opportunities for **AVG**.

So **AVG** is adapting its technology as the data security risks and use cases morph. It all started with protecting desktop computers from the threats of viruses, but **AVG** evolved via internal research and development as well as acquisitions. The proliferation of how and where people access data and information creates questions about protection. To date, **AVG's** opportunity to help small/medium businesses with their data/device security hasn't been fully developed. These are companies with limited IT infrastructure and staff but with large needs to address security.

TWST: Did you want you highlight a second company?

Mr. Grosman: The second company I would highlight is a company called **Planet Fitness** (NYSE:PLNT). **Planet Fitness** is a chain of over 1,100 fitness clubs, the majority operated under franchise agreements. We've owned it since the IPO in the fall of 2015.

1-Year Daily Chart of AVG Technologies N.V.

Chart provided by www.BigCharts.com

Planet Fitness primarily targets the about 80% of the U.S. population that are not members of gyms, either because of the costs, access or other reasons such as not feeling comfortable because they may not be in shape. The **Planet Fitness** model is to operate large gyms with top-of-the-line equipment but no ancillary offerings such as group lessons or pools. The goal is a high-quality product served at a low price of $10 a month with no long-term commitments. This price point and lack of contract removes some of pressures of joining a gym.

Serving this large population in a consumer-friendly way has translated into significant success, as noted by the growth into

over 1,100 stores. It has become the first national fitness brand to utilize its scale and the power of a single brand through national advertising and marketing. A high-quality product at a low price results in large membership per location, which has created high returns on the capital invested for each gym, whether it is owned by the company or a franchisee. Franchisees have embraced the success, as noted by the signed commitments to develop 1,000-plus additional locations in the U.S. over the next few years.

"The reality is that risk is present at all times; the question becomes how to approach it. For us and for our investors, we focus on what is discounted in the price of a stock and what is the value of the corporation under a range of future scenarios. The probabilistic approach helps us frame where on the continuum of risk an investment is."

Long term, the company can triple or even quadruple its U.S. stores based on the required population density to generate good returns. Opportunities also exist abroad, with **Planet Fitness** already entering Canada, Puerto Rico and the Dominican Republic. The growth opportunity, and the free cash flow that results, is not fully discounted in the stock today in our opinion.

TWST: Do they target any specific age group, or is there a pretty strong variety?

Mr. Grosman: It's across the board. The target audience is those that either don't belong to a gym for some reason or are looking for a high-quality gym at a lower price.

TWST: Did you want to highlight another company?

Mr. Grosman: I will highlight a couple more companies to emphasize something that I mentioned earlier, how we apply our valuation-driven process across a very broad spectrum of investment candidates. I've covered two companies that are more dependent on growth for value creation, so I will now highlight one that is a more consistent business and one that falls into the traditional deep-value category.

CSG Systems (NASDAQ:CSGS) is one that falls into the steady-business category. The focus of our analysis is much on the duration of free cash flow generation as opposed to rate of growth. **CSG** is a provider of customer management services, largely for the cable TV industry in the form of billing and provisioning of services. We've owned the stock for well over two years now.

At the time of purchase, we concluded that the expectations that were discounted in the stock were for a long-term decline in profitability, likely due to concerns about pricing from consolidation in the cable TV industry, especially one upcoming contract at the time. The conclusions from our research on the industry and **CSG** led us to conclude that consolidation in the cable TV sector would ultimately be good for the company, as lower prices would be offset by a higher number of subscribers, new services provided by **CSG** to the same customers and the economies of scale that this type of business enjoys. As such, we believed, and still do today, that the duration of free cash flow generation by a business with high return on capital was not appropriately discounted in the stock price.

TAL International (NYSE:TAL) is an example of a very traditional deep-value holding in our fund. **TAL** is a lessor of intermodal containers. We've owned this stock for about six months. At the time of purchase, **TAL** was trading at half of book value.

Our analysis indicated that some 80% of the stock price was explained by two factors that gave us good downside protection: first, the existing leases with no consideration for renewals and scrap value of steel at the then-prevalent cycle low prices. And second, our analysis made us comfortable with **TAL's** liquidity and leverage so that, in most scenarios, the company would be able to see through what continued and has remained a very tough cycle in the container-leasing business. The rest of the value will come over time from lease renewals and higher scrap prices, which will lead to new builds as global trade stabilizes. Another contributing factor to our investment was the supply and demand fundamentals in steel scrap, an area that I have researched over several cycles and we already have some exposure to through other holdings in the fund.

The **TAL** investment also illustrates the emphasis on risk in the research process. We consider the risk of capital impairment, the distribution of the potential outcomes and where the current price lies within the distribution, and finally, various measures of diversification. **TAL** is an example where the risk profile warranted an investment but resulted in a smaller position size in our portfolio and caused us to consider more broadly our overall exposure to a single economic driver — steel scrap prices in this case.

1-Year Daily Chart of CSG Systems International

Chart provided by www.BigCharts.com

TWST: You talked about risks. For the average investor, as this year continues, are they willing to take risks, or are they kind of concerned about them as they put together a portfolio?

Mr. Grosman: Yes, there has been a lot of focus on different risks so far this year, be political or otherwise both domestically and globally. The reality is that risk is present at all times; the question becomes how to approach it. For us and for our investors, we focus on what is discounted in the price of a stock and what is the value of the corporation under a range of future scenarios. The probabilistic approach helps us frame where on the continuum of risk an investment is. More things can happen than will, so framing the magnitude of the impact is important to

understand risk. We then consider our broad exposures, be it economic drivers or sector/industry exposure, as we aggregate the risks of individual positions into the portfolio.

Over the last few years, there haven't been too many areas of excessive investments that suggest any higher degree of risk. We continue to find undervalued investment opportunities, but the degree of undervaluation and the diversity of the companies that are undervalued has narrowed over the last year or so. As a result, the number of positions in the fund has trended up a bit. Our target number of holdings is 60 to 100 positions, and we have gone from the mid to the high 70s into the low 80s as a result of the investment opportunities present.

TWST: And do you get a sense from the Millennials about their own risk tolerance? Do you think they have a comfort level with risk, or is it hard to say?

Mr. Grosman: The answer is hard to say for sure. And the reason it's hard to say is because, as a generation, there will be an evolution as individuals go through various stages of life. The Millennial generation has witnessed two negative periods in the financial markets — the dot-com bust and the great financial crisis — so there is more than a little bit of scarring from that. You also have a generation that is coming into the work force with more debt, namely student debt, than previous generations. Ultimately, long-term savings for retirement and/or providing for the next generation will cause individuals to take some appropriate risks to save for the long term.

We position our fund as an option for a portion of one's savings, the portion focused on long-term value creation through investing in undervalued securities. Our valuation-driven process applied to small-cap companies, a segment where there has great diversity of types companies, seeks to take risks where we have a chance to be properly compensated for doing so. Since 2009, this strategy has done that; it has delivered benchmark-beating results with lower-than-average risk.

TWST: Thank you. (ES)

ALBERT GROSMAN
Co-Portfolio Manager
ClearBridge Investments, LLC
620 Eighth Ave.
48th Floor
New York, NY 10018
(800) 691-6960 — TOLL FREE
www.clearbridge.com

A Five-Pillar Process to Uncover Small-Cap Opportunities

AARON GARCIA AND FARAZ FARZAM, BROADVIEW ADVISORS LLC

AARON GARCIA is a Co-Portfolio Manager at Broadview Advisors LLC, an equity-focused fund manager based in Milwaukee, Wisconsin. Broadview Advisors LLC sub-dvises the FMI Focus Fund (FMIOX), a long/short hedge fund, and various institutional accounts in small-cap core and all-cap core strategies. Mr. Garcia joined Broadview Advisors LLC in 2003 as a Senior Analyst. Mr. Garcia has 12 years of experience in equity research, including three as a Portfolio Manager and 10 as a Senior Analyst. His current areas of focus include industrials, health care, materials, and more recently, energy. Mr. Garcia graduated from Rice University with a B.A. in chemistry.

FARAZ FARZAM is a Co-Portfolio Manager at Broadview Advisors LLC, an equity-focused fund manager based in Milwaukee, Wisconsin. Broadview Advisors LLC subadvises the FMI Focus Fund (FMIOX), a long/short hedge fund, and various institutional accounts in small-cap core and all-cap core strategies. Mr. Farzam joined Broadview Advisors LLC in 2001 as a Research Analyst. Prior to joining Broadview Advisors LLC, Mr. Farzam was a Research Analyst with Strong Capital Management. He graduated from the University of Wisconsin with a B.S.

SECTOR — GENERAL INVESTING

(AHJ501) TWST: I thought to get started, maybe you could tell me a bit about your firm and then sort of your investment philosophy, and then the five pillars that you use, screening processes that you use, and how you build and maintain your portfolio.

Mr. Farzam: So at a very high level what we're trying to do in our investment process is to identify great businesses, enduring franchises that for whatever reason are trading at significant discounts to our assessment of what their intrinsic value might be. Oftentimes those reasons could be misunderstanding by the market, a short-term hiccup that gets overinflated and gets perceived to be a much bigger issue than it is or some kind of change that the company is undergoing — perhaps it's an acquisition, perhaps it's a divestiture, perhaps it's new management change. That again, for short-term reasons, has left the stock price less than what we think the underlying business is truly worth over the long run. That is a high level of what we're trying to look for vis-a-vis our process.

Now we do have our five-pillar process that's designed to sort of uncover these kinds of situations, and I'll quickly go through the five pillars with you. The first pillar is businesses with strong economic traits. So what we're trying to do with the first pillar is to identify certain quantitative factors, tangible factors that we believe great businesses all share. And these include but aren't limited to factors such as high return on invested capital, the ability to generate a lot of free cash flow to fund their own growth, some degree of recurring revenue in the business model; so the business has predictability, and in some sense visibility and recoverability. I think it's fairly self-evident why these are attractive factors to seek out. But in and of themselves, they're a bit immaterial. Because if you have high returns on capital, if you have high profit margins, they're meaningless because competition usually comes in and drives those returns down.

And so on our second pillar and arguably our most important pillar: We spend a lot of time focusing on businesses that can build economic moats around their profit pools or their means to protect those returns over the long term. We spend a lot of our research time trying to, number one, identify what those

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economic moats are, what those barriers to entry are. And number two, how sustainable and durable they are. And we talk to of course management teams of the companies that we're interested in, but we also talk to suppliers, customers, competitors, as many people as we can to make sure that those economic moats are deep and wide and as impregnable as possible.

The third pillar is our focus on growth. And the reason why we focus on growth is this: High returns on capital are obviously attractive. High barriers to entry are obviously even better, to protect those returns, but we want those returns to multiply. We want those profit margins to expand. We want that free-cash-flow-generation capability to get bigger and bigger, and we think growth is the best way to achieve that. However, we look at growth a little bit differently than our peers do. And it is a little bit of a way that we differentiate ourselves versus our other growth investors, and that is we're really looking for businesses that can grow over the course of a two- to three-year horizon. Our perspective takes into consideration, I should say, a two- to three-year horizon. We believe that Wall Street these days and investors in general, are much too focused on short-term results. However, in a way we're thankful that they're a little bit too focused on short-term results because that's where we believe we can find a lot of opportunities.

Oftentimes businesses get thrown away because people are so focused on the short term that they seem to miss the big picture in terms of what makes the business really great. One of the things that we say over and over again at Broadview Advisors is that business isn't linear. Nothing goes in a straight line, and that's an idea that I'd like to return to in a second, but it's a very important principle vis-a-vis our process.

The fourth pillar is really just our way of saying the horse is important, but so is the jockey, and we do spend quite a bit of time evaluating the management teams that we are going to invest alongside with hopefully. And the way we do that is of course, we look at their compensation and assess whether or not, A, they're incented alongside with us to generate shareholder wealth, and B, we look at their past transaction history as well as their capital-allocation policies to see if they're good stewards of capital. Have they made good decisions with shareholders' money? Do they overpay or underpay? Do they hoard cash or do they deploy it wisely? These kinds of things are very important to us.

The fifth pillar is our valuation discipline. And our valuation discipline is referred to as private market value, and let me just very briefly touch on what that is. So private market value is defined as what a theoretical strategic acquirer would pay to buy a business in its entirety. So a strategic acquirer would be buying a business' entirety, not the stock, with the whole thing, lock, stock and barrel. And that's an important concept that I'll get back to in a second, but we spend a lot of time evaluating M&A historically within our respective sectors. And we pay a lot of attention to how much is paid for what businesses and why. We've had a lot of M&A over the course of the past few years, and obviously all of us are very much tuned to it to see what multiples are being paid for what businesses and why. Why did **Microsoft** (NASDAQ:MSFT) buy **LinkedIn** (NYSE:LNKD)? How much did they pay for it in terms of multiples and why? We really spent a lot of time thinking about these things.

And then what we learned from that analysis, we then use to assess what we believe is PMV, private market value for the businesses that we're evaluating. Now the trick is there aren't that many great businesses that exhibit the characteristics that I just talked about in pillar one through four that are sitting around at discounts — deep discounts to private market value, because that's what we're looking for. We're looking for deep discounts to private market value in order to initially buy these stocks. And so our research process is really aimed at constantly evaluating businesses that we believe fit the first four pillars, we then place an assessment of private market value on the businesses that we want to own.

And then we wait very patiently. We wait very, very patiently for something that I asked you to sort of put in your back pocket earlier, and that is this: Business isn't linear. Things don't go in a straight line. Businesses have hiccups. There are short-term issues that you have to deal with. And those short-term issues that we believe the market is sometimes myopically focused on give us opportunities to buy great businesses but only pay the bargain prices that we're looking for.

TWST: Let me just ask a quick question. I noticed on the fifth pillar that you're looking for a discount to private market value. Do you have a target discount?

Mr. Farzam: Yes, there is a target, and frankly it's very specific to the industry. And let me tell you what I mean. So I cover tech and consumer, and so historically if you look at tech and consumer, the discounts that we've seen empirically in the past, companies get to — are very different in those two sectors. So I will just give you a couple of examples. Technology because of the inherent risks that are involved in tech, risk of obsolescence, is the obvious one. Technology stocks tend to get to very deep discounts to PMV. And so when we look to buy our tech stocks, we're looking for very deep discounts because we need those discounts to compensate us for the volatility and the risk that we're taking in order to make those investments.

On the other end of the spectrum, if you look at for example consumer, and let's look at a very specific part of consumer and say consumer staples or food-style companies. These are stable businesses. They are food companies, and they tend to be defensive, and they may not be as high growth; sometimes they may be in our world because we're small-cap investors, but they don't tend to

Highlights

Aaron Garcia and Faraz Farzam discuss their investment strategy. Mr. Garcia and Mr. Farzam aim to identify great businesses that are trading at significant discounts to intrinsic value. They have a five-pillar process to uncover those situations, which focuses on strong economic traits, economic moats, growth, management teams and valuation.

Companies discussed: Microsoft Corporation (NASDAQ:MSFT); LinkedIn Corp (NYSE:LNKD); Mobileye NV (NYSE:MBLY); Toyota Motor Corp (ADR) (NYSE:TM); Autoliv (NYSE:ALV); NVIDIA Corporation (NASDAQ:NVDA); Alphabet (NASDAQ:GOOG); Intersil Corp (NASDAQ:ISIL); Apple (NASDAQ:AAPL) and Silicon Laboratories (NASDAQ:SLAB).

reach those deep discounts to PMV. So empirically, we've seen maybe 35%-type discounts in subsectors such as consumer staples. So again, it's a very complex way of saying that it's really industry-specific. But generally speaking that's a fairly good rule of thumb, 50% to 35% discounts is the kind of things we're looking for. We are really looking to pay an unfair price for great businesses, so that we can get really unfair returns. And by unfair, I mean really high.

"We are really looking to pay an unfair price for great businesses, so that we can get really unfair returns. And by unfair, I mean really high."

TWST: So at any given time, how many holdings do you typically have in your portfolio?

Mr. Farzam: So I think if you were to look at the absolute number of names in our portfolio, it looks high, but there's a reason for that. I would say that the core of our portfolio, the positions of true size are about 50 to 60. Now, because we are small-cap investors, because we are opportunistic investors in that we buy stocks that are under pressure, and we're selling stocks that have perhaps experienced some short-term euphoria that allows us to let go of stock at good prices. We're very incrementalist in that sense. We layer into our position slowly, and we scale out of our position slowly as well. So while the core of our portfolio is 50 to 60 names, there are probably 10 names that are on their way in and on their way out that make that number look bigger than it is, maybe like 70, 80. But again, usually that incremental 10 to 20 is like I said 10 names that are slowly making their way in, and 10 names that are slowly making their way out.

TWST: OK. That makes sense. Why don't we talk about a couple of specific examples that might be recent additions to your portfolio or ones that you're layering in.

Mr. Farzam: Let me hand off to Aaron. I've spoken too much. Aaron, maybe you want to talk about one you're layering into. You've got a good one in **Mobileye** (NYSE:MBLY), I think.

Mr. Garcia: Yes, so one of the newer additions to our portfolio, although it's not a large position at the current time, is **Mobileye** technology. And **Mobileye**, if you are not familiar with it, is a company that provides image sensing and processing technology for automobiles. And so what they do is, they make a chipset that takes the image from a camera typically located on the rearview mirror and have a software written into that chipset that allows them to detect pedestrians, other cars, bicycles, foreign objects in the road, anything that could impact the safety of both the driver and any object. And their current iteration of the solution actually ties into the braking system, and it enables autonomous emergency braking.

One of the reasons we were attracted to this investment was the company went public a couple of years ago, had a massive run-up as people took a look at the market opportunity, which was incredibly large. In the U.S. we have about 30,000 traffic deaths a year, and great many of those are rear-end collisions, and great many of those could be avoided if automobile makers adopted this technology. So the stock ran up extremely high to about $65-level range and then pulled back in the rough market we had in the first quarter of 2016, pulled all the way back into the mid-$20s. And at that point, we took a look at the name because we had always been believers in the market opportunity and the potential growth.

We always thought that the barriers to entry of the business were quite strong, given their win rate with OEMs. So they have over a 90% win rate on current OEM platforms, which are platforms that are typically three- to five-year-type rollouts. So their revenue stream is very visible up to 2019, 2020 on current contracts. And so the barriers to entry were very strong, the growth opportunity incredibly strong, over 100 million automobiles will be produced per annum in the world by 2020. You have just a very attractive opportunity to penetrate those automobiles.

And in terms of business characteristics, the other reason we liked the investment was incredibly strong margins. They have roughly 75% gross margins and over 50% cash flow margins. So the business was extremely profitable, growing very fast, very high win rate on contracts that are long-lived at this point. The management, we had to wait to do our due diligence based on the management being located in Israel, but we've had the opportunity to meet them several times at conferences, and I think that they are extremely capable. And so really the only problem that we had was the discounted private market value. And at $65, we couldn't justify the valuation even though the company was growing very fast, the earnings were still ramping, and you are looking at 50-plus p/e, I think actually over 50 as they're expected to do around $1 in earnings in 2017. So when the stock pulled all the way back into the mid-$20s, we took a look at the growth opportunity and decided that a mid-$20s p/e on 2017. And when you go up further on revenue that's already visible and you look at the earnings power for the company, we're very comfortable that the company can earn between $2.50 and $3.00 by 2019. We felt that that was a very strong earnings power on a company that was in the mid-$20s.

1-Year Daily Chart of Mobileye N.V.

Chart provided by www.BigCharts.com

So we initiated a small position, and I want to stress that one of the ways that we look at risk in our portfolio is companies that are

higher-growth that have these maybe multiyear opportunities are just going to be more volatile. And the duration of earnings is longer, and they're going to get swung around a lot more, which is usually what gives us our opportunity. But with those volatile companies, we want to be a little bit more careful on position sizing, and so it's a 50-basis-point position roughly, and I don't foresee it getting much bigger than that. It's because of the volatility of it we take a little bit more of a conservative view on position sizing with those types of companies.

"Analog technology is actually very sophisticated technology. There aren't too many analog engineers in the world, most of them are in the United States, most of the expertise is in the United States. There isn't very much, if at all, true Asian competition."

TWST: How crowded is the market, and what's their market share and who are their biggest contract wins?

Mr. Garcia: They have relationships with most of the large OEMs and 90% win rate on autonomous emergency braking. They were first to market, which has given them a huge advantage in the development of the software that they write, because they have millions and millions of miles of visual data in which that they can improve their software algorithms. The other competitors in the industry, **Toyota** (NYSE:TM) has an in-house solution, and a few other of the tier-1 auto suppliers such as **Autoliv** (NYSE:ALV) are entering the market, but their distance from **Mobileye** is quite severe.

There is long term going to be competition in this market, but what I think is so attractive about **Mobileye** is one, they were so far ahead of the game in terms of rolling out a product, and two, when you look at some of the maybe the more technological providers or maybe the more kind of Silicon Valley-type potential entrants into the market — **NVIDIA** (NASDAQ:NVDA), **Google** (NASDAQ:GOOG), things like that — everything that they have in concept right now is thousands of dollars for the set up for the automobile, whereas **Mobileye's** chipset is about a $40 ASP to the OEM. And when you're talking about millions of cars produced per year and the cost of implementing an option or a technology to be under $100 for the actual chipset for this current generation, I think it's really powerful, and it spurs adoption, and it just continues to give them a kind of a leg up on the competition.

TWST: Interesting story. OK, why don't we do one more stock?

Mr. Farzam: Yes. So let's talk about **Intersil** (NASDAQ:ISIL), which is a semiconductor company. That's a relatively new position as well as being a core holding. And I think it's been about a year, if not — I think we're coming on about a year in terms of its history and the portfolio. It took us a while to build the position and gain the conviction that we have today, but it's one of our top positions.

Like I said, it's a semiconductor company. It's a very specific type of semiconductor company, however, which is analog semiconductors as opposed to of course digital. Analog really is referring to the fact that they are focused on interactions with human. So analog refers to how we interact with technology, whereas digital is within the domain of computing in electronics, communications between ones and zeros, whereas the analog side takes that information and then presents it to the real world, to us, the humans. And analog technology is actually very sophisticated technology. There aren't too many analog engineers in the world, most of them are in the United States, most of the expertise is in the United States. There isn't very much, if at all, true Asian competition, and that lack of availability of analog engineering talent and the deep patent portfolio of **Intersil** is what makes it really interesting.

But before we get to all of that, within analog semiconductors, where **Intersil** plays even more specifically is in power analog, and that is in semiconductors that measure, regulate or control power and the use of power in whatever application they're deployed in. That's very important concept that I'll get back to in a second. But let's just kind of talk about **Intersil** vis-a-vis the five pillars that we just talked about for example. So **Intersil** is a company that has very attractive profit margins, 20% profit margins. It generates a ton of free cash flow and is in some very attractive businesses that are very sticky, and what I mean by that is they're not generally speaking in consumer electronics, where the product cycles in consumer electronics are very short.

Cellphones, for example — **Apple** (NASDAQ:AAPL) comes out with a new cellphone every two to three years. And so every two to three years, there's a chance for you to lose that business to a competitor. They're much more focused now in longer-product-cycle end markets such as industrial and automotive. And once you get designed into an industrial part, those are seven- to 15-year cycles that you're in a product, and so it's very, very sticky business that generates lot of cash flow, and it's very attractive. And so I've already touched on the first two pillars in those traits that I talked about. Long design cycles, very difficult technology, very little competition from Asia, limited supply of engineering talent in analog that makes this very attractive.

1-Year Daily Chart of Intersil Corporation

Chart provided by www.BigCharts.com

What makes **Intersil** very interesting vis-a-vis the third

pillar or the growth pillar is the following. A few years ago, I would say about four or five, **Intersil** had a lot of business in PCs and cellphones, very commodity-type businesses, mature businesses or just bad business, especially in the case of cellphones. Three years ago, **Intersil** hired a new CEO, and this new CEO had quite an interesting track record. He came from **Silicon Labs** (NASDAQ:SLAB) and was very well-known throughout the industry, and immediately he made some profound changes to the business. The first thing that he did was he decided to shed or discontinue or not focus on the computing, the PC computing and the handset businesses. So these are just not very good businesses, let's just kind of not focus on these or just shed them.

The second thing he did was — and this of course immediately helped the profitability of the business because you know you weren't spending valuable R&D dollars on poor businesses. And he said, look, it's going to take us a while to cycle through the revenue that we're losing, and we're going to focus on industries such as industrial and automotive, where power consumption is really important and has some big secular tailwinds behind it, but it's going to take time. And so in the meantime what we're going to do is we're going to take all the free cash flow that we generated, which is quite a bit, and we're going to pay big dividend, so that investors are paid to wait in other words. And so the company has very nice 4% dividend yield, and in a yield-starved world, it's very attractive. That 4% dividend yield essentially pays us to wait while they cycle through the shedding of those old businesses and start getting design wins that eventually turn into revenue in industrial and automotive.

So we feel that the company now is really at a hinge moment. It's been a couple of years now. They've cycled through certainly the loss of revenue from exiting PCs and cellphones, and now they're on the cusp of generating revenue from design wins that they've gained in power consumption, in industrial and automotive. As you can imagine, Aaron sort of talked about automotive with **Mobileye** with the autonomous vehicle and driver-assisted technology that are becoming more and more pervasive in automotive, but it speaks to a broader trend in industrial as well as automotive, which is the electronification of both industrial and automotive. There are so much more electronics that are going into cars versus history, and it's staggering, and that number is only going to continue to go higher.

Right now the average dollar content of semiconductors in the average car is about $300. However, if you look at very high-end luxury cars like a Tesla for example, the number is close to $1,000. And so semiconductor content is just increasing in cars, but it's also happening in industrial parts as well. I'm sure you've heard of the concept internet of things. Industrial parts are requiring more and more semiconductor content to — sensors to kind of see what they're doing out in the field, because you need analog to do that to sense what's happening in the real world and then transmit that data back through the Internet so that you can make better and better decisions vis-a-vis servicing those parts for example, and this is a trend that's really just beginning. And so in industrial and automotive, semiconductor content is growing, and that's what **Intersil** is really trying to play and in fact is playing in many cases. And so we really like the growth opportunity for **Intersil**.

Finally on valuation, there has been a wave of M&A in analog semiconductor. Brocade was bought out. National Semiconductor was bought out. A lot of companies have gone through quite a bit of consolidation, and transactions in that space have ranged between 20 to 25 times earnings. Now, we believe that **Intersil** in a couple of years, depending on where we are in the cycle, could earn pretty close to $1. And if you just use the low end of where transactions are going, that places the private market value of the company we think very conservatively at $20 a share. The stock is currently trading at about $12, so that's a fairly significant discount to what we believe it would be worth in a takeover in an industry that's rapidly consolidating. And so we think there is — although we like the business prospects for **Intersil** on its own, we think there's a fairly good chance given the economic characteristics of **Intersil**, its strong patent portfolio, its position in the industry and its opportunity that it certainly could get acquired as well.

TWST: OK. Well, both are very interesting stories to tell. Is there anything that you'd like to add that we have not talked about?

Mr. Farzam: Aaron, is there anything you'd like to expand on or add or talk about it all?

Mr. Garcia: I think I'm fine, thank you.

TWST: Thank you. (JM)

AARON GARCIA
Co-Portfolio Manager
FARAZ FARZAM
Co-Portfolio Manager
Broadview Advisors LLC
330 East Kilbourn Ave.
Suite 1475
Milwaukee, WI 53202
(414) 918-3900
www.broadviewadvisors.com

Using Satellite Managers to Provide Alpha

JEFFREY R. ERICKSON, ABBOT DOWNING

JEFFREY R. ERICKSON, CFA, is Head of Investment Strategies, Asset Management for Abbot Downing. Mr. Erickson is a managing director of asset management at Abbot Downing. He is also the head of equity strategies in the asset management group and leads the Abbot Downing Select Global 25 equity strategy. Prior to Abbot Downing, Mr. Erickson was an investment principal at Lowry Hill. Mr. Erickson joined Lowry Hill in 2000 to help establish the Naples, Florida, office. Mr. Erickson has 30 years of investment-related experience in the United States and Switzerland. Before joining Lowry Hill, he was a portfolio manager for Advantus Capital where he managed $1.5 billion for mutual funds and other institutional clients. Prior to joining Advantus Capital, Mr. Erickson was the North American Equity Strategist for Credit Suisse in Geneva, Switzerland. He began his career as a financial analyst focused in the areas of stocks, fixed income private placements, and oil and gas limited partnerships. Mr. Erickson earned a Master of Business Administration degree in finance with a concentration in applied security analysis and a bachelor's degree in finance with a concentration in economics and international business from the University of Wisconsin-Madison. Mr. Erickson is a holder of the right to use the Chartered Financial Analyst designation and a member of the CFA Institute. He is a former President of the Naples Financial Analysts Society and has been a member of the CFA Society of Minnesota or CFA Society of Naples since 1987. Mr. Erickson has served on the board of the Community Foundation of Collier County and is the former Chair of its investment committee. Mr. Erickson's comments on investment strategy have appeared in international, national and local media, including *The Wall Street Transcript*, Toronto's *The Globe and Mail*, *Florida Trend*, *The Business Journal of Minneapolis and St. Paul*, *Gulfshore Business*, *Twin Cities Business*, *St. Louis Post-Dispatch* and the *Naples Daily News*. Mr. Erickson and his family make their home in Naples, Florida.

SECTOR — GENERAL INVESTING

(AHJ502) TWST: Tell me a little bit about Abbot Downing. Then, tell me what you manage in particular, and your process of how you build and manage your portfolio. Then, maybe we can talk about a couple of recent additions that you've made.

Mr. Erickson: We work with wealthy families, and we help them manage their wealth, so the asset-management side, the investment side is only part of it. We have a group that works with families in terms of planning and family dynamics. There's a group that works with families in terms of banking needs, and then, we also work with foundations and endowments, and then, there's trust and fiduciary and administrative services.

So my focus is on the asset-management side, and our approach is primarily on the equity and fixed income side. It's a core-beta satellite-alpha approach, which means that we can buy beta for the markets relatively inexpensively, and that forms kind of the core

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part of our equity and our fixed income portfolios. So that's the core-beta side of the equation, and then, we look for satellite managers that can provide alpha. So we're looking for managers that are structured in a way that increases the odds they can add alpha. So what that means to us is we're looking for managers that are highly concentrated in terms of the number of positions that they own so that we get the — in the case of the Global 25 — 25 best ideas, and we're not getting their 100th best idea. So that's one component.

The other component is that we want managers with relatively low turnover so that we're efficient in terms of taxes and in fees. So the Global 25 is structured in that way. So it's a concentrated portfolio with 25 companies, and we have relatively low turnover. Our turnover has, in the past, been right around 20%, but we're targeting 20% to 25% kind of turnover.

TWST: In this Global 25, what percentage of your portfolio is outside of the U.S., and is there a target?

Mr. Erickson: It's about 40%, and we include, for example, **Aflac** (NYSE:AFL). Even though it's headquartered in Atlanta, about 70% to 75% of their revenues are from Japan, and operating earnings are roughly the same. So we look at beyond just where they're domiciled, kind of where their primary businesses are. So we're about 40%, but the target over time would be roughly 50%, and our benchmark is the ACWI Index or Country World Index. So at the moment, we're overweight the U.S., but that's not something that's structurally going to be built into the portfolio permanently, more of an embedded one.

TWST: How do you find your 25 ideas?

Mr. Erickson: It's a combination of screens, so quantitative screens, and we start to boil down a manageable universe. Our approach is that we're looking for what we call high-quality companies. We define that as companies with strong return on capital, which is kind of the first priority for us, and then, we are looking at the managers as good stewards of that capital. So as they are generating cash flow, how are they reinvesting that; what are the opportunities to grow the business; and if they're generating excess cash, are they returning that to shareholders? So those are critical things that we're looking for.

So we start out with screens looking at companies with either a high return on capital or companies that are improving the return on capital. So in instances like that, we can look for companies that are either in the process of restructuring or management has some incentive to improve what maybe is a company with average-type returns and they are making strides to improve their return on capital. So we start with those screens, and then, we're looking at talking with research firms and basically honing down those screens. So we're focusing our efforts on companies that we know meet the characteristics that we're looking for, and then, we want to dig in and do the work. So we also talk directly with the companies and then sellside research.

TWST: In reading through some of the materials, I'd noted a section where you talk about using disruption for buying opportunities. Maybe you could talk a little bit about that.

Mr. Erickson: Recently, some of the trades that we've done, we've had an overweight and still have a little bit of an overweight in consumer staples, so we own **Reckitt Benckiser** (OTCMKTS:RBGLY), **Nestle** (OTCMKTS:NSRGY) and **Unilever** (NYSE:UN). The consumer staples is an area that has benefited from a flight to quality over the last number of years actually. So with all the uncertainty going on in the world, many investors have been looking for companies that have consistent operations, consistent growth in earnings. So over the last several years, the multiples have been moving up. With the Brexit vote really being a surprise, uncertainty has peaked, and **Reckitt**, **Nestle**, **Unilever** on a relative basis have done better in the markets. Currently, we just trimmed **Reckitt Benckiser** and **Nestle**, which had become larger positions in our portfolio. We've added money to **IHS** and **Facebook** (NASDAQ:FB), **Facebook** being a relatively new purchase at the end of May.

TWST: So walk me through the addition of Facebook to your portfolio. What made that the right time?

Mr. Erickson: So we've been watching **Facebook**. For the last couple of years, the stock has done well. This year it's retrenched a bit, and so as we're digging into it and looking at the growth parameters, in a sense, it's been growing into a devaluation. So as we look at it, it's a company that's growing sales at a 30% rate, earnings growing at a 25% to 30% rate and selling at a multiple on next year's earnings of about 23 times earnings, I guess maybe it's 25 times now.

We compare that to some of the staples companies like **Colgate**, for example, which is a great company, but it's growing top line at maybe, call it 4% to 5%, which in this environment is good, but it's selling at a multiple of 23 times. So you've really had multiple compression between **Facebook** and these consumer staples, and **Facebook** has a much stronger growth profile. So to us, it made sense to do the trim in this case of **Reckitt Benckiser** and **Nestle**, put some

Highlights

Jeffrey R. Erickson discusses Abbot Downing and the Abbot Downing Select Global 25. Mr. Erickson focuses on equities and fixed income using a core-beta satellite-alpha approach. This approach involves buying beta relatively inexpensively and using satellite managers to provide alpha. The portfolio is concentrated with the 25 best ideas and has low turnover to make it efficient in terms of taxes and fees. Currently, about 40% of the portfolio is outside of the U.S.; however, Mr. Erickson doesn't just consider where a company is domiciled but also where their primary business is. Mr. Erickson looks for high-quality companies, which he defines as companies with a strong return on capital and with managers who are good stewards of that capital.
Companies discussed: Aflac Incorporated (NYSE:AFL); Reckitt Benckiser Group Plc (OTCMKTS:RBGLY); Nestle SA (OTCMKTS:NSRGY); Unilever N.V. (NYSE:UN); Facebook (NASDAQ:FB); Markit Ltd. (NASDAQ:INFO); Taiwan Semiconductor Mfg. Co. Ltd. (NYSE:TSM) and FMC Technologies (NYSE:FTI).

of the money in **Facebook** and then some in **IHS**.

“So you can imagine that business being cut back as those small companies are feeling the stress of lower oil prices. So there was an adjustment to earnings expectations, the stock came down, and we thought that provided an opportunity because you’re going to lose a certain number of customers, but the underlying strength of the business is there.”

TWST: You said Facebook is trading at about 25 times 2017 earnings. What do you project that will grow to?

Mr. Erickson: We’re not expecting a big increase in the multiple. What we’re expecting is continued growth in the earnings. So we expect the return to come from earnings growth and no doubt overflow from the current rate of 30%, and maybe five years from now, it will be growing at more like 20%. But in the meantime, we think that the stock will grow in line with earnings.

TWST: What’s another recent addition to your portfolio?

Mr. Erickson: So **IHS** would have been the most recent. This is earlier this year, and I don’t know if you’re familiar with **IHS**, they just bought **Markit** (NASDAQ:INFO), which you might be more familiar with. So this is a company that provides information and analytics. In the case of **Markit**, they are in a similar business; they provide information and analytics for the financial industry. So for example, PMI industry numbers for different countries, the countries themselves provide it, but also **Markit** numbers, they provide their own indices. So in the case of **IHS**, they’re providing information and analytics to companies and governments, professionals in various industries.

They’ve got three different segments. One segment is focused on resources, so they are providing information on energy. So it’s analysis on wells and production, pipeline information, regulatory and mineral rights documentation. They’re basically serving the oil and gas market, the coal industry, power and utilities, chemicals industry. You see **IHS** quoted pretty often in publications that are giving information on the oil industry, so let’s say news on Saudi Arabia and Japan, and that includes information on their production that will generally be information coming from **IHS**.

They’ve got another division that is focused on transportation, so a lot of that is autos and commercial vehicles. That’s data going to carmakers, dealers, agencies. Also, they have a small area that looks at maritime, so shipping industry, aerospace, defense, things like that. So basically, it’s an information and analytics company.

TWST: How did the buying opportunity come about?

Mr. Erickson: They had an earnings disappointment. Earnings estimates were cut right at the beginning of the year, and that was tied to when they’re selling information to energy companies, a number of their customers were small independent energy companies. So you can imagine that business being cut back as those small companies are feeling the stress of lower oil prices. So there was an adjustment to earnings expectations, the stock came down, and we thought that provided an opportunity because you’re going to lose a certain number of customers, but the underlying strength of the business is there. So you’re going to continue to grow maybe from a lower base than what the market had thought earlier. That looked attractive to us.

TWST: So I’m assuming revenues fell as they lost customers, how drastically?

Mr. Erickson: Looking at it from an earnings point of view, the estimates came down from $6.45 for this year to $6.25.

TWST: That revision, I’m going to assume, hammered the stock or gave you a buying opportunity?

Mr. Erickson: Right. So the stock fell almost 20%.

TWST: Did they actually miss earnings, or was this a straight-up revision?

Mr. Erickson: It was a revision, and then, they made the revised earnings as usual.

TWST: Why don’t we talk about one more stock in the portfolio?

Mr. Erickson: So another one that was a new company to us, but it was in December of last year, is **Taiwan Semiconductor** (NYSE:TSM), which is a semiconductor foundry, and they would be the world industry leader in the dedicated foundry business. They are almost five times larger than the number-two competitor and larger than the next 10 competitors combined. It’s an industry where it’s capital-intensive and technology-intensive, and what they’ve been very good at over many years is to be first to the market. So they capture the initial orders, and in this industry, as you ramp up volume, you drive down the unit cost. So if you’re first to market, that’s important because you’re getting that initial volume, and you’re driving down your unit cost of the semiconductors.

1-Year Daily Chart of Taiwan Semiconductor Mfg. Co. Ltd.

Chart provided by www.BigCharts.com

So they’ve been able to be the cost leader over time, and as a result, that’s been able to fuel their growth. So this is a case where they’ve been able to enjoy sales growth of 8% to 10% per year. We think that that’s going to continue. We don’t really expect a lot of improvement in margin because their margins are already very good, and they really manage the business so that as they drive cost down, they’re passing that along to their customers and improving their competitive position. So we’re looking for 8% to

10% earnings growth over time in a company with a p/e rate right now of 12 times next years' earnings, so relatively attractive earnings, strong CFROI. They've been very good managers of the cash that they generate, it's got a nice dividend yield of 3.8%, and while the semi industry is cyclical, they've done a very good job of managing through the cycles over time.

TWST: Is there still opportunity to lower their per-unit costs?

Mr. Erickson: We're not expecting that. We think that the margins, they're going to manage it to pretty much where they are now. But what we think is that the multiple at 12 times, it's at the lower end of the range where it historically trades. We think it deserves a higher multiple. It typically is traded between 13 times and 17 times, so we think that it'll trade up into that range again. So it's a combination of decent sales growth — and in this environment 8% to 10% sales growth is pretty good — and then some multiple expansion, and then, you get the dividend yield on top.

TWST: Is there anything else that you'd like to add that we have not talked about?

Mr. Erickson: I guess the only thing would be, when we added **Facebook** at the end of May, we funded that with **FMC** (NYSE:FTI), which is an energy company. So we were slightly underweight energy. But after we got the rebound in energy prices to $50, then we sold **FMC** to fund the initial position in **Facebook**. So now we're more underweight energy than we were.

TWST: Thank you. (JM)

JEFFREY R. ERICKSON, CFA
Head of Investment Strategies, Asset Management
Abbot Downing
90 S. Seventh St.
Suite 5100
Minneapolis, MN 55402
(612) 667-1764
(888) 648-8157 — TOLL FREE
www.abbotdowning.com

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DAN DAVIDOWITZ AND DAMON FICKLIN, POLEN CAPITAL

DAN DAVIDOWITZ is CIO and Portfolio Manager of Polen Capital. Mr. Davidowitz joined Polen Capital in 2005. Mr. Davidowitz leads the Investment Team and is the lead Portfolio Manager on the firm's flagship Focus Growth Strategy. Prior to joining Polen Capital, Mr. Davidowitz spent five years as Vice President and Research Analyst at Osprey Partners Investment Management. Before joining Osprey Partners, Mr. Davidowitz spent one year as a research analyst at Value Line, Inc., and five years in the health care sector holding various analytical positions at Memorial Sloan-Kettering Cancer Center. Mr. Davidowitz received his B.S. with high honors in public health from Rutgers University and earned his MBA from the City University of New York, Baruch College Zicklin School of Business. Mr. Davidowitz is a CFA charterholder. He is a board member of the American Association of Caregiving Youth, or AACY; and a member of the CFA Institute and the CFA Society of South Florida.

DAMON FICKLIN is Portfolio Manager and Analyst of Polen Capital. Mr. Ficklin joined Polen Capital in 2003. Mr. Ficklin is Co-Portfolio Manager and Research Analyst on the firm's flagship Focus Growth Strategy. Prior to joining Polen Capital, Mr. Ficklin spent one year working as an equity analyst with Morningstar and four years as a tax consultant to Fortune 500 companies with Price Waterhouse. Mr. Ficklin graduated magna cum laude from the University of South Florida with a B.S. in accounting, earned an MSA from Appalachian State University and earned an M.B.A. with high honors from The University of Chicago Booth School of Business. He serves on the investment committee to the board of the Make-A-Wish Foundation of Southern Florida. Mr. Ficklin is also a certified public accountant — CPA.

SECTOR — GENERAL INVESTING

(AHJ503) TWST: Why don't we just start at the beginning?

Mr. Davidowitz: I'll start with the philosophy, and I'll let Damon cover the process. We've been doing this for a long time. Polen Capital has been managing our Focus Growth Strategy for 28 years at the end of this year, and Damon and I have both been here for over a decade. The philosophy and process came from our Founder, David Polen, who originated this product in 1989 and passed away in 2012. David had a core belief that by setting extremely high thresholds for companies on strength of balance sheet, cash flow dynamics, competitive advantage, that if you set these extremely high hurdles and only invested in the best of the best, you would be able to produce superior returns in the market. As a byproduct of only investing in the most financially strong, competitively advantaged companies, you're likely to produce strong returns with a lot less risk.

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So we hold all of our companies to extremely high standards. They must have balance sheets that are flush with cash and have very little debt. They must have more free cash flow than they could use to run their business. They must have returns on capital north of 20%, which is a big hurdle. They must have at least flat, hopefully expanding, profit margins, and they must have real organic revenue growth. So we use those five criteria to screen, and we are looking for companies that have a $4 billion market cap or higher.

When you look at the large-cap universe in the United States, there are only about 200 companies in the United States that even pass that screen. So we're already looking at a very stocked pond of the best businesses that we can find. But in addition to that, we believe that our returns are going to be generated by the compounded earnings growth of the businesses, not from our buying and selling activity. So Damon and I aren't sitting here and saying, "What can we buy now or sell now because of the Brexit vote, or because of an opinion that we have on an economy or a short-term view on a company?" We look to find the 20 best companies that we can invest in for the next 10 years and let the earnings growth provide that return for us. It's a bit of a different way of generating returns than I think most of our peers do.

We also believe in concentration and own around 20 companies at any point in time. We think that as you overly diversify past that point, you're increasing your chance of risk because you're increasing the chance of owning an inferior business. So we believe concentration is good for not only generating returns but for risk management as well. And our holding period is roughly five years on average for our companies. It's a pretty long-term time horizon that we have with very low turnover.

Going all the way back to the inception of this product in 1989, we've only owned 106 companies in total. That gets you to our thought process on each of the businesses that we invest in. We think and act as if we own the entire businesses. It's a very different way of doing it. I think that's unique, I think it's different, and I think it's a way to invest that produces exceptional returns with a lot lower volatility and certainly a lot lower risk of capital loss. I'll turn it over to Damon now unless you have any questions on that.

TWST: One aspect that we've not touched on is when you buy, in terms of price, I mean. For instance, if an equity is fully valued, but it meets all of your other thresholds, is that something that you will add to your portfolio?

Mr. Ficklin: I'll take you through the process, and I think that will help clarify the answer to that question a little bit more. So picking up where Dan left off, we initially reduce the universe to companies that have 20%-plus return on equity on an economic basis, better than average growth, high and improving margins, low levels of debt or leverage. So when we get down to the 200 companies or so that meet that criteria on a quantitative basis, we'll do initial research or analysis to understand the business.

And we'll kick out or exclude companies that are highly cyclical or economically sensitive from what we call our coverage universe, which is about a 100-plus companies. Some of those businesses — energy, material, telecom or utilities companies — might meet our criteria at a positive point in the cycle, but very few of them sustainably deliver what we're looking for over time. So those businesses will fall out of our process. And we'll also exclude anything that we don't believe has a sustainable competitive advantage for the next five-plus years.

As Dan mentioned, we're not trying to time the market, we're not trying to buy low, sell high and generate returns through activity. It's about owning about 20 great businesses for the next five-plus years. And so when we get down to that coverage universe of about a 100 or so companies, that's where the investment team spends the vast majority of our time just trying to understand the businesses over time. And we do not start with valuation, to your question, so we don't say, "This is a really attractively valued or cheap company, let's convince ourselves it's great and we should buy it now." We start with, "Let's understand the businesses," and we work to identify what we think are the 20 best businesses to own for the next five or 10 years.

By going through that process and effort of really trying to understand the business, we come to the insights. We find a few good ideas. It's a very collaborative team-oriented process. We are all analysts on the team, and anyone on the team can champion an idea into the portfolio through their work. So as we go through that process, when we identify something that we think is pretty compelling, if it was one of the other analysts who identified the idea, then Dan or I would usually get involved if one of us wasn't already.

Our coverage list doesn't change dynamically over the years, given that great companies aren't created every day. So Dan and I have been studying or looking at most of the companies for a long time, but if it was new in some way and we weren't fully up to speed, then one of us would dig in and get up to speed. The idea would ultimately be presented to the whole investment team in what we call a peer review. That gives everyone a chance with very

Highlights

Dan Davidowitz and Damon Ficklin discuss Polen Capital and the Focus Growth Strategy. The idea behind the strategy is that setting high thresholds for companies and only investing in the best will result in superior returns. Mr. Davidowitz and Mr. Ficklin screen companies on five criteria: balance sheets with cash and low debt, more free cash flow than they could use, returns on capital north of 20%, profit margins that are at least flat and real organic revenue growth. In addition, they are looking for a market cap of $4 billion or higher. Mr. Davidowitz and Mr. Ficklin aim to generate returns from compounded earnings growth rather than buying and selling. For this reason, they have a low turnover and maintain a long time horizon for their investments.

Companies discussed: Visa (NYSE:V); MasterCard (NYSE:MA); Align Technology (NASDAQ:ALGN); ABB Ltd. (NYSE:ABB); Facebook (NASDAQ:FB) and Tencent Holdings Ltd. (HKG:0700).

different perspectives and approaches to thinking about businesses, to poke holes or ask questions, which really can direct future research.

"We believe our portfolio has been driven by the actual growth of the business, not by buying it opportunistically at a great price and then selling it when it's too dear. It's really paying a fair price or better and owning it over time and letting the earnings drive the performance."

If the idea is still standing and compelling after it goes through the peer-review process, then a separate presentation is made to Dan and I, and we would talk more about valuation after we've checked all the other boxes. Yes, this is a great business. Yes, this falls within our investment guardrails. Yes, we understand the business, the opportunity, and we understand the risks.

Then, we think about valuation. And really for the quality of company that we're looking for, I'd say, while we love to find a very attractive value, we're usually happy to pay a fair value. As Dan said, we believe our portfolio has been driven by the actual growth of the business, not by buying it opportunistically at a great price and then selling it when it's too dear. It's really paying a fair price or better and owning it over time and letting the earnings drive the performance.

TWST: OK, so is it a proprietary quantitative-metrics screening process that you begin with?

Mr. Ficklin: I guess you could say it's proprietary by fact that it's ours, but I wouldn't say there's anything out of the ordinary about the metrics we use. I think we do hold the businesses to much higher hurdles than a lot of investors do. 20%-plus return on equity on an economic basis is a high bar. That's a couple of standard deviations above normal. I think the average return on equity for an American company is about 12%. So it is a very high hurdle that we set.

I think our leverage thresholds are also very conservative. We're looking for roughly no more than two times net debt to free cash flow. That's quite conservative. We certainly have opportunities to make exceptions there depending on the quality of the business, but that's a benchmark that we hold to in most instances, which is a high bar. So I would say it's proprietary in that it's ours and that we hold ourselves to a criteria set that's a lot more difficult to meet than many investors.

TWST: OK, and so let's talk a little bit about the qualitative research process. For instance, what do you look for in management?

Mr. Davidowitz: Well, management is probably the most difficult part to really assess well. We don't really start with management. We start with the business, and what is this business about? Are there long-term secular demand drivers for that business? Are there competitive advantages in the business that make it hard for someone to compete or to take away the customer? Is there some lock into the customer, high switching costs, or patents or network effects, something that makes a business permanent?

And so we're really focused on that first, and that's where the vast majority of our time is spent, is on the individual business. What makes it tick? What is the industry about? What are the long-term opportunities and threats to that business model? That's where we spend the vast majority of our time, and that's where I think more of the value add occurs.

When we're trying to access management, it is a little bit more difficult because there's not always a tangible thing that you can look at there. So what we try to do is not just listen to what management has said but look at what they have actually done. And we want to see smart capital-allocation decisions. We want to see prudent reinvestment back into the business. We want to see that shareholders are treated well and thought about primarily. And so those are the kind of things that we look for.

We also look at the incentives that management has. You can see that pretty clearly usually in proxy statements, and depending on where the business is at any moment in its life cycle, we want to see that management's incentives are aligned with shareholders. So we like to see long-term incentives. We like to see incentives that have some tie to a return metric, like a return on invested capital.

We also like to see something that has total shareholder return in it. Not all of our companies do. Those are kind of our wish-list things. But more important to us is the business. Is the business the one we want to invest behind, and is management basically trustworthy and good stewards of capital?

1-Year Daily Chart of Align Technology

Chart provided by www.BigCharts.com

TWST: Now, in terms of sectors, what sectors do you have in your portfolio right now, and what ones are you avoiding?

Mr. Ficklin: I'd say, we are not so much avoiding per se, but we've never owned energy, a true materials company, utilities or telecom. We just don't find the best businesses in those industries. They are mainly commodity-type businesses, and some of them are very capital-intensive. We just don't find a whole lot of what we're looking for from a bottom-up perspective. So it's not that we are avoiding those industries per se, it's just that we don't think they are the best businesses. So it's unlikely that you will find us exposed to those areas, although we do research some companies that we think might be exceptions.

We tend to be heavier or overweight health care, technology

and consumer-oriented business. Again, this is not because we have a top-down view that those are the best places to invest, but when we approach it from the bottom up and look for what we're looking for, we find many companies in those areas. In terms of the financial services, we do have exposure there, and we've been overweight and underweight at different points in time. What I would say is unique more to us in that particular sector is that you won't find us in traditional banks or insurance companies, or companies that have large balance sheets with considerable liability. So you will find us invested, as we are today, in companies like **Visa** (NYSE:V) or **MasterCard** (NYSE:MA), or fairly unleveraged businesses, if you will, or businesses that don't carry any financial risk.

> ***"In terms of the financial services, we do have exposure there, and we've been overweight and underweight at different points in time. What I would say is unique more to us in that particular sector is that you won't find us in traditional banks or insurance companies, or companies that have large balance sheets with considerable liability."***

TWST: Now, I know you that you've said you had very low turnover, but maybe we can talk about the last couple of stocks that you have added to your portfolio?

Mr. Davidowitz: Sure. The last one that we added actually was the company called **Align Technology** (NASDAQ:ALGN). You may have heard of Invisalign, which is the clear aligners that are used instead of braces for both adults and kids. It's a company that we've been researching for a number of years now, and what I could tell you about the business — I'll start, and Damon actually did most of the research on this, so he can fill in whatever I missed — but **Align** has a product that is equivalent to, if not better than, braces.

Obviously, it's removable. You do keep it in most of the day, about 20 hours a day. You can remove it to eat, which is a big deal. It doesn't look nearly as bad as braces do. When you think moving teeth, using brackets and wires and cement is a 100-plus-year-old technology. It certainly seems a little outdated.

Invisalign and **Align Technology** have figured out better ways to move teeth. Actually, the science of moving teeth is not all that straightforward. It's not the easiest thing in the world to do. **Align** actually custom makes aligners for patients and provides the software in the orthodontist's or the dentist's office. By the way, this is something both dentists and orthodontists can do, as opposed to braces, which are pretty much only orthodontists. **Align** basically surrounds the dental practice or the orthodontic practice with software and services to help the practitioner create the treatment plan, and then, **Align** custom makes, with the help of 3D printing, all the aligners for the patient.

It costs, to the end patient, about the same as braces do. There is a little bit higher cost obviously to the practitioner of buying the aligners from the **Align Technology** than just the brackets and wires that they buy, but they get much faster throughput in their practice so that they can get patients in and out a lot faster using Invisalign than they can brackets and wires, which take a lot of manual labor. And so we believe that most volume orthodontist users of Invisalign actually have at least the same, if not higher, profitability on their **Align** patients.

We believe there are actually some fairly large competitive advantages here. Besides the fact that **Align** surrounds its customer, which is the dentist or orthodontist, to make it hard for anybody else to get in there, it is a real brand. Invisalign is a brand that customers ask for by name. On top of that, it has hundreds and hundreds of patents around its technology that would be incredibly difficult to work around. So we find multiple layers of competitive advantage here.

The company meets all of our criteria very, very well. **Align** has a cash-rich balance sheet, tons of free cash flow, very high returns, increasing profit margins and a lot of real growth. Today, we think, based on what Invisalign is approved for, the type of cases that it is approved for, we believe it has penetrated about 10% of the market globally. We think that could be a lot higher than it is today given that it is innovating to expand the market.

It is actually working now on products that only have to be worn at night and don't have to be worn during the day. So it may eventually be able to provide similar treatment results with a slightly longer time horizon but more convenience to patients. It is also working on a new technology that would make it even faster, which would allow the treatments to be done in a lot less time than braces would be. So imagine if you could have it for the same price as braces but have the treatment done faster. So there is a lot of interesting innovation.

It has a management that has been upgraded with a new CEO, Joe Hogan. He was the CEO of **GE Healthcare** and **ABB** (NYSE:ABB), a much larger company than **Align**, and we find that to be a very interesting proof statement about the potential for this company. We think Joe is upgrading the management ranks and the infrastructure of the business, and we see very bright days ahead for **Align**. Did I miss anything?

1-Year Daily Chart of Facebook

Chart provided by www.BigCharts.com

Mr. Ficklin: No, I think you hit all the high points. One thing that's really exciting is that it's a big market. There are roughly 8 million orthodontic case starts every year. And even though **Align** with the Invisalign product is clearly and far away the dominant

invisible orthodontic provider, it's still only treating about 10% of the cases that it can. We think that number can very easily go up to 50%-plus over time, and that it will become the standard of care, because even excluding some of the options that Dan was mentioning, where they may be able to treat it faster or only treat it at night, or different flexibility, just today it's a better treatment than traditional braces for most cases.

And **Align** has clearly built a brand. I think Invisalign is synonymous within invisible orthodontics, much the way Kleenex is with tissues. It's not easy to get into that position where the customer is actually asking for by name and demanding your products. So when you think about would-be competitors that are going to try to come to market in the coming years to compete for this big opportunity, they just don't have the brand. They'll have to go one door at a time, dentist by dentist, orthodontist by orthodontist to try to go in there and win the business and compete, and frankly, we do not believe there will be a great reason to change and to risk not getting the outcome for their patients. So we think that there are many different competitive advantages that you roll together that will make this quite a formidable company over time.

TWST: You've made a very compelling case, and yes, that is the only brand that I'm familiar with, and I did not have to go through braces. They have definitely built a direct-to-consumer brand name for themselves. Very interesting. What would be another recent addition?

Mr. Davidowitz: Facebook (NASDAQ:FB) was the one before that. It's the second time we've owned **Facebook**. We bought it back in May 2015. We had originally bought it in July 2013 and then sold it in February 2014. So our first holding period was less than a year. We had a great experience with **Facebook** that first time around. We had waited to purchase the business until we were sure that their mobile strategy was locked in, which it was by the middle of 2013.

You remember they came public and all of its revenue was from desktop advertising, and of course, everybody knew that people were consuming **Facebook** on mobile, but it hadn't yet monetized the mobile news feed. We had to wait to see that it would be unintrusive to the user and worth the advertising dollars from advertisers before we could commit to investing in **Facebook**. That would prove to us that it finally got those things figured out, that the competitive advantage was locked in, and of course, it did that. So in July 2013, we felt comfortable investing.

Everything was going fantastic. The business was growing phenomenally well. We were very happy with our investment. But like I said, by early 2014, the valuation had become a little bit high for our liking, for our comfort, and it was right around that same time that it offered to pay what turned out to be about $22 billion for **WhatsApp**. At that time, we just had a very difficult time understanding the strategic and financial rationale for that acquisition at the same time when we felt that **Facebook** had an elevated valuation. So we decided to move aside and sell our position.

We continued to study the business over the next year or so. As we said, **Facebook** is a business that we think has dominant competitive advantages and wide-open growth. We feel very, very comfortable with it. We really needed to evaluate the **WhatsApp** deal, which our team did over that year.

We looked that the parallel of **Tencent** (HKG:0700) and its **WeChat** business in China. **WeChat** is a messaging business like **WhatsApp**, and **WeChat** has been a revenue-generating machine for **Tencent** for a while. **Tencent** has been monetizing its messaging service very, very nicely, and so it gave us the understanding of why **Facebook** really wanted this business strategically and then how it could also get an economic return on it. So that made us more comfortable with the **WhatsApp** acquisition.

And then, while we were out of the stock for a little over a year, the earnings continued to compound at a very fast rate. I think the time that we we're out of the stock, earnings had grown by about 70%, yet the stock price had only gone up about 15%. So the p/e multiple had come down from over 50 times to about 35 times. We felt that was a much more comfortable valuation for us to invest in, and we felt better about **WhatsApp**, so we bought the shares again in May 2015, and we increased our position earlier this year, a couple of months ago.

TWST: Again, a compelling story. Is there anything that either of you would like to add that we have not talked about?

Mr. Davidowitz: No, I think that's pretty good.

TWST: Thank you. (JM)

DAN DAVIDOWITZ
CIO & Portfolio Manager
DAMON FICKLIN
Portfolio Manager & Analyst
Polen Capital
1825 NW Corporate Blvd.
Suite 300
Boca Raton, FL 33431
(561) 241-2425
(561) 241-2710 — FAX
(800) 358-1887 — TOLL FREE
www.polencapital.com
e-mail: info@polencapital.com

Casting a Wide Net to Find Cheap, High-Quality Stocks

BRIAN J. FRANK, FRANK CAPITAL PARTNERS LLC

BRIAN J. FRANK has been the Portfolio Manager for Frank Capital Partners LLC — FCP — and the Frank Value Fund since inception in June of 2003 and July of 2004 respectively. After working at Lightyear Capital, a private equity fund organized by Donald Marron of Paine Webber, Mr. Frank co-founded FCP. FCP started as a small family office, and Mr. Frank managed the assets with the goal of maximizing wealth for the long term. The success of this strategy led to the creation of the Frank Value Fund, a mutual fund employing the same strategy. The belief that large asset managers have significant disadvantages in their strategic approaches and corporate structure has guided Mr. Frank in building his business. Excellent performance and word-of-mouth created demand for both separate accounts and a mutual fund. Mr. Frank and his family are personally invested in the fund, so additional assets are treated the same as family assets. Now, with over 10 years of public track record, the Frank Value Fund's long-term record is better than the majority of its peers. The Frank Value Fund has nine times been awarded as a *The Wall Street Journal* Category King in the Multi-cap Core category. Mr. Frank has dual B.S. degrees from New York University's Stern School of business in finance and accounting. He is a Registered Investment Adviser and has a Series 65 license. Mr. Frank has appeared on *CNBC, Fox Business, Bloomberg Radio, MarketWatch Radio, PBS, TheStreet.com TV,* and has been featured in articles in *The New York Times, Bloomberg, Barrons.com, InvestmentNews, Investor's Business Daily, CNNMoney, Ignites, MoneyShow.com, Mutual Fund Observer, Kiplinger, Registered Rep, The Star-Ledger, TheStreet.com* and *The Wall Street Transcript.*

SECTOR — GENERAL INVESTING

(AHJ504) TWST: I was looking at your website, and I was interested in this comment, "We concentrate in the best 25 to 32 ideas regardless of market capitalization because we believe in order to beat an index, you must refrain from looking like one." And I thought that was an interesting perspective. So maybe can start with that approach, and how you built the fund and manage it.

Mr. Frank: The fund still believes in that concentrated philosophy, and we also believe that you need to go anywhere in the stock market. You need to have as wide a net as possible in order to find the best ideas. So 15 years ago, I started by managing family money, and I didn't have the constraints of a style box. And today, with the same Value Fund that's now 12 years old, we still embody that approach. We still believe in very cheap companies but very high-quality companies, so we want the best of both worlds.

In looking for those cheap, high-quality companies, it doesn't happen very often, so that's why the net needs to be as wide as possible. And we are looking at every profitable company that trades above $100 million market cap. So that puts us at about 3,500 companies in our universe, which is seven times larger than the large-cap guys because they look at S&P 500, and it's almost two times larger than the Russell 2000 guys who just look at the Russell 2000. So we are looking at more companies, and we can find better ideas, and when we do find a good one, we believe in concentration. We wanted that to be a material portion of the portfolio; we wanted the best ideas in there and nothing else.

And once we buy something, we hang on as well. If you

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believe in market inefficiencies on the buy side, you have to believe on the sell side, meaning you're going to need some time for the market to see the result of these companies; perhaps the fear of whatever reason that we bought it, that fear has to kind of get dissipated. So you need to hang on for a while. You need to be patient, and you need to weather things like the Brexit, and both fear and greed.

TWST: When you wrote the first-quarter report, you had a significant amount of your holdings in cash. Has that changed?

Mr. Frank: We have 65% cash at the end of the first quarter. I think the second highest before that was 20% in 2007, which obviously was a great thing going into the financial crisis; we were able to buy some great opportunities. But I am not saying we are due for another financial crisis, but I am trusting our process and our instincts here. So other value guys will buy the cheapest portion of the market whether it's a — kind of like a value index or value stock picker. They are looking at the bottom 10% to 20%, and they stock pick from there, and they stay fully invested.

For me, coming from the family-money perspective, I managed money for my dying grandfather. He said, "Don't lose me any money." So if there is not a good stock out there, but it still fits the cheapest 10%, I don't have to buy it, and that's a major difference between us and other value firms. We'll call them our absolute metrics. So there are relative metrics, and there are absolute metrics. We fall fully on the side of absolute, and if you are using those absolute valuation metrics today, you are not finding a lot of cheap companies out there.

I think the market and participants are falling into the trap that the Fed has set, where interest rates are very low. So if you do relative evaluations of stocks versus interest rates and bonds, you're coming out with cheap stocks. But to me, that's very, very dangerous because stocks are more volatile, businesses have more risk than fixed income, and I don't think you're getting paid enough to buy bonds. I think bonds are seemingly overvalued and stocks are overvalued, but it doesn't mean you should buy stocks. It means you should be careful.

So the portion of the portfolio that is invested is still in these good, cheap, quality companies that will be well should the rest of the market come down. And in the second quarter here, small value has continued to be punished relative to the market. So we found some companies to buy. We bought three things in the last quarter, and that's wonderful. That brought our cash down to 50%. There's still a long way to go. But we are not making market calls here. We are very procedural. So we are seeing things that are cheap, and we'll buy them.

TWST: So from what I'm hearing, the most recent turmoil did give the opportunity on some equities that you've had your eyes on.

Mr. Frank: That's correct, but don't get me wrong, I think buying the S&P index or the Russell 2000 Index, or most stocks during the Brexit turmoil and last Friday and Monday were a huge mistake. S&P, according to us, could come down about 50%. So it came down 5% those two days. It still means it's still got 45% to go. But on the other hand, there are some small value stocks that, yes, we picked and we do believe have very minimal downside with some large upside.

TWST: Take me through your stock-selection process. Do you start with a quantitative screening or exactly how do you come up with your ideas?

Mr. Frank: We do screening, but we also just have kind of a wish list of high-quality companies. And for both of those sides, we use an absolute evaluation metric. And our preferred metric, which works for most companies is EBIT over enterprise value. EBIT is operating income that's in the middle of the income statement. It's not distorted by tax payments or interest payments, or perhaps one-time events like restructuring or selling a building or something like that. It's the pure operating income of the company that they get from doing what they are supposed to do. And then, we take that, and we divide it by the enterprise side.

Another major difference between other firms and us is we use enterprise value only, and the way you calculate that is you start with market cap. Most asset managers on the equity side end with market cap. But for us, that's just the beginning, because when you buy a whole business and as — I am kind of like a Warren Buffett for that investor. When he buys a business and that business owes the bank $200 million, you owe the bank $300 million as the new owner of the business. So in enterprise value, you take market cap and you add debt to it, but you also subtract the cash. So they've a lot of cash lying around. It looks cheaper under our model, but if they have a lot of debt, it looks more expensive. So this pushes us to cheap companies based on operating income with strong balance sheets.

And then, the absolute value metric that we use that doesn't change regardless of interest rates is that number; if you

Highlights

Brian J. Frank discusses Frank Capital Partners LLC and the Frank Value Fund. Mr. Frank looks for companies that are both cheap and high quality. In order to find stocks that fit both criteria, Mr. Frank casts as wide of a net as possible by being willing to go anywhere in the stock market. He also believes in maintaining a concentrated portfolio of best ideas so that each investment is a material portion of the portfolio. In addition, once an investment is made, Mr. Frank thinks it is important to hang on and be patient. Since Mr. Frank doesn't look at value alone, he is able to hold cash if he isn't finding stocks that meet his criteria, and as of the end of the first quarter, he was holding 65% cash.

Companies discussed: Liberty Tax (NASDAQ:TAX); H&R Block (NYSE:HRB); Blackhawk Network Holdings (NASDAQ:HAWK); CPI Card Group (NASDAQ:PMTS); Citigroup (NYSE:C); American Express Company (NYSE:AXP); Wells Fargo & Co. (NYSE:WFC); Visa (NYSE:V); Office Depot (NASDAQ:ODP); Staples (NASDAQ:SPLS) and Amazon.com (NASDAQ:AMZN).

take EBIT divided by enterprise value, it must be greater than 8% on a high growth company. For lower growth, we're going to want an even cheaper price. But very simply, if you pay $100 for a business, we want at least $8 of operating income. Now, for 99% of my career, going back to the year 2000, I could give you 200 companies on any given day that gave you more than 8% of operating income. It's a pretty healthy list to choose from.

"I read the 10-K, I read the 10-Q, we listen to management and conference calls, we'll call them if we have questions, we'll look at competitors, and we also look at the last 10 years of earnings to see what type of valuation it trades at normally and how cyclical the company is."

Starting about the first quarter of 2014, that list started to dwindle as companies became more expensive. We are coming up on the fifth quarter in a row here of earnings declines, or earnings are going down, and enterprise value, which includes market cap, is going up because prices are going up. And at the height of it, which was the first quarter of this year, I was coming up on some days with zero companies that gave you more than 8% on operating income.

And we look a little bit forward as well. Some oil companies on a trailing basis have more than 8%, but it's clear their operating income is going to come down like 50% this year. So that's the cash component. When we don't hit that metric, that's when we hold the cash and hope that earnings go up or prices go down or both.

TWST: Can you talk about the three recent additions that you made to the funds?

Mr. Frank: So that's just a starting point, kind of that quantitative focus. But we believe in reversion to mean. We are valuing that just in that respect, where you buy cheap stuff, you have a very high probability of success because the bar is set so low. The expectations are low on those companies. So starting in the second quarter, things started to come up, but most of them didn't pass our qualitative screen, which is the second layer of research that we put on these things.

I read the 10-K, I read the 10-Q, we listen to management and conference calls, we'll call them if we have questions, we'll look at competitors, and we also look at the last 10 years of earnings to see what type of valuation it trades at normally and how cyclical the company is. So some of those cheap stocks in Q2 are cyclical, and there appears to be, especially in industrials, cyclical downturn right now. So they were thrown out.

But one stock that kind of passed all the tests was **Liberty Tax** (NASDAQ:TAX) and what they are is a tax prep firm. And taxes, as even your readers might know, are not a cyclical thing. They are one of the two certain things in life, death and taxes, as people like to say. So you don't have to worry about a huge downturn like you do when you are buying an oil company, as we've seen in the first quarter there.

So **Liberty Tax** took a big hit this year. It's down 50% year to date at our time of purchase, and more because it's a franchise model. There are 4,000 of these things across the country. They are the number-three tax firm behind **H&R Block** (NYSE:HRB) and **Jackson Hewitt**. And there were a few bad apples running those franchises.

So a couple of them got shut down; the IRS was involved. But they came out, and they said, "Look, it's less than 2% of our franchises. We are coming up with a compliance team. We're going to have all of our prep people take compliance courses. We're going to have them adhere to our code of ethics." They did the right thing I think. And the money is where their mouth is too because the CEO and a director collectively own 40% of the company. So they have a vested interest in fixing this and continuing to run a good firm.

So at that 50% decline, **Liberty** had a 16% EBIT. So if it costs $100, we're getting $16 every year in operating income. So finally, it passed our quantitative screen. And then, qualitatively, we looked at it versus **H&R Block**, and they actually had more growth. They have an interesting idea, which is a tax firm that conducts business in Spanish, and that's the number-one immigrant to the U.S. There are large populations of Spanish speakers in New York, LA, and Miami and elsewhere, and they went from zero locations to 150 in the last two years. So not only is **Liberty Tax** cheap on an absolute basis, it's cheap relative to **H&R Block**, and I would argue it has a lot more growth prospects because there are 4,000 **Liberty Taxes**, there are 10,000 **H&R Blocks**, and the CEO said there could be a **Liberty Tax** next to each and every **H&R**, and they have this new interesting idea, they went from zero to 150 locations in the last two years.

1-Year Daily Chart of Liberty Tax

Chart provided by www.BigCharts.com

TWST: So with Liberty Tax, what will be another one that you added recently?

Mr. Frank: The other one we bought was **CPI Card Group** (NASDAQ:PMTS). And what they do is they actually manufacture credit cards. There is somebody that needs to make that, printing suppliers so you can put your name on it, put the magnetic stripe and now actually put the chip into it. And that's really the exciting thing I guess, if you could call it that, of the credit card manufacturing today is they all have to have what are called EMV

chips in them. So a private equity fund bought up a bunch of credit card manufacturers a few years ago and put them all together, combining operation in anticipation of this conversion to EMV chips.

"What's really hurt them is they actually have a bigger market share with the small and medium issuers, so things like credit unions and debit cards and gift cards, those types of things that aren't done by the major banks. So I think they've been disproportionally hurt by the decline here, and hopefully, they will disproportionally benefit next year."

Normally, it costs $0.20 to manufacture a regular magnetic-stripe credit card. But with the chip, now it's going up to $1. So if you think about it, that's five times the revenue per card. Now, of course, the costs are going up as well. But if you can consolidate and get a big piece of market share, your gross margin will definitely, on the aggregate, go up. So this private equity fund put these credit card manufacturers together. They called it **CPI Card Group**.

They IPO-ed last year. Unfortunately, they didn't hit the targets that they wanted in terms of the pricing on it. But it still came out I think about $10 a share. And then, they ran into some unfortunate industry problem. The EMV chips, if you think about it, were a kind of a spectacular failure.

A lot of people got their EMV cards toward the end of last year, beginning of this year. You went to the store, you try to swipe it, it didn't work, and then, you put the card in the machine so it'll read the chip, and it takes 20 seconds, and sometimes it doesn't work. Some of the retailers didn't want to buy the point-of-sale systems because of its expensive rollout and all industry was fighting with itself. So basically, all the gross that **CPI Card Group** promised in 2016 is failing to materialize, and they are actually going to have lower revenues this year than last year.

So the thing about an IPO that was promising a lot of growth switching to a value company that's going to have revenue decline in 2016, you can see why the stock went down almost 75% from its highest. So we did the research on that, and even at the lower end of revenue this year, it's still got a very acceptable operating income yield of above our target there. And through some other holdings that we actually had, we've been involved in **BJ**'s MasterCard before. We currently own a company called **Blackhawk Networks** (NASDAQ:HAWK), which runs the security network on gifts cards.

We're well-aware of this issue, and we think it's a temporary one. The reason for that is the major credit card companies are saying, "If you don't get the point-of-sale system to retailers, you are going to be responsible for fraud, not us." So there's going to be a push to get all these chip cards and chip readers working, and that push looks like it's out to 2017, so I think there could be a material line of growth at **CPI Card Group**. There's only one analyst covering it, and they have the same revenue for next year as this year, which doesn't make much sense to me, but that's where the bar is low, that's where expectations are low, and I think there is opportunity. So we took a position in the second quarter.

TWST: And this consolidated concern, how much of the market share do they have?

Mr. Frank: They have 35% of the market, which makes them the biggest player. And if you look in your wallet, the rollout has really been the big guys. If you have a card issued by **Citigroup** (NYSE:C) or **American Express** (NYSE:AXP) or **Wells Fargo** (NYSE:WFC), the big companies have done the EMV conversion already, and they have a lot of inventory on hand. So they are squeezing their manufacturers on price right now because there hasn't been as much demand going forward because it is in turmoil.

That's hurt **CPI**, but what's really hurt them is they actually have a bigger market share with the small and medium issuers, so things like credit unions and debit cards and gift cards, those types of things that aren't done by the major banks. So I think they've been disproportionally hurt by the decline here, and hopefully, they will disproportionally benefit next year when the small and medium issuers convert to EMV.

TWST: From my user experience with the chip, I know it's more secure, but it takes about three times longer.

Mr. Frank: Yes, and **Visa** (NYSE:V) is working on that. I don't know why they didn't do this beforehand, but they are trying to get that time down with software. It doesn't sound like it should be such an issue, but you are talking millions of transactions every day. There is this thing I forgot to mention about it — again, if you think about your wallet, you have cards expiring, you lose cards, you have cards that get damaged, and you unfortunately have cards that experience fraud. Over 80% of their revenue is recurring because of this, because people replace cards so much.

1-Year Daily Chart of CPI Card Group

Chart provided by www.BigCharts.com

TWST: Right. I was going to ask you if you knew what that number was on an annual basis.

Mr. Frank: They said in their 10-K and in the IPO perspective that it's 88%. I'm not quite sure if it's that high. It's difficult to back out because they get revenue from personalizing the cards; you can print your name on it. They get revenue from securing gift cards. On the back of the gift cards now, you have to peel off kind of like a secured tab. Somebody has got to put that tab on that and then get a little revenue from that. So it's tough to say,

but I'm comfortable that it's a pretty high percentage of their revenue, which is another great thing.

TWST: Do you want to talk about one more and then we'll wrap it up?

Mr. Frank: The other one is a special situation, and it's a smaller position size for us, and that is **Office Depot** (NASDAQ:ODP). Everybody knows retailers are in big trouble right now and probably the second most trouble behind sporting goods would be office supply stores. We got involved not because we think the industry is going to turn around, quite the opposite. We got involved because the merger between **Staples** (NASDAQ:SPLS) and **Office Depot** failed.

And when that failed, **Office Depot's** stock declined 50%, so it's trading at half of the value that **Staples** thinks it's worth through the takeover, and probably a major reason for that is a lot of the merger arbitrage guys were involved in **Office Depot**, expecting the acquisition to close, and it's a smallish company, and there's not a ton of volume on it. So I imagine all the unwind caused the stock to go down 50%. So it has a strong balance sheet, stronger than **Staples**. They have about 60% to 70% of the revenue that **Staples** does now, because a few years ago, **Office Depot** bought **OfficeMax**.

And **Office Depot** has been really benefiting from shutting down **OfficeMax's** that are close to **Office Depot** and recapturing the revenue. So their margins have actually been going up in the last few years as they have been closing stores, which, to me, is an operational feat. That's hats off to management there, and with the new management that came in after the **OfficeMax** merger. And that team didn't come from either company. The board found outside guys that are pretty good at turning around retailers.

So I think the bar is just amazingly low for **Office Depot**, and they may be able to pull a rabbit out of their hat and get rid of the European business that was slated to be sold under the **Staples** merger, and **Office Depot** management is continuing that process. And I think they will be able to squeeze a lot more cash out of it than what the market cap is currently. So it's not the super-high-quality company — there is definitely pressure from **Staples** and **Amazon** (NASDAQ:AMZN) and tons of other office suppliers — but it looks like it's just way too cheap right now, which makes it an interesting opportunity for us.

TWST: To your point, there was an Office Depot and OfficeMax very close to each other. And recently, when I went to the OfficeMax, it was closed, and so I just drove two more blocks to the Office Depot. So that strategy worked.

Mr. Frank: Yes, exactly. If you think about it, they are paying twice the expenses to keep those stores opened, and if they can recapture just — I think management's target is 30% of the revenue from the closed store. They are making more money. It's a good process for them.

TWST: Anything else you want to add before we end?

Mr. Frank: The thing that's painful and that we are focused on, as values did not favor us for a solid two years here, and this has also been the worst 10-year period for value probably in history, we're focused on indexation and passive investing. We really didn't touch on that, but I think there are two things happening. One, the value stocks that we own, many of them are under pressure because of that. They are not big portions of indexes. That's how I beat the index; I don't buy things that are in it. So indexes are getting flow, and those stocks are going up, and active managers are moving assets, and those stocks are going down.

But the good side of that is, it is creating opportunity like **Liberty Tax** for us. So I'm happy to see those opportunities back on my screen. And I think, at some point, the pendulum will swing the other way, and you will have money coming out of the indexes, which means we'll outperform by way more than we underperformed by in the last couple of years. So we are staying the course; we are maintaining our process.

TWST: Thank you. (JM)

BRIAN J. FRANK
Portfolio Manager
Frank Capital Partners LLC
6 Stacy Court
Parsippany, NJ 07054
(973) 887-7698
(800) 869-1679 — TOLL FREE
www.frankfunds.com

Combining Fundamental Analysis with a Quantitative Research Front End

PETER DECAPRIO, CROW POINT PARTNERS

PETER DECAPRIO co-founded Crow Point Partners in 2006, and he serves as the firm's Head of Trading, and is a Co-Portfolio Manager on the Crow Point Defined Risk Global Equity Income fund, the EAS Crow Point Alternatives Fund and other private L.P. vehicles. Previously, Mr. DeCaprio worked at Evergreen Investments as a senior analyst covering the utility, telecommunications and media sectors. Prior to Evergreen, Mr. DeCaprio was a senior equity analyst at Thomas Weisel Partners. He has also worked as an analyst at BancBoston Robertson Stephens, Dillon Read and Co. Inc., Houlihan Lokey Howard and Zukin, and TIAA-CREF. He is a graduate of Duke University's Fuqua School of Business, where he received his MBA, and Tufts University, where he received a Bachelor of Arts degree.

SECTOR — GENERAL INVESTING

(AHJ505) TWST: I know you founded Crow Point in 2006. Tell us a little bit about the firm and how it has grown over the last 10 years.

Mr. DeCaprio: We started out with a fundamental-strategy approach, and that changed In other words, we were just running fundamental strategies, fundamental equity strategies. That changed in 2012 when one of our former colleagues at Evergreen joined us, Amit Chandra. And Amit was the co-head of the quantitative strategies group at Evergreen when we were all there together. And we have used his expertise to supplement the firm's product offerings, and we now have a number of new products in the marketplace that are driven by a quantitative research front end.

So we have some L.P.'s that are available to investors; we have SMAs that are available to investors. We are now running three of our own branded mutual funds, largely driven off of our quantitative research process, and then, we have teed up on a drawing board a number of additional closed-end funds and ETF offerings that are all going to be driven off of our quantitative research front end. We do the quant research model a little bit differently. Since we started out running fundamental strategies, we have a full team of fundamental analysts here, and the combination of fundamental analysts with the quantitative research front end is interesting. It's effective, and it makes for pretty efficient operations, so it's where we are right now.

> **Highlights**
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> *Peter DeCaprio discusses Crow Point Partners. The firm started out using a fundamental-strategy approach before developing new products that are driven by a quantitative research front end. According to Mr. DeCaprio, the combination of fundamental analysis with the quantitative research front end is powerful because each approach has deficiencies. Fundamental analysts can be emotional, which can lead to irrational decisions, while the quantitative research is blind and dispassionate. When building portfolios, Mr. DeCaprio begins with a 10,000-stock universe and ranks them by region and industry. The stocks are then ranked within each group, with the top-ranked names becoming investments. The fundamental analysts will then look at the names generated by the quantitative model and kick names out of the portfolio based on their insights.*
>
> *Companies discussed: CenturyLink (NYSE:CTL).*

TWST: You mentioned a number of new products. Can you go into a little bit more detail about some of those products and the investment objective of each?

Mr. DeCaprio: I'll give you a perfect example. We are, today, launching an interval fund, which is a closed-end fund. It has a ticker symbol and CUSIP, and it is available for daily inflows, but it doesn't trade on any national exchange. The redemption periods I think are quarterly for investors, but it's a long/short global primarily equity vehicle that is designed to give income investors and bond buyers an alternative.

If you look at the yield curve today and if you're a bond buyer, you're seeing very low yields and a lot of asymmetric risk with

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bond yields at historic lows. It's very difficult for people that need income to generate income, given the current investment backdrop. So this product — the long/short global equity strategy that emphasizes, obviously, high-dividend-paying global stocks — the strategy is we buy, in the long portfolio, stocks that are yielding 5%, 5.5%, 6% on average, and the short book, the average dividend yield is probably closer to 30 or 40 basis points. So every dollar that you take from your short book and you reinvest in the long book, you're generating an incremental 500 basis points of yield on average.

"So what typically happens with our fundamental analysts is they're really only allowed to kick names out of a portfolio. They're not really allowed to overwrite the conclusions of the models, but they add insight, because I told you earlier in the interview, we think the combination between fundamental analysts and a quantitative research front end is powerful."

In addition to providing that yield bump, the short portfolio obviously gives you a lot of downside protection. For example, the big Brexit day last week, when everything was at its ugliest and you had many global markets that were down double digits plus, this portfolio was, I think, down 80 basis points at the end of the day.

So when you're giving bond investors an income alternative that is based largely on stocks, what's their biggest concern going to be? Volatility. So we think that we've solved that problem with the long/short portfolio. Obviously, there's no duration risk, which is the other risk that bondholders face. They don't — maybe not on equities to a large extent because of the volatility. But at the same time, they're taking duration risk, which can be an even bigger risk than stock volatility. So we think we've solved a little bit for both of those issues with the long/short portfolio.

TWST: Is there another product that you can talk about?

Mr. DeCaprio: We have a series of ETFs that we are going to launch under the IBEX Funds brand name. You've heard a lot, I'm sure, about smart beta investing. Franklin just came out with their LibertyQ ETFs, which is an actively managed take on a passive index, while we've been doing that kind of investing for decades. And the whole point of most quantitative products that we offer to the institutional marketplace is to replicate indexes, yet outperform. So if you're creating index vehicles or if you're creating strategies that have a very low tracking error to the index, yet outperform the index, mission accomplished. And that's what smart beta investing is all about.

It's about transparency in the portfolios. So investors know what's in the underlying portfolio, how is it going to perform, and then, if you can add to the index itself through some active management and improved performance, it's the best of both worlds. So you get all the benefits of passive investing, low fees; you know directionally or at least you know what your exposure is going to look like because you have a number of comps in the marketplace.

But if you can offer a product that improves upon that passive index performance, you give investors a lot of flexibility. They can hedge your vehicle with one of the passive indices; they can lever with one of the passive indices and then invest in your smart beta product. So we have two planned for a September or October launch, and we hope to do three or four more after that. But again, all based on that smart beta notion that's starting to be talked about with a rate of frequency in the marketplace.

TWST: Last time that we spoke, you talked about how your team reviews the quant rankings and then finds outliers that shouldn't be in the portfolios. Could you give us an example of one of those outliers and tell us why it got kicked out?

Mr. DeCaprio: When we build portfolios, our global stock universe is 10,000 names deep. So you have to winnow that down pretty quickly. What we're doing is we're ranking stocks based on regions and industries, and we group them that way. And then, we rank the stocks within each region or industry grouping against each other, and then, we come up with a model portfolio. So what we do is basically just invest in the top-decile-ranked names. Obviously, you're going to drift into the second decile if some of your industry groupings are small and you need a little bit more depth in the portfolio. But by and large, you're buying the top-ranked names out of your global rankings list, and in our short portfolios, we're shorting the bottom-decile-ranked names.

So what typically happens with our fundamental analysts is they're really only allowed to kick names out of a portfolio. They're not really allowed to overwrite the conclusions of the models, but they add insight, because I told you earlier in the interview, we think the combination between fundamental analysts and a quantitative research front end is powerful. And it's powerful because there are deficiencies to both. Fundamental analysts can tend to be emotional, and that leads to irrational decisions sometimes, and at the same time, quantitative models are completely blind and dispassionate and rational. But that blindness can cause problems.

So the example that I would give you to answer your question is, I can't remember exactly the timing, but about a year ago, maybe more, **CenturyLink** (NYSE:CTL), which is a telephone company, was one of the highest-ranked stocks on our list, and it was actually one of the best-performing names in our portfolio, as it was for anybody that owned it. But our fundamental analyst has deep expertise in the space, so in one of their 8-Ks, he saw that their tax losses were going to expire fairly quickly, and it was going to have a sizable impact on cash flows, definitely going to have an impact on earnings going forward, but more importantly was the impact on cash flows. And our concern was with the dividend and with their ability to service their debt and making sure that the balance sheet remained as healthy as it had been in the past while it was sheltered by these tax losses.

And we found that not anybody else had really been focusing on the company's tax position, and so we eliminated the name from the portfolio, even though it was highly ranked, because we didn't want to get in front of the announcement when the company had to start talking about the impact of the tax losses and the expiration thereof on their future cash flows. So

when it came time to rebalance the portfolio in that particular round and **CenturyLink** was the name that was on the rebalance list to buy, we eliminated it because we were concerned about the company's cash flow going forward.

TWST: On the flipside, can you talk about three names that have made the cut and tell us what you like about them?

Mr. DeCaprio: That's very difficult for us to do because we really don't have favorites in the portfolio. The way we manage our strategies now, we obviously don't evenly weight every single name that's in the long book, but a lot of our weightings are roughly the same across the board. We're really investing in factors, and generally speaking, we're investing in companies that are valued in what we think is a proper fashion and relative to historic norms, we're investing in good-quality earnings streams, and we're investing in good-quality balance sheets. So if you look at our portfolio, you would probably see 65, 70 names that were evenly weighted in the book. So it's very difficult for us to pick one name over another. And that's deliberate.

TWST: What are the questions and concerns that you're getting from clients at this point, and how do you respond?

Mr. DeCaprio: It's an excellent question, very topical. I think the overarching question that we get more and more is: Where are we in the investing cycle? Is there still more for stocks to run, or should everybody start thinking about finally getting defensive in their portfolio positioning? And the preponderance of the evidence that we see makes us nervous, and it should be making everybody else nervous.

There are too many fundamental flaws in the basic economic picture globally to get really aggressive right here with stock portfolios. Wholesale sales are down; the manufacturing index is down. We've had earnings stagnating across the board since probably late 2013, yet stocks are up 20% from those levels. Most of the buying that we've seen in the last 12 months that supported stock prices has really come from corporate buybacks. That's not a healthy backdrop. So there's a whole host of factors, but primarily, more than anything else obviously, it comes down to valuations and earnings, and we just don't think the momentum is there to propel earnings, to support the multiple that stocks are trading at today. And it's a big concern of ours.

So it's obvious that the Fed has distorted the fundamental and technical backdrop for stocks. If you take QE out of the picture, it's likely the stocks would be 20% to 25% lower than from where they actually are. So you know it's had an impact, you just don't know how significant an impact it has been and how significant a distortion it has been. My concern is when QE stops because it has to stop at some point. And there's talk now that there's going to be QE4; I would doubt it. But if we're over-replying on the Fed to keep propping up equity values, that's just not a healthy backdrop for equities.

TWST: Can you tell us a little bit about your background as well as some highlights about the people you have on your team at this point?

Mr. DeCaprio: I started out on the credit side of the business. That was actually in the restructuring world. Coming out of graduate school, I did corporate bankruptcies and reorgs for a number of years, and then, I went into the high yield business. It was right when Drexel Burnham was blowing up. So there was a lot of distressed debt in the marketplace, and then, the high yield business post-Milken took off and became mainstream. So I spent 20 years in high yield and then drifted over to the equity side.

Most of the people here at Crow Point, we've all worked together before in some capacity. Most of us have had 10-plus years of experience working prior to Crow Point, working together. So our 10 years with each other have been long. We've had no turnover at the firm since we started in 2006. I think a lot of that has to do with back when we've all worked together for years and years and years.

But everybody here brings something unique to the table. Amit, obviously, has a very deep and broad and strong background in quantitative research at a lot of big shops. My partner Tim, likewise, came from Eaton Vance, also spent some time at Gabelli — really deep expertise in the utilities and telecom sector. I doubt you'd find many more people on Wall Street that know as much about utilities and telecom as him because he came from Eaton Vance and Gabelli. He's got a lot of knowledge regarding closed-end funds and the management of closed-end funds, which is a specialty area of expertise.

And then, I've got analysts that have either run sector funds like Alex Marshall or Andrew, who backs Tim up on the utility and telecom space. We've got guys that have just really deep knowledge in some important sectors of the marketplace. So we let everybody rely on their core competencies, and as management, we just try to get out of their way. I mean, these are all grown-ups, and they're all experienced, had a lot of time in grade. They're well-proven over the years, so we're lucky that we have a deep engine. My job is just to basically get out of everybody else's way.

TWST: Thank you. (MES)

PETER DECAPRIO
Head of Trading & Co-Portfolio Manager
Crow Point Partners
25 Recreation Park Drive
Hingham, MA 02043
(781) 875-3185
www.cppinvest.com
e-mail: info@crowpointpartners.com

Generating Outsized Returns with a Managed Futures Strategy

MARTIN H. BERGIN, DUNN CAPITAL MANAGEMENT, LLC

MARTIN H. BERGIN is the President and Co-Owner of DUNN Capital Management, LLC. Mr. Bergin is in charge of directing and overseeing the firm's research and development efforts, and constructing and managing the firm's managed futures portfolios. Mr. Bergin also assists with the operational and financial activities of DUNN. His duties include overseeing day-to-day trading and risk management; directing the accounting, budgeting and long-range planning processes; and managing the human resources function. In January 2010, a Business Succession Plan was put into place that gave Mr. Bergin partial ownership of the firm and will transition the entire ownership to Mr. Bergin at the end of a 10-year period — December 2019. Mr. Bergin joined DUNN in September 1997 as Accounting Systems Manager and was promoted to Vice President and Chief Financial Officer in March 2001. In May 2007, Mr. Bergin was promoted to President. Mr. Bergin earned a Bachelor of Science in business administration degree from George Mason University in 1987. He became a certified public accountant in 1988. From 1987 through 1997, he practiced public accounting in northern Virginia, where he became Partner at a local CPA firm, managing audit, tax and consulting engagements for clients in the managed futures, banking and defense industries.

SECTOR — GENERAL INVESTING

(AHJ506) TWST: DUNN Capital is a commodity trading adviser. I know that you take a 100% systematic and quantitative approach to investing. Can you tell us a bit more about your approach and why it's a good strategy?

Mr. Bergin: As you mentioned, we are a CTA, which is a commodity trading adviser. We've been in business for over 40 years, and we are one of the oldest and one of the more respected managers out there. We have over $1 billion under management. I think the important thing to remember about CTA or managed futures strategies is that we are noncorrelated to most other investment classes. Most people are invested in long-only equities or bond funds.

It really bothers me when I see on TV and finance shows or business news, they bring people on, and they talk about portfolio allocations and divide them between equities and bonds, 60/40 or some other split depending on your age, and they never talk about alternative investments, which is the class that managed futures falls within. And because of the noncorrelation of alternative investments, which is why they are called alternatives, they offer a great benefit to a portfolio. And it's something that more people should look at, even at the retail level of investing, because if you can add an alternative investment that has zero correlation to your existing portfolio, you can actually lower your overall volatility and thereby increase the overall risk-adjusted return of your portfolio. Another thing to remember is that even if you have a managed futures manager that trades at a higher volatility, which we tend to do, the higher volatility actually gives more benefit to your overall portfolio because you are getting more bang for your buck when you invest in the noncorrelated revenue stream that we offer. So I think that's the important thing from an overall portfolio point of view.

The second point is, we offer insurance against bad events that happen in the equity markets — the fat-tailed event or the black-swan event. 2008 is a good example when managed futures overall did very well. We made 52% during that period of time when everything else was going south, and that's when we tend to do particularly well.

The Brexit is another good example, which is something that's on everybody's mind today. The markets were in turmoil, and I don't know how our industry as a whole did, but I know we did very well that day. We made over 7% in one day, which is an outsized one-day return for us, which meant that we had to adjust our risk before the end of the day to get the portfolio back to the risk profile our program was targeting. So that's the kind of insurance that we offer people.

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TWST: How does your strategy compare to traditional long-only strategies?

Mr. Bergin: Well, as I said before, we are noncorrelated. So we basically have no correlation whatsoever, and the reason for that is because we trade a different type of portfolio of assets. We don't just trade equity-type investments. We do trade equity index futures, but we also trade energy futures. We trade currency futures. We trade the bonds futures. So we look at both short-term rates and long-term rates. We are also trading all the liquid commodities, everything from metals to grains to cocoa to corn — all these different markets we trade, making our portfolio very, very diversified. We also trade the volatility index. So this gives us more diversification than a typical long-only equity portfolio.

And then, the kicker to the whole thing is that we can be short just as often as we are long. So we are making a directional bet, either long or short, wherever the trend of the market takes us. So the only thing we are looking at are price movements in the market. And if the price is trending down, we tend to be short; if the price is trending up, we tend to be long. And it doesn't cost us anything extra to be short the market as it does to be long, and therefore, we are short just as often as we are long.

We are not reliant on positive news or events in the economy. We can make money whether the economy is doing well or the economy is doing badly. We tend to make more money when the economy is doing badly.

TWST: Can you talk a little bit about the risk-management features of your trading programs?

Mr. Bergin: So from the inception back in 1974, when Bill — Dr. William A. Dunn, Ph.D., Founder of the firm — started our program, we've always looked at the percentage chance of losing a large sum of money. The way we always attack it is by focusing on the value at risk. And what we originally did in the beginning was to size our portfolio based on a 1% chance of losing 20% or more in one month. And we did that from inception all the way up to January of 2013.

During that time frame, we actually lost more than 20% in a month 1.2% of the time. So given the fact that it was much more difficult to calculate risk in the 1970s when we were using punch cards, and we didn't have the instantaneous ability to read the market and do our calculations at the same time, we were pretty good at targeting that risk. You've got to understand, it's an art form, not so much of the science because you never know what the future day's volatility is going to be, just like when the Brexit came about. We had a targeted risk going into that day, but when you see the pound move 8% in a day, that blows your estimated volatility calculations out of the water. So you have to take that into account and do trades toward the end of the day to adjust your risk to get it back in line with expectations.

What we changed in January of 2013 was we started looking at the market conditions and determining whether it was a positive or a negative market environment for what our strategy does. In other words, if a market is trending or not trending, we then adjust our risk each day depending on those market conditions. And we call that the adaptive risk profile, and it's all done systematically based on the data; we aren't making subjective judgements. So the program tends to increase our exposure during times when the market is trending and decrease our exposure when it's not trending.

Now, this isn't like a light switch where we turn it on and off. It's not risk-on/risk-off-type scenario. This risk-targeting calculation adjusts very slightly on a day-to-day basis, maybe two basis points to three basis points a day. If you have significant moves in the market, it may move as much as 0.05% in a day. So it gives us the opportunity to continue to make the same type of outsized returns that we've historically made without having the same exposure over a long period of time that we've had historically.

Therefore, what our research shows is that we decrease the downside risk by about 25%; we can decrease drawdowns by 25% and still have the same upside we had in the past. The reason that's important to DUNN is because we don't charge our clients management fees. All our fees are incentive-driven, which means we are on the same side of the table as our investors. We don't want any conflicts of interest.

A lot of our competitors have decreased their volatility because the one thing investors don't like is having significant losses in a short period of time. You can avoid that by decreasing your volatility in your trading, and you're able to accumulate and maintain your assets. And as long as you are charging a management fee, that business model works just fine for the manager. But since we're not charging a management fee, our success is basically predicated on generating absolute returns for our clients. What we found is by implementing this new methodology for risk, the adaptive risk profile, we are able to increase our Sharpe ratio significantly. So our risk-adjusted rate of return is high, and we still achieve the actual absolute returns that we have in the past, which I tend to think separates us from most of our competitors.

Highlights

Martin H. Bergin discusses DUNN Capital Management, LLC. DUNN Capital is a commodity trading adviser. Mr. Bergin thinks managed futures strategies are a great benefit to an investor's overall portfolio because of their noncorrelation. This noncorrelated characteristic lowers the overall volatility of a portfolio, increasing the overall risk-adjusted return. In addition, according to Mr. Bergin, managed futures provide insurance against bad events in the equity markets. Compared to a traditional long-only equity portfolio, Mr. Bergin's strategy trades across different markets and commodities, which makes it very diversified. The managed futures strategy can also make money whether the economy is doing well or not. When it comes to risk management, Mr. Bergin uses a systematic program to adjust risk each day depending on market conditions. This approach has allowed DUNN Capital to decrease risk while still making outsized returns.

If you look at any kind of reporting service out there, we tend to rise to the top when looking at other people in our industry based on our risk-adjusted returns from 2013 forward. Another example of that is that *Barron's* just released the top-100 hedge funds in the world. I think they used three-year performance for that calculation, and we were number four, which meant we were also the top managed futures product on the list.

"All the calculations we do could be done by hand. We could manually reproduce all the moving parts of the program that work together to generate the day's trades, but it would take an exhaustive amount of time. The technology we use is just an efficiency tool, not a black box. Once people understand that, they tend to appreciate the systematic nature of our trading style."

TWST: Who are your clients, and what is the profile of an investor who might want to consider this strategy?

Mr. Bergin: Our clients are pretty diversified. We offer two different leverages on our strategy. We have our standard leverage, which is our WMA program that targets this higher volatility that I was talking about. And in that, we have a lot of high net worth individuals, a number of private investment pools. 25% of all the money we trade is our money; it's proprietary money. So the employees of DUNN Capital, we trade our money right alongside the investors in exactly the same methodology as the investors. We don't have anything special set aside for us. We have public funds that use our methodology. We also have an institutional leverage, which is one-half of our standard leverage. And our institutional accounts are mainly public funds.

TWST: What are the factors that a client should consider when deciding which portion of their portfolio they want to allocate to one of your programs?

Mr. Bergin: Well, the first thing I would say is they have to get away from looking at it from an AUM perspective, and they have to look at it from a risk perspective. So they should allocate between 20% and 25% of their risk allocation to managed futures or other types of alternative investment strategies. The reason I would recommend managed futures is because, over long periods of time, it tends to be the most consistent from a performance standpoint, especially trend-following.

When I say risk, in most cases, a strategy like ours, it is trading at maybe twice the volatility of the S&P or 1.5 times the volatility of the S&P. So you wouldn't have to put 20% of your AUM, you would put 10% to 15% of your AUM into a strategy like ours and get that same bang for your buck. Our research shows that a 20% allocation gives you the highest risk-adjusted impact to your portfolio.

TWST: What do you think are some of the misconceptions or complexities about investing in managed futures?

Mr. Bergin: Well, I think the biggest complexity is people don't understand what it is we do. So it's hard for people to get their arms around something that they don't understand. We don't have a story to tell about a certain stock that has a good management team and is in an underserved market, so it's going to do well in the future. We are not trying to predict the future. All we are doing is taking historical data, plugging it into our models and statistically determining what is the best risk-adjusted approach going forward, so whether to be long or short in a certain market. And it's all driven by price data, and it's very simple.

Now, some people are not comfortable with algorithmic-based trading. They call it a black box. But that's really a misnomer. All the calculations we do could be done by hand. We could manually reproduce all the moving parts of the program that work together to generate the day's trades, but it would take an exhaustive amount of time. The technology we use is just an efficiency tool, not a black box. Once people understand that, they tend to appreciate the systematic nature of our trading style. They like that it's a repeatable process that eliminates emotion and doesn't rely on someone's gut instinct.

The other thing is most people think of futures as being something that they've heard stories of somebody buying futures, and then two days later, they are given a margin call, and then another day, they're getting another margin call, and the next thing you know they've been wiped out, and they only invested $10,000 originally, and they've lost $100,000. That's absolutely possible. That's why you want to get a manager or an expert to do the trading for you because we diversify the portfolio. We manage the margin. We protect you from those outsized losses. Plus, when you invest with us, the most you can lose is whatever you invest.

Now, with that said, we take the money and there's only about 10% to 20% of the cash used as a deposit to actually buy futures contracts. The rest of the money is invested in bonds — short-term bonds, government bonds, corporate bonds, municipal bonds. But we manage that money separately to protect it from the broker accounts.

TWST: Is there anything that we didn't discuss that you think is important to add?

Mr. Bergin: The only other thing I would say is that strategies like ours are becoming much more available to the marketplace. So in the past, it was only available to QEPs, people with a large amount of assets and large assets available for investment, and people would invest through limited partnerships. Now, you are starting to see that this strategy is available in the 1940 Act space, or the mutual-fund space. We have an account in Europe in the UCITS space, which makes this available to more retail clientele. And I think that's important, because from a retail investor's point of view, this is a very valuable asset, and yet, in the past, it's never been made available to them.

And the people that we've partnered with to offer these retail products are very aware of cost, which is one of the big negatives to the retail space these days. A lot of competitors charge fairly significant fees. We still charge the zero management fee and 25% incentive fee, even in our retail products. So even though some people would say that we are charging this significant incentive fee, we're not charging a management fee.

And I don't think any investor is too concerned about paying a manager when they are making money. When investors

aren't happy is when they are losing money consistently, and they are still paying somebody to lose their money. I've never gotten a complaint from an investor when we were making money that they are paying me. Most of them are very happy to be paying me. I guess that's the only other thing.

TWST: Thank you. (MES)

MARTIN H. BERGIN
President & Co-Owner

DUNN Capital Management, LLC
DUNN Building
309 SE Osceola St.
Suite 350
Stuart, FL 34994
(772) 286-4777
(772) 286-5366 — FAX
www.dunncapital.com
e-mail: info@dunncapital.com

Focusing on Dividends, Quality and Valuation

JIM WRIGHT AND JOHN FATTIBENE, HARVEST FINANCIAL PARTNERS

JIM WRIGHT is President and Chief Investment Officer of Harvest Financial Partners. He has worked as an investment adviser and analyst for nearly 25 years. Before forming Harvest Financial Partners, Mr. Wright worked at Davidson Trust Company, Delaware Investments and PNC Bank. He also spent four years working for a trust company in Portland, Maine. Mr. Wright is a Chartered Financial Analyst. He received his B.A. from Vassar College and his MBA from the Amos Tuck School at Dartmouth College.

JOHN FATTIBENE is Director of Financial Planning of Harvest Financial Partners. He began his career as a commercial lending officer in Baltimore. When he left lending, he joined Vanguard where he worked as a financial planner. After leaving Vanguard, Mr. Fattibene worked for two financial planning firms and an investment management firm. He is also an attorney. He attended Vassar College as an economics major. He received his J.D. from the University of Maryland School of Law. Mr. Fattibene is a Certified Financial Planner.

SECTOR — GENERAL INVESTING

(AHJ507) TWST: Please give us an introduction to Harvest Financial Partners, and tell us a bit about your overall investment philosophy.

Mr. Fattibene: Jim and I started Harvest Financial Partners in 2008, as an independent registered investment adviser, to work with people, regardless of their asset size, and to give them independent unbiased financial advice. Since we started the firm we primarily work with individuals, but we also work with some institutions and as the investment adviser for 401(k) plans.

Mr. Wright: I will take a moment and tell you about our investment philosophy, which hasn't changed since we started our firm. There are really three tenets that we focus on: dividends, quality and valuation. To start, every company that we buy for a client's portfolio has to pay a dividend. We like dividends because they provide cash that can be used by our clients or reinvested. As of today, the current yield on our stock portfolio is about 3.2%.

While paying a dividend is important, we really want to narrow it down to those companies that represent the best quality. To us, that means companies that have attractive returns on investment, are very profitable, generate lots of free cash flow and generally have low levels of debt. Quality companies also have managements that we like and trust.

Finally, as we have said many times in the past, high-quality dividend-paying companies purchased at a premium valuation really do not make great investments. So we try to wait to buy these companies at attractive prices. We tend to think of our focus on valuation as almost synonymous with patience. We patiently wait until good companies come down to prices we think are attractive or cheap. That means we have and will miss a few good opportunities, but we are comfortable with our patient approach.

TWST: So like you said, buying dividend-paying companies is one of the tenets of your strategy. What do you think are some common misconceptions about dividend investing?

Mr. Fattibene: A common misconception would be that dividend-paying companies are necessarily slower-growth companies. That's not always true. We've seen some companies that, because of their profitability, have been able to initiate and grow dividends. Many of the dividend-paying companies that we own have pretty attractive growth potential.

Another misconception, I think, is that a high dividend is not synonymous with an attractive dividend. We can find companies that have high dividend yields, but that might be a precursor to cutting the dividend. It could be because of business reversals or

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just having increased the dividend to an unsustainable level. So we think that, oftentimes, lower dividend yields and the growth of that dividend are more important than a higher initial yield.

Mr. Wright: And I'll just add sustainability. We want to make sure that when we buy a company, that we think not only can they pay the dividend today, and hopefully grow it in the future, but we are not at risk of a dividend cut or elimination at some point in the future.

TWST: What are the trends or themes in the macro environment that you believe are creating some interesting investment opportunities at this point?

Mr. Fattibene: We would tell you that after having a few years of lower volatility in the marketplace, we are seeing more volatility creep back in. That creates disconnects between individual stocks as opposed to them trading as a group, when we would have risk-on days, and all stocks would go up, or risk-off days when they would decline. Now, we are seeing some differentiation between stocks. That's occasionally presented opportunities where an individual stock might get mispriced.

Mr. Wright: I think we are still trying to figure out — not just us, but all investors — what's going to happen with interest rates. That's definitely been a big overhang. The Fed finally raised interest rates by 25 basis points in December of 2015, and I think there was a belief by a lot of people, including by us, that we would see rates go up again this year. As of today, we are halfway through the year and still no increase.

It's hard to say whether we will see one at some point this year or not. We don't spend a lot of time forecasting macro events like that, but it's still important. Interest rates are used to determine the value of companies, and at some point, when the Fed does raise rates, we think that's going to be a depressant on the valuations of stocks. Right now, market valuations are not crazy expensive, but they are not cheap by any means. And we definitely think we will see a multiple compression as rates go up — maybe even before that.

TWST: Could you walk us through the nuts and bolts of your process? How do you identify investment ideas and then select stocks?

Mr. Wright: There is not one way that we do it, as ideas can come from anywhere. As we said, every company that we own must pay a dividend, so we start with the universe of all large-cap companies that pay a dividend. It doesn't matter what the yield is, we just want to see a company committed to returning money to its shareholders by paying a dividend. After that, we try to screen for quality factors: high returns on equity, great free cash generation, high levels of profitability, etc.

After we narrow down that universe to what we believe are the highest-quality companies, then we focus on valuation. We want to concentrate on those that are trading at lower valuations. In many cases actually, the companies that we like a lot are kind of expensive, so we do our homework and are prepared to buy if we do see a price decline.

And that is really the process, but of course, like a lot of things, it rarely moves in a straight line. John and I do a lot of reading, we talk to a lot of people, and names just come from all over the place. As we hear interesting ideas, we will take a look, and if they make sense, we will put them on our watch list.

TWST: Let's talk about some specific names. Can you share three stocks that you really like right now, and explain what attracted you and your outlook for each?

Mr. Wright: Sure, I will start with one. We talked about being patient and being opportunistic, and I think a good example of that was the stock we bought earlier this year, **Walt Disney** (NYSE:DIS). This is a company that we have known well for a long time, and obviously, a lot of people know **Disney**. But it's a type of company we wanted to own. It has strong franchises.

For example, they just expanded their theme-park business into China, and now have theme parks throughout the world. They own ESPN, which is the most valuable cable brand out there. They also own ABC. And of course, the movie studios led by the **Disney** brand. They also have Pixar and Marvel. So it's a company that is just full of wonderful brands and great franchises, and it's run by Bob Iger. He has been a terrific CEO, and we like the management that **Disney** has.

This is a company that we have identified and watched for a while. At some point last year, the stock was at $110 or $120, and it just didn't represent really good value to us selling at a fairly large premium to the market. But we've done our work, and we were ready. Then, fortunately for us, in February, they disappointed some investors when they released earnings and showed a modest decline in ESPN subscribers. So after the earnings announcement, the stock dropped into the mid to high $80s, and we jumped in and initiated a position. Right now, the stock is selling in the mid to low $90s. We would be excited to buy more in the $80s, but it's not overly expensive here.

We have a company that is selling probably about 15 times forward earnings. So we get all of those terrific businesses at less than a market multiple. **Disney** also provides a 1.5% dividend

Highlights

Jim Wright and John Fattibene discuss Harvest Financial Partners. Their investment philosophy is based on the three tenets of dividends, quality and valuation. When selecting investments, Mr. Wright and Mr. Fattibene look for companies that pay sustainable dividends and are high quality. To them, quality is defined by attractive returns on investment, profitability, free cash flow, low debt and trustworthy management. Once they identify companies that meet these criteria, Mr. Wright and Mr. Fattibene wait patiently for the valuations to become attractive or cheap. Their sell discipline is then a mirror of their buy discipline. Dividends being cut, a slip in quality or a stock being overvalued are all reasons that Mr. Wright and Mr. Fattibene would sell a position.

Companies discussed: Walt Disney Co. (NYSE:DIS); T. Rowe Price Group (NASDAQ:TROW); Apple (NASDAQ:AAPL) and AT&T (NYSE:T).

yield, and it is a dividend that the company has been raising regularly. So **Disney** exemplifies the characteristics we have mentioned: a high-quality company committed to paying and increasing its dividend. Because we were patient and waited, we finally got our chance to purchase it. We certainly think it has 20% to 30% upside from these prices.

"Currently, with client equity portfolios, we're looking at a third of client assets overseas that will be mostly in developed markets but also with a slice in emerging markets. And we think that even with these low interest rates, fixed income belongs in most client portfolios to provide income and to dampen volatility. We typically accomplish that with a laddered bond portfolio."

TWST: And a couple more?

Mr. Fattibene: I will do one. **T. Rowe Price** (NASDAQ:TROW), which is a big asset manager in Baltimore, Maryland, they have a yield of a little over 3%. So it's much higher than the market right now, and they increased it every year for the last 10 years. For the quality component, the company has very high returns on equity, high returns on invested capital. They don't have any debt on their balance sheet. And as a matter of fact, they have over $2 billion of cash and investments on the balance sheet. So they are a net cash company.

T. Rowe Price, at the end of the first quarter of this year, had over $750 billion of assets under management. With the stock trading at $69, the market cap is $17 billion. So you're buying **T. Rowe Price** for a little bit over 2% of their assets under management, which is very reasonable. Two-thirds of their assets are in retirement accounts and variable annuity portfolios. We think that makes them a little bit stickier.

Another part of their quality is the executive team. They're managed by an executive committee. All the people on that committee have decades of experience at **T. Rowe Price**. One of the members is their Chief Investment Officer, Brian Rogers, and he has been there forever. So there is great stability, not a lot of surprises. They've managed the business for the long term, and they seem to have made very shareholder-friendly decisions about capital allocation and things like that.

T. Rowe Price has been in the news lately because they made a proxy mistake when **Dell** went private several years ago, and their mistake cost their shareholders over a $190 million. They are going to reimburse their shareholders for their mistake. No question about it, said they were going to do it, acknowledged the mistake and just move forward. It's a high-quality business run by high-integrity managers. The company strikes us as attractively valued. It's projected to generate over $1.3 billion in free cash flow annually for 2017 through 2020 and earn around $5 a share next year.

TWST: And the third one?

Mr. Wright: I'll talk about one we've discussed with you in the past, and that is **Apple** (NASDAQ:AAPL). **Apple** is a company that we really like. It's one of our largest holdings at the firm, and we still think it represents terrific value. The stock price is, right now, in the low $90s, and it has a dividend yield of about 2.5%.

Apple is fairly new to the dividend game. They had not paid one until 2012 or 2013. While they don't have a long history of paying dividends, they have increased the dividend fairly significantly in that period of time. It's up about 50%. We think management is very committed to returning money to its shareholders through the dividend and a large stock buyback, and we like that.

The stock is in the low $90s, and just like **T. Rowe Price**, it is a net cash company. **Apple** does have some debt, but they have a lot of cash on the balance sheet. The net cash position is nearly $30 a share. You are getting the underlying business for $70, if you tax adjust the cash. They'll probably earn somewhere around $8 this year. So you are paying a single-digit multiple.

We recognize that they do have some headwinds. They have done a great job on the smartphone side. The iPhone 6 has been a home run for them, and now one of the issues will be, can the iPhone 7 be even better? Can it generate continued growth? Will new platforms be added? We will wait and see. But this is a company that has been very innovative. They come up with products that excite consumers, and we have no doubt that they will continue to do that.

In the meantime, we are holding a stock that is selling at a very low valuation and is paying us to wait. We think **Apple** is worth significantly more than this, probably somewhere in the $130 to $150 range over the coming two to three years.

1-Year Daily Chart of Walt Disney Co.

Chart provided by www.BigCharts.com

TWST: What is your philosophy on diversification?

Mr. Fattibene: We think it's basically the only free lunch in the investment business. Currently, with client equity portfolios, we're looking at a third of client assets overseas that will be mostly in developed markets but also with a slice in emerging markets. And we think that even with these low interest rates, fixed income belongs in most client portfolios to provide income and to dampen volatility. We typically accomplish that with a laddered bond portfolio. So we'll have some maturities coming due every year that we can, hopefully, reinvest at higher rates. Like everybody else, we're still waiting for higher interest rates.

TWST: What is your sell discipline, and can you share

a recent example of a sale with us?

Mr. Fattibene: Well, I would just tell you that it's a mirror image of what makes a company attractive to us. So we talked about dividends. If there is a dividend omission or cut, that would lead us to sell. If we see quality slipping, returns are dropping, management seems a little bit more interested in their pay package than in shareholders returns, that may lead us to re-evaluate the holding. And then, the nice reason to sell is valuation, when a stock does so well it becomes overvalued. I'll let Jim pick it up from here.

Mr. Wright: Yes, actually, earlier today, we sold part of our position in **AT&T** (NYSE:T). It is a stock that we still like; we are still holding it. But over the last year or so, the stock is up about 30%. On top of that, we probably received about a 6% yield on the stock. So it has been a great total return for us. We think **AT&T** is getting a little bit expensive, so we decided to take some money off the table.

Mr. Fattibene: But I think that **AT&T** is really illustrative of something we often hear from individual investors. They typically talk about one of the most difficult things they try to manage is when to sell a stock. We don't think there is anything fundamentally wrong with **AT&T**. We still think it's a good company and a good business that has the ability to generate attractive returns. It's just that the share price did exactly what you want it to do when you own it. It went up, and it went up a lot faster than the market or its business results. We got to a point that for the dollar we were getting in earnings for that company, we decided it was getting expensive, and we would reduce our exposure to it. So those are our favorite sale stories.

Mr. Wright: And I think, just like we talked about, again, a lot of it comes down to valuation. We've reduced some of our consumer holdings as they become very expensive, and we will continue to look for opportunities to reduce or eliminate holdings, when warranted. So we think valuation is important both on the buy side and certainly on the sell side.

TWST: What are some common questions or concerns that you're hearing from clients these days, and how do you respond?

Mr. Wright: I would say a lot of clients who we talk to are interested in when they can retire. Do they have enough? I'll let John add to this, but we have a lot of people who, because the markets have been a bit volatile, are concerned. Will they have enough to retire? What do they need to do to retire in five years, 10 years, whenever it is?

Mr. Fattibene: Yes, those are our favorite questions, as opposed to: Do you think we should sell stocks because Great Britain voted to exit the EU? Those kinds of questions about cash flow and retirement start us to focus on the controllable aspects of our client's life. When do I want to retire? How much do I need to save? How much can I spend in retirement? Could I do this? Could I do that? Should I get a part-time job? I mean, they're all complicated questions, and we think they deserve a thoughtful discussion. And we also think that when you focus on that kind of picture, their intensely personal financial life, it takes some of the pressure off the headlines.

Mr. Wright: That said, we do get a lot of phone calls whenever we have volatile periods, whether it was earlier this year when the market dropped 10%-plus or around the Brexit. Those are times when we do hear from our clients. John and I are much more excited when the market drops because we often have cash on the sidelines, and that gives us potentially an opportunity to buy some good companies at cheap prices. And so we try to explain to our clients how excited we get, and hopefully, we'll leave them with the feeling that they should be excited too. A selloff is often an opportunity as opposed to a time to sell

TWST: Is there anything that didn't come up that you want to add?

Mr. Wright: I think one thing that we have been doing in many of our client portfolios is we have been continuing to shift dollars into funds that invest overseas, in developed international and emerging markets. We think there is terrific opportunity overseas, and we think clients may see better returns from those funds than they will from the U.S.

TWST: Thank you. (MES)

JIM WRIGHT
President & Chief Investment Officer
JOHN FATTIBENE
Director of Financial Planning
Harvest Financial Partners
159 W. Lancaster Ave.
Suite 3
Paoli, PA 19301
(610) 240-4740
(610) 240-4743 — FAX
(877) 240-4740 — TOLL FREE
www.harvestfinancialpartners.com