

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

The Successful Company Discipline



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TWST: Would you give us a brief overview of Davidson and its investment philosophy?

Mr. Costigan: Our firm was founded in 1974 to provide wealth management and wealth counseling services to affluent families. From the beginning, our philosophy has centered on developing portfolios composed of superior operating businesses, what we call "The Successful Company Discipline." As a result of this history, our focus has always been on long-term growth and preservation of wealth.

Over the years, as our reputation for managing wealth grew, our clients began to ask us to get involved in managing institutional style portfolios and so now in 2008, our portfolio managers/analysts manage approximately \$1 billion, of which approximately 20% is institutional in style and 80% is portfolios owned by high net worth families. For most of our affluent clients, we enhance our Core Equity portfolios with best-of-breed managers from complementary asset classes.

TWST: How was your investment performance over the past year and were you affected badly by the subprime and credit crisis?

Mr. Costigan: Because our firm focuses on owning high-quality operating businesses, 2007 was for the most part a normal year. You might recall that we exited our position in Ryland, our only homebuilder stock at the end of 2005 and we began 2007 with an underweight in financials so our clients avoided some of the large problems related to the credit and housing markets. Relative to our benchmark, which is the S&P 500, 2007 was a good year for us.

Generally speaking when there is uncertainty in the market, higher-quality and lower-volatility business models, the kinds of opportunities we look for, tend to perform better and that's what we experienced last year. It's of course a two-sided coin — when the sun is shining and everyone is optimistic, common shares of companies that we feel aren't of high enough quality often outperform the stocks

of our Successful Companies. Our clients understand and are comfortable with our philosophy because they know that eventually a new crisis will come around the corner.

Equities in our focused composite were up about 10.8% last year relative to the S&P 500 which was up about 5.5%. We had solid relative performance compared to our benchmarks.

driving force in the economy. Instead, we think housing will be more of a drag than a drop.

In the meantime, the export numbers that we saw in the third quarter were so large that if they were to persist through 2008 we think that the economy could be in reasonably good shape, particularly for the second half.

“Over the last year we have increased our exposure to quality financials and reduced our exposure to consumer names. Some of the names that we’ve eliminated or reduced were companies that were economically disadvantaged. We eliminated our position in eBay in August and sold Family Dollar in June and September. We sold Applebee’s when the deal with IHOP was announced.”

TWST: What is the outlook for your quality businesses in 2008?

Mr. Costigan: 2008 has started out as an even more interesting year than 2007. Our opinion is that with this kind of price volatility, we have sharply contrasting opinions in the marketplace. We have folks who are extremely bearish about the economy and therefore the market, and folks who are convinced that the economy is okay and the market is oversold. Right now there aren’t many people in the middle, so that’s one of the reasons why we think we’re seeing such large daily swings in price. When we look at the economy and the market, we are more optimistic in large part because of our long-term emphasis, but also because of some of the fundamental things we’re seeing. So we feel relatively good about 2008.

For example, the strong export component in the third quarter GDP number surprised us. We believe that if that relationship continues in 2008, we’ll see some tailwinds to the economy, which may supercede the drag that we’re seeing from the dislocated credit markets and the housing bubble deflating. When we think about the national economy and particularly housing, our estimate is that housing on a national level could be still overvalued by as much as 15%. Much of that pricing problem will go away over the next four or five years as inflation and rising wages bring home prices and wages back into alignment. There will still be some weakness in housing prices of course, but we don’t think housing by itself is going to be a real

So we are fairly optimistic for our style of risk averse long-term oriented investing.

TWST: What about the bottom-up outlook? Tell us about your investment process and what you’re looking for specifically in these companies.

Mr. Costigan: What we’re looking for are companies that are market dominant, conservatively financed relative to their peer groups, managed by seasoned professionals, and have a history and future prospects of revenue and earnings growth. If a company doesn’t have this combination of characteristics, then we won’t consider it for our client portfolios.

When we look at the equity market, we start with quantitative screenings. Key screens eliminate companies that are aggressively capitalized, without minimum levels of liquidity or have an inferior return on invested capital. Our quantitative process generally results in approximately 500 opportunities. At this point our analysts look at that population and evaluate management expertise, industry characteristics and the potential for future growth. This qualitative process, bottom-up fundamental analysis results in a list of businesses acceptable for our clients to own. This list, which usually runs between 100 and 150 names, is called our Master List and is updated weekly. Our portfolio managers/analysts share company updates and proprietary valuation metrics in meetings scheduled throughout the week.

In the final step, our portfolio managers/analysts develop client portfolios of operating businesses that we feel will both reduce a client's risk and have the best opportunity for long-term outperformance.

TWST: How has the portfolio shifted in emphasis over the last 12 to 18 months?

Mr. Costigan: Over the last year we have increased our exposure to quality financials and reduced our exposure to consumer names. Some of the names that we've eliminated or reduced were companies that were economically disadvantaged. We eliminated our position in **eBay** (EBAY) in August and sold **Family Dollar** (FDO) in June and September. We sold Applebee's when the deal with **IHOP** (IHP) was announced.

One, in our opinion it's a well-run market dominant company; they are number two by volume in their industry but we believe number one from a value-added approach. Second, they service the global consumer products industry and when we look at the global market for consumer products, we know that there are large populations in emerging markets, particularly in India and China, where folks are going to move from a poverty level existence into the middle class and we know when that happens, the consumption of consumer products grows exponentially. We're looking for a way to participate in this long-term trend, that is, the long-term increase in consumption of consumer products, particularly in emerging economies, and **IFF** gave us the opportunity to do that.

“International Flavors & Fragrances is a well-run market dominant company; they are number two by volume in their industry but we believe number one from a value-added approach. Second, they service the global consumer products industry and when we look at the global market for consumer products, we know that there are large populations in emerging markets, particularly in India and China, where the consumption of consumer products grows exponentially.”

We also eliminated and reduced positions in some businesses that had performed well. We sold our holding in **Sanderson Farms** (SAFM) last summer and reduced our positions in **Intel** (INTC) and **Chevron** (CVX).

Last year we bought **International Flavors & Fragrances** (IFF), and **Texas Instruments** (TXN), and later in the year we bought **Kohl's** (KSS) and **US Bancorp** (USB) and added to positions in **IBM** (IBM) and **Wal-Mart** (WMT).

TWST: Tell us about some of the companies that you feel are representative of your investment approach. What attracted your attention to International Flavors & Fragrances?

Mr. Costigan: Because we look for conservatively financed businesses with consistent operating models, we are, generally speaking, biased against basic materials companies which tend to be too cyclical for our taste. Despite this bias we found **International Flavors & Fragrances** and it interested us for the following reasons.

1-Year Daily Chart of International Flavors & Fragrances



Chart provided by www.BigCharts.com

TWST: Would you tell us about the other companies that you bought in the last year or so?

Mr. Costigan: Last year we introduced **Campbell Soup Company** (CPB) to our portfolios. **Campbell Soup** is of course fa-

amous for the red and white labeled condensed soup with the Campbell name on it, but in addition to condensed soup, **Campbell** makes V-8 vegetable beverages, Pepperidge Farm food products and Pace Salsas, among other foods. In short, we view **Campbell's** portfolio of brands as having above average potential for growth, particularly the V-8 brand. Last year **Coca-Cola** (KO) agreed to distribute **Campbell's** juice products to convenience stores and potentially to vending machines. We believe that single serving distribution will help seed case sales of **Campbell's** juices. We also believe that with a few tweaks (think fiber, vitamins and maybe protein) the company will be able to move the V-8 brand from the beverage category to the portable meal category. Chunky might be the soup you eat with a fork but V-8 could be the meal you drink with a straw.

like **Kohl's** and **Wal-Mart** (WMT) are now at values that are compelling to us. **Kohl's** was a new position in 2007 and it's probably a position that we'll add to in 2008.

TWST: What are your views on the technology companies? You mentioned Texas Instruments as a new purchase and also Intel that you were reducing your position in.

Mr. Costigan: We're finding market dominant companies with broad global platforms that are competing in a currency-friendly environment in geographies where the payback on technology is fairly short. **Cisco** (CSCO) and **IBM** are certainly examples of that. **Texas Instruments** is a company that, we feel, is fairly well positioned in its marketplace. We like each of their portfolios and we view them as fundamentally shareholder-friendly.

“We view Campbell’s portfolio of brands as having above average potential for growth, particularly the V-8 brand. Last year Coca-Cola agreed to distribute Campbell’s juice products to convenience stores and potentially to vending machines. We believe that single serving distribution will help seed case sales of Campbell’s juices.”

We are now reviewing **Sanderson Farms** (SFM), which we sold last year at about \$44. The stock hit our price target and we felt better off leaving the position. **Sanderson Farms** is a company that grows and processes fresh and frozen chickens for sale, primarily in the southeastern part of the United States, but also internationally. At the time we sold it, we kept **Sanderson Farms** on our Master List because we believe it is a quality business. At the moment, it's now trading at under \$30 a share, a level where we find it interesting again, and it could be a position that we'll add to our clients' portfolios in 2008.

One business where we increased our position last year was **IBM**. We know that the dollar has declined and with the Fed easing, it could continue to slide so we wanted more international exposure.

TWST: You bought Kohl's, which is a retailer. What's special about Kohl's?

Mr. Costigan: We have followed **Kohl's** (KSS) for over six years and we're comfortable with their business model. The stock was beaten down along with other retailers. We feel that companies

1-Year Daily Chart of Campbell Soup



Chart provided by www.BigCharts.com

One of the things that we find extremely interesting and it applies to emerging companies, particularly tech, is the improvement in corporate governance that's begun over the last few years.

Over the second half of the 20th century and the first part of the 21st century, we witnessed a large improvement in the science

of corporate management. However, the science of corporate governance has in our opinion lagged. In our view, board independence and sophistication didn't keep up with the improvements in management techniques fostered by technology. This became evident to us as we studied the disconnect between retained earnings growth and growth in book value per share.

folks who now think all financial services companies are going to get dragged under will look back in a few years and wish they had been more confident.

We believe that normality will eventually return to the yield curve, that there will be enough liquidity in the market to absorb distressed assets and those financial services stocks will come back.

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We now believe that corporations, because of class action lawsuits, government intervention, activist shareholders and because it is the right thing to do are paying more attention to shareholders.

We believe **Microsoft (MSFT)** is another good example of this shift toward a higher level of corporate governance.

TWST: Are there any areas of health care that you are looking at?

Mr. Costigan: In health care, we're focused on the long-term connection between research and development as a percent of sales and earnings growth. We calculate a historical return on R&D investment and use it to estimate the potential for long-term growth for a business. We weigh this against forecast changes in a company's IP portfolio in determining opportunities. When we look at the marketplace, two companies that we feel strongly about for the long run are **Johnson & Johnson (JNJ)** and **Amgen (AMGN)** where R&D investment as a percent of sales imply to us potential long-term earnings growth rates that are in excess of the consensus long-term earnings growth rates for the businesses.

TWST: We haven't mentioned financial services. Are there any quality companies left in that sector that you still retain in your portfolio?

Mr. Costigan: There is an old saying, "Things are never as good as you hope or as bad as you fear." Clearly the folks who invested in subprime assets hoping things would stay good forever didn't have a sufficient level of fear. Alternatively, we believe that

1-Year Daily Chart of Sanderson Farms



Chart provided by www.BigCharts.com

We think operationally there still could be a few hiccups left in the financial area but from a valuation level, we feel we're probably pretty close to the bottom. Companies that we feel comfortable with for the long run are **US Bancorp (USB)**, we own **Bank of America (BAC)**, we own **Wells Fargo (WFC)**, we own **American International Group (AIG)** in a relatively small position and may add to that this year, and we own **Prudential (PRU)**, which is another small position that we will likely add to in 2008.

TWST: What about the sell process? Do you set price targets for each of the stocks?

Mr. Costigan: We eliminate positions for three basic reasons: a company is trading above our fair value range, we have de-

cided that our original investment thesis is flawed or we have found a better long-term opportunity. Our analysts set three prices for each stock. We set a fair value, which is our estimate of long-term fair

systems and to really manage portfolio risk in an intelligent manner you need experienced people interacting and sharing with experienced people. Toward that end we rely on a rigorous peer review process.

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value, we set a minimum value, and a maximum value. Our analytical process is such that if a company that we own falls below our minimum value and underperforms the S&P 500 by 10% over a 10-day period, we automatically schedule a review of our investment thesis for that asset. At the end of that meeting, our team usually decides to either increase our investment in that company or sell it. It’s rare that we will decide to do nothing.

If a stock is over our high value, then we tend to trim. We’d like to enter and exit investments in multiple stages and we think that gives our clients some event diversification.

We also have what we call the pigs at the trough philosophy. Generally speaking, for us to add a name to a portfolio, we have to remove a name from the portfolio. This forces us to push out business where long-term prospects are relatively weak.

TWST: Do you always have a reserve bench of companies that can fit right into the portfolio?

Mr. Costigan: Our Master List, which is, again, between 100 and 150 names, represents those companies that our analysts are actively following. Our portfolios run between 35 and 50 names depending on the client and their circumstances. Approximately 70% of the companies we follow we are not actively buying, either because they are not trading at prices low enough to attract us or we have found a superior opportunity and they represent our reserves.

TWST: What about risk control at the portfolio level and at the individual security level?

Mr. Costigan: We have a policy not to put more than 5% of a portfolio into any one security. So there is a modest level of idiosyncratic risk management there. But the fact is, people can always circumvent

1-Year Daily Chart of Kohl's



Chart provided by www.BigCharts.com

TWST: What do you think gives Davidson its edge? What are the defining features that distinguish your investment process from that at other firms?

Mr. Costigan: There are a lot of firms that say they have a long-term investment focus, but quite frankly they don’t. I think one of the main features of Davidson’s process that gives us an edge is that we truly have a long-term focus when we look at the market. Our long-term focus and our willingness to adhere to it is far and away one of our greatest advantages. Our willingness to invest in quality businesses that are temporarily unattractive because of our long-term perspective is a differentiating factor.

TWST: Somewhat like a value investor in that sense?

Mr. Costigan: I think that’s a really good point. Our bias is to find growing operating models, but our benchmark is a core benchmark. The only way that that formula really works is if we focus on the value/price relationship when we are investing.

TWST: You mentioned the problem areas for 2008 and beyond for investing, but are there any particular challenges that you think that investors in general should be wary of?

Mr. Costigan: The number one challenge, which I believe applies to 2008-2009 and probably every year after that, but which was clearly evidenced in 2007 is to truly understand what you own. The investors that purchased subprime debt and were harmed by those purchases clearly didn't read the fine print.

When we're looking out into 2008, I think two big issues will be unemployment and inflation. Our sense is that of the two the much bigger long-term threat will be inflation. We have entered an era of global capital, labor and resource markets. Our take is that global consumption will continue to increase as living standards around the globe improve, while independent central banks struggle to rein in liquidity in a global capital market.

TWST: Is there anything that you would like to add?

Mr. Costigan: The only other thing that I think is important is that we track the relationships between small, mid-, and large cap companies in the United States. Our sense is that in early 2007 the deck was stacked significantly toward large cap companies. We think that's come in a little, but we still look at larger businesses as having an advantage in the market for this year and maybe into 2009.

At the moment, our expectation is that larger companies will outperform smaller companies for the next year or so. That is not what we would normally expect; we would expect the smaller companies to have a slightly better performance. We're feeling comfortable with a preference for large companies, particularly through 2008, and we think that might even persist into 2009.

TWST: Is there anything else?

Mr. Costigan: I just think that this is a really good time to remind folks to make long-term plans that make sense for their personal situations and to have the courage to stick with them even when the market is not moving in a direction that they find appealing.

TWST: Thank you.

Note: Opinions and recommendations are as of 2/6/08.

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