

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Large Cap Core Investing



ALAN COLE is President of Cedar Hill Associates, Inc., a registered investment advisor with \$800 million in assets under management. Mr. Cole is Portfolio Manager for Cedar Hill's Core Equity portfolio strategy. Additionally, he shares in the development of Cedar Hill's non-traditional investment strategies. Prior to joining Cedar Hill, Mr. Cole performed a variety of analytical and accounting functions at U.S. Bancorp and Ford Motor Credit Company. He received his Bachelor of Science degree in Mathematics from Vanderbilt University and an MBA in Finance and Accounting from Indiana University. He is a CFA charterholder, Chartered Investment Counselor and member of the CFA Society of Chicago.

TWST: Would you please begin with an overview of Cedar Hill Associates and your responsibilities there?

Mr. Cole: Cedar Hill is a registered investment advisory firm that develops custom investment strategies to meet the needs of our clients and their families. Currently, we manage over \$800 million of client assets.

The firm was founded in 1984 with the goal of providing clients with sound portfolio management utilizing traditional stock and bond investments. In the mid-1990s, Cedar Hill expanded into other strategies for qualified clients, including hedge funds, private equity and direct private investments in real estate and energy partnerships. We work with each client on an individual basis to come up with strategies that are suitable for their specific circumstances.

TWST: So the customized portfolio is your main product?

Mr. Cole: Yes. We don't really focus so much on products, per se. We look at creating an appropriate allocation of investment strategies for each client. Strategies may include domestic equities, foreign equities, fixed income, absolute return, real assets and private equity. In most cases, our solution incorpo-

rates several of these asset classes — in others, we may invest in just a single strategy. Our structure is more client-driven as opposed to product-driven.

TWST: Do you have different investment styles like growth or value?

Mr. Cole: Our primary equity style is a large cap core strategy, so it really is a blend of both value and growth.

TWST: What is the investment climate like at this time for large cap stocks?

Mr. Cole: It seems like large cap stocks have become more popular in the press recently. Whether the consensus view ends up being right or not is anyone's guess. We don't spend a lot of time worrying about whether one style is going to be more in favor than another. Our focus is on finding good investments over the long term, trying to buy companies that are under-appreciated either for the value of their assets or for their growth prospects. But it seems like after a number of years of relative underperformance compared with small and mid-cap stocks, large caps might be positioned to do relatively well over the next couple of years.

TWST: Tell us about your investment decision-making process and what qualities you are looking for in these companies.

Mr. Cole: The objective of our equity strategy is to produce consistent returns by investing in a diverse group of companies that individually have attractive growth prospects relative to their valuation, or presently are undervalued relative to the net assets of their businesses. We are indifferent as to whether a stock is labeled growth or value — we are just seeking the best companies to invest in.

In terms of our overall equity analysis, we focus on three different criteria. First, we evaluate the current state of the company. Second, we devote considerable effort to analyzing the industry that the company operates in so that we can fully understand the competitive landscape. The final piece is valuation analysis, considering both historical valuation metrics and understanding what may influence future valuations.

TWST: Do you look for certain industries or sectors, or is that just a product of your selection of stocks?

Mr. Cole: We employ both a bottom-up and a top-down approach. Sometimes when looking at investment ideas, we identify specific industries that we feel are either out of favor in the market today or perhaps are undergoing a fundamental change where we expect competitive trends will become more accommodating over the next couple of years. Other times, we focus on individual names, trying to assess if there are unique characteristics that will provide future value. After getting comfortable with that analysis, we then look at the industry in more detail to make sure it is an industry that we want to be invested in and commit additional funds to. We need to make sure that we are not investing in a potential trap situation, such as a strong company that's in a weak industry with further problems ahead.

TWST: Is the S&P 500 the benchmark that you use to measure your performance?

Mr. Cole: Yes.

TWST: Are you overweight in any areas compared to that benchmark?

Mr. Cole: Yes. Right now, the two sectors that we are most overweight versus the S&P would be health care and energy.

TWST: Have you shifted in emphasis over the last 12 to 18 months in the composition of the portfolio?

Mr. Cole: There hasn't been too big of a change. Entering 2006, we wanted to be a little bit overweight in health care, but we trimmed back on that position as we approached the end of 2006. With all of the rhetoric from the new Democrat-controlled Congress, we were concerned that it might be more difficult for price/earnings multiples to expand from depressed levels.

We've also maintained an overweight position in energy. We have been positive on the energy sector for the past three or four years. We have changed some of our holdings within the sector because a couple of the companies that we owned were acquired, but

we continue to like the energy sector, notwithstanding the recent drop in commodity prices over the past couple of months.

TWST: Are there any areas in your portfolio that you deliberately underweight or avoid?

Mr. Cole: Financials are probably the area that we are most underweight today. Although it makes up the largest percentage of the S&P 500, it's probably our third largest sector in portfolios. This is not necessarily a specific call on the markets or on interest rates. We just don't find too many compelling companies from a valuation standpoint. Fundamentally, we are concerned about future earnings growth both for money center banks and investment banks. In part, this reflects our view that the market is overly optimistic on the future direction of interest rates; we believe that it's more likely for long-term interest rates to head higher, creating additional headwinds for the economy and the equity markets.

TWST: What are some of the representative stocks that you have in your portfolio?

Mr. Cole: Right now, our largest holding is **Microsoft** (MSFT), and that's a reflection of where we think the company is in terms of the new product cycle. We took a position in **Microsoft** a little more than a year ago in anticipation of Vista coming out. We think that there is good earnings growth in the company for at least the next 18 months, so that's a pretty good opportunity.

Thermo Fisher Scientific (TMO) is our second largest holding. We originally held a position in Thermo Electron, and they recently merged with Fisher Scientific to become the leader in providing analytical instruments and laboratory equipment to be used by healthcare, scientific research and educational customers.

Praxair (PX) supplies gas to industries primarily in North and South America. They are one of the largest suppliers of hydrogen, nitrogen and oxygen. What is interesting about **Praxair** is it could be considered an energy company, with hydrogen having the potential of being a major fuel source for future power generation equipment. While that may be true over the long term, what we also find attractive today is the company's present ability to serve the energy, healthcare and waste and water treatment industries by providing gases that help businesses become more efficient or productive. They also are a beneficiary of the substantial industrial growth in China and other emerging markets. They expect to see their revenues double over the next four years in China alone, and we think that there is a great long-term opportunity there for **Praxair**.

TWST: Is having international operations and/or a market lead a factor in your selection?

Mr. Cole: Almost all large cap companies have sizable international operations, so it is really not much of a factor to differentiate one company versus another. We do seek market-leading companies, as we prefer businesses that have the foresight and resources to shape their industry, rather than being a marginal player in a highly competitive environment.

TWST: Do you have any proportion of your portfolio in international stocks?

Mr. Cole: We only have two holdings presently headquartered outside of the US — **Novartis** (NVS), a large pharmaceutical company based in Switzerland, and **Sony** (SNE), headquartered in Japan. Since the companies in our portfolios have anywhere up to 60% of their revenues from overseas, we don't really focus too much on where a company is headquartered, because at the end of the day, whether you own **Novartis** or **Pfizer** (PFE), they both have substantial sales in the US, as well as internationally.

TWST: What other multinational corporations are in your portfolio?

Mr. Cole: Almost all of the stocks we own have operations internationally. Some of our largest holdings include **General Electric** (GE), **Schlumberger** (SLB), **American International Group** (AIG) and **News Corp.** (NWS). **General Electric** is a well run company with above average earnings growth. The shares are selling at essentially a market multiple, which we think underappreciates their growth.

TWST: You mentioned Schlumberger. Is oil service important?

Mr. Cole: We think oil service is very important. Large energy companies continue to find it difficult to replace reserves. The easy oil has been found; new oil discoveries will be in harder to reach places. Additionally, there is increasing pressure to maintain or increase production from existing facilities. As the leading oil service company in the world, **Schlumberger** benefits from both factors and will continue to receive a growing share of oil companies' budgets to utilize their technology and expertise. One of the things that we like about **Schlumberger** is so many key members of its management team are natives of the countries from which they operate. It really is a quintessential global company, which we think is a significant competitive advantage.

We also own companies with oil and gas reserves, such as **ConocoPhillips** (COP), **Devon Energy** (DVN) and **EOG Resources** (EOG). We believe demand for oil is growing at a faster rate than supply. Many of these companies are priced as if oil were \$40 per barrel or lower. Our expectation is that oil prices will head higher, so we think it makes sense to hold these companies until their share price appropriately reflects their net asset values.

TWST: What is the sell discipline? What triggers an exit from your portfolio?

Mr. Cole: When we initially purchase a company, we set up short- and long-term price targets. We initially develop price targets to make sure that there is an adequate opportunity for appreciation if the company executes the plans as we expect them to. Once we've purchased a company, we periodically revise those price targets based on factors either related to the company or to the broader market.

Essentially, a sell will be triggered through one of three events. One scenario is that the share price goes through our valua-

tion target set for the company, and we will evaluate it at that point and determine whether we still have the appropriate price targets or whether we should sell the security out of the portfolio. The second scenario is if we find another investment opportunity that is more appealing. The third situation is if there is a negative event. We will assess whether it's a permanent or long-term impairment to the company. Under this situation, we completely re-evaluate the company and management team to determine whether management has a handle on the problem and whether their action plan is adequate. If we can't get comfortable with the answers to those questions, we exit the position to find a better investment opportunity.

TWST: What is the average turnover?

Mr. Cole: Historically, our turnover has run between 20% and 30%. When we take positions in companies, our analysis is focused on looking at earnings and cash flow three to five years out. Our turnover is reflective of that long-term view. We prefer to focus on companies with a good long-term strategy and whether they can execute on that strategy.

TWST: Do you ever have a contrarian bent to your investing?

Mr. Cole: Absolutely. We have found numerous opportunities over the years where a stock or industry is out of favor for some reason. Our analysis attempts to place less value on headlines or events that relate to the past, and assesses the outlook instead. We attempt to ascertain if there is value there, even though the sentiment of the markets is decidedly against a company or an industry. Sometimes it's just a matter of being patient and allowing these opportunities to develop.

TWST: Was AIG a contrarian pick? Did you get into that when its stock was declining?

Mr. Cole: Yes. We purchased **AIG** in May 2005 after **Hank Greenberg** resigned from the company and after the various SEC and internal investigations were well publicized. The stock had already taken a sizable hit, having declined from over \$80 per share to the low \$50s. The sentiment toward the stock was about as bad as it could get, with investors selling the stock at any price.

Although investors were largely in the dark about the materiality of the restatement of prior financials, our analysis determined that with the stock in the low \$50s, the company was tremendously undervalued compared to a conservative assessment of their likely earnings level.

TWST: How do you attempt to control investment risk in the portfolio?

Mr. Cole: From a portfolio standpoint, we have risk controls that focus on how much we have allocated to a given security and to an economic sector, making sure we have a diversified portfolio. Our portfolios typically have 30-40 holdings. We limit position size of a single security to 5% of the portfolio value at cost, and our sector exposure is limited to twice the weighting of the S&P 500 Index.

TWST: What do you think differentiates the investment approach at your firm from that at others? What are you bringing to the table that others might not?

Mr. Cole: There are several points that differentiate us. The first is our determination to understand an investment's risk prior to evaluating return potential. We devote significant effort toward analyzing the factors that might lead to disappointing events, and determining the magnitude of the downside under these scenarios.

Second, we are opportunistic in how we allocate assets and implement investment strategies. Asset allocation is a dynamic process. Although many advisers believe that allocations should change over time only as a result of the aging of the client, we believe that a sophisticated allocation process should incorporate an analysis to determine present market opportunities and risks.

Third, we are proactive investors, attempting to anticipate trends as opposed to reacting to the past. Our investment professionals have a passion for searching for undiscovered or unloved investment opportunities. Each of these factors plays a role in the value we bring to our clients.

TWST: Have you noticed a growth of interest by your clients in the alternative investments that you mentioned at the beginning?

Mr. Cole: Yes. We started to invest in hedge funds in the mid-1990s. Qualified clients were interested in these investments, but with the equity markets doing so well back then, I don't think it was the perfect environment to validate the investment strategy's purpose.

Our alternative investment strategies attempt to produce attractive returns, even if the equity markets don't cooperate. With the stock market shakeout in the early part of this decade, clients investing in these strategies appreciated the benefit of complementing traditional stock and bond investments with allocations to absolute return vehicles. Over the last 10 years, we have expanded these strategies for qualified clients to incorporate direct investments in private equity, energy and real estate, where these strategies are suitable.

The breadth of investment opportunities allows us tremendous flexibility in developing a plan for a client to meet their investment objectives while operating within their constraints for risk and liquidity. We can put together an attractive asset allocation, whether it is entirely in traditional investments, all alternative strategies, or a combination thereof.

TWST: What about your more conservative clients? Are they more interested in yield and dividend-paying stocks?

Mr. Cole: Probably the more conservative ones are. We do have clients that are entirely invested in bonds. I should take a step

back and say that for well over 90% of our clients, we supervise all of their assets, so usually they will have multiple investment strategies within their allocation. But we do have clients who are invested solely in bonds, because for their circumstances, that is the most appropriate investment.

Our stock strategy is pretty conservative, with less volatility than the S&P 500 Index. We typically are looking for high quality companies, even though some of them may be out of favor. Typically, they are very strong financially and have a good record of paying out and increasing their dividends.

TWST: Are your equities and fixed income tax efficient? Is that a consideration with your clients?

Mr. Cole: Absolutely. The majority of our assets are taxable assets, where we do pay close attention to the tax situation and make sure that we investing in a tax efficient manner. Because of our long holding period within the stock portfolio, it is exceptionally rare that we take short-term gains on holdings. Strategies that are less tax efficient are typically held in tax-deferred accounts, such as profit sharing plans and individual retirement accounts.

TWST: Is there anything else that you wanted to bring out in this interview?

Mr. Cole: We are truly dedicated to serving our clients. Providing innovative, custom-tailored investment solutions to each client is our primary goal. Our open-minded thinking has allowed us to invest in a broad spectrum of assets, providing clients a truly diversified portfolio. We analyze opportunities based on their merit, and are not constrained by the prevailing need of many in the financial community to categorize an investment in a box. The consistency of our results has led to rewarding, long-term relationships with clients, which at the end of the day is the best proof of the value Cedar Hill offers.

TWST: Thank you.

Note: Opinions and recommendations are as of 1/30/07.

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