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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Fundamental Value Investing Strategies

ERIC KALLEN is President and Chief Investment Strategist at Hayek Kallen Investment Management, LLC. He joined the firm following a career as an Investment Banker in New York and London with Morgan Stanley as a Vice President in Mergers and Acquisitions. Mr. Kallen's focus within the firm is portfolio management and security analysis. His opinions and analysis have been published in *The Financial Times*, *The Wall Street Transcript* and *The Mobile Press Register*. Mr. Kallen received a B.A. from Washington & Lee University and an M.B.A. from The College of William & Mary.

TWST: Please provide an overview of Hayek Kallen Investment Management.

Mr. Kallen: Hayek Kallen Investment Management is an investment advisory firm whose goal is to serve the long-term financial interests of their clients by preserving and growing their capital in a tax-efficient manner. Since 1985, Hayek Kallen has used fundamental security analysis and a balanced-value investment approach to prudently manage individual stock and bond portfolios. Hayek Kallen strives to operate without conflicts of interest and act as trusted fiduciaries for their clients. Hayek Kallen manages approximately $235 million for roughly 240 families.

TWST: You follow a fundamental value investment discipline. Would you explain what that means?

Mr. Kallen: As value investors we strive to identify companies whose inherent or intrinsic value is significantly above where the market has priced it. To identify a company's true value we focus on the core elements of the company. Part art and part science, we utilize a comprehensive top-down and bottom-up approach. At the center of this is the company's financial performance. Cash flow, balance sheet strength, dividend track record and the ability to continue to grow the dividend, returns on assets and equity are all important to us. Layered on top of this are assessments about the products and services being produced, the management team and their overall competitive position. Ultimately we arrive at a numeric value for the business, and if the market prices the company at a significant discount to that value we will make an investment. We try to never forget that really good businesses at really high prices do not always make good investments.

TWST: You also focus on allocating capital from overvalued areas to undervalued areas. How do you identify those areas, and what is the process like?

Mr. Kallen: I think one of the biggest challenges that investors face is their emotions. When emotions drive an investment decision, whether it's buying or selling, they will generally do the wrong thing. When are you going to buy? Generally in a period of time when there is positive sentiment and prices are higher. When will you most likely sell? Frequently it's after significant drops, when you can't take the pain any longer. This is an easy trap to fall into. What we try to do when we establish an intrinsic value for a company is to remove the emotion from the decision and rely on our analysis. When we look to make an investment we will establish a numerical value for that company. If the stock market is not in agreement with us and is pricing that company at a significant discount to that value we will make an investment. If that stock appreciates to within 10% or 15% of our intrinsic value, then we begin the sale process.

In my experience, it is often harder to sell stocks that have done very well than it is to sell stocks that have performed poorly. Emotionally it can be hard for investors to say goodbye to a company that is doing very well, particularly when it has made them money. But over time, the process of selling stocks that have appreciated and reached full value, and reinvesting in stocks that offer a much better opportunity for return is core to our strategy.

TWST: What is the process you use to select stocks? What do you look at and what is the combination of qualitative and quantitative analysis you use?

Mr. Kallen: Cash is king. We look at cash flow, and cash flow yield, as being central to our valuation models. The way that cash flow is utilized is another very important element. We want to see companies exercise a disciplined approach to putting that cash to work. We have a bias towards dividend-paying companies, but we do not look at that as a prerequisite for us to invest. Buying back shares is another trait that shows us that management is focused on total shareholder return, not building an empire. I think it's ironic that many people view cash on the balance sheet as a negative, an admission of failure. When you look at some of the criticism that **Apple** (AAPL) has faced, you will see foremost among them the idea that they have too much cash. Really? I guess if you are a growth investor looking at an investment horizon measured in weeks or months, then I understand the impatience. But for us, cash provides flexibility and the ability to enhance our returns through share buybacks and dividends.

In our analysis we utilize models to discount the value of future cash flows and create an idea of what the shares are worth today. We view this as an input into the final decision about a company's intrinsic value, but not the only input. Investing is an art and a science. One of the most important aspects of our work is to try and find what I would consider to be good businesses that are producing valuable products and services. A subjective assessment for sure, but one that we feel helps us identify companies with the ability to be successful in all phases of an economic cycle, which is important when you invest with longer-term objectives.

Highlights

Eric Kallen of Hayek Kallen Investment Management discusses the firm's fundamental value investment discipline. He says the investment strategy is to establish an intrinsic value for a company, where cash flow yield is central to the model, to remove any emotion in the stock selection and sell processes. Mr. Kallen also highlights some of his favorite names in the portfolio and explains how it is constructed.
Companies include: Apple (AAPL); McDonald's (MCD), Wal-Mart Stores (WMT); The Coca-Cola Company (KO); Qualcomm (QCOM); Novo Nordisk (NVO); Hertz Global Holdings (HTZ); Philip Morris International (PM) and Altria Group (MO).

TWST: Would you explain how bond analysis differs from stock analysis?

Mr. Kallen: We look to our bond portfolios for stability and income. When we buy bonds we do so with the idea that we will hold them to maturity. We are certainly open to the idea that bonds can be sold prior to maturing, but in practice, this is more the exception than the rule. Given that we generally hold bonds to maturity, we are less focused on price movements between issuance or purchase and maturity. If we feel that a company offers significant opportunities for capital appreciation, we will buy the stock and not the bond, where we can take part in more of the upside. For this reason, our fixed income analysis is more focused on the credit of the company. How likely is it that we will receive our initial investment at maturity? As a policy we do not invest in junk bonds, so we try to lessen our exposure to the issuers who are deemed to be riskier.

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In addition to analyzing the credit, we try to formulate a macro strategy to build into our bond portfolios. Currently, we are investing with an eye toward higher inflation and higher rates. Many of our clients rely on their portfolios to fund living expenses, so we need to ensure that we can protect their purchasing power as much as possible. With this in mind we are focusing on short- to intermediate-term bonds, using laddered maturities. We also try to find structured bonds that might offer some element of inflation protection built in — step-up coupons and floating-rate coupons as examples. While this strategy might offer lower yields today, it will help to offset the impact of rising rates down the road.

TWST: Do you always use both stocks and bonds in a portfolio, and how do you determine that balance?

Mr. Kallen: The asset allocation decision is driven by the facts and circumstances in our clients lives, not by our views on the prospects for the markets. Items such as income needs, risk tolerance and ultimate goals or legacy help us formulate an asset allocation that our clients are comfortable with. We have some clients who are younger, still working, and able to tolerate much higher levels of risk than some of our older, retired clients who rely on their portfolios to fund distributions. The majority of our clients have between 30% and 50% of their portfolios dedicated to the fixed income markets. What is important to remember is that these objectives are meant to be fluid and not driven by short-term or emotional factors. I always get nervous when I hear predictions about what an investor's stock allocation should be for the next six months, largely because these decisions are made based on recent performance.

1-Year Daily Chart of Apple

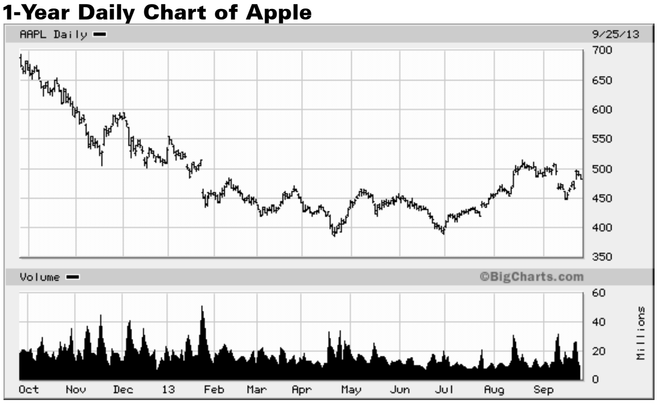

Chart provided by www.BigCharts.com

TWST: Do you invest both internationally and domestically?

Mr. Kallen: We firmly believe that investing today should be carried out with a global focus. By doing so we gain access to a much larger universe of companies, and we also gain exposure to economies that have different characteristics than our own. We have some limitations, primarily that we will only make investment in foreign stocks through ADRs. This way we know that internationally accepted accounting principles are being followed, as well as certain other requirements.

In addition to direct investment in international companies, we also look at the international exposure that a number of our multinational holdings have. When you look at a company like **McDonald's** (MCD), **Wal-Mart** (WMT) or **Coca-Cola** (KO), these are core holding of ours that are seeing much higher growth rates in international markets than our own. Over time we expect these companies to see larger and larger contributions from foreign markets.

TWST: Where do you focus in terms of cap size?

Mr. Kallen: To us value is value. As long as we have adequate liquidity we will invest in small-cap companies that trade on a major exchange. Having said that, in practice we invest primarily in mid- to large-cap companies. This is due in large part to the fact that cash flow and balance sheet strength are two components of our investment thesis that carry the most weight, and early stage or small businesses rarely have what we are looking for here. Given that we also need to understand the businesses that we are buying, and ultimately to value them, we need access to a certain amount of public information. Experience has shown that smaller companies are usually less well-covered, and in many cases hard to get good information on.

TWST: Given the current investment climate, where are you seeing opportunities right now?

Mr. Kallen: That is the million-dollar question. Given the recent performance of the market, it feels like opportunities are available, but not broadly. One of the advantages to using individual stocks and bonds when investing is that you can be much more flexible and selective when it comes to making investment decisions. To me, the idea of 'buying the market' boils down to getting the good with the bad. In a market where returns have been robust, valuation plays a bigger and bigger role. We are looking at certain sectors that have not kept pace with broader market gains as good places to look for value, but more than that we need to find companies within those industries with similar traits.

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For example, we are very interested in the technology sector. While technology used to be a four letter word for value investors, we see it as a place where we can find very stable and well-established companies, with strong balance sheets, high levels of cash flow and higher growth rates than in many other areas of the economy. But not all companies in this sector share these characteristics. If you invest broadly in the sector you will get some of the exposure that offers value, but you will also get the rest. We see technology as an industry in transition. The shift is away from the traditional desktop model to mobility and the cloud. Evidence of this is in the migration of value from the traditional technology powerhouses — PC manufacturers like Dell, HP and Compaq for example — to those companies who are establishing themselves in the next wave. We see this shift as taking place over time, and while it isn't obvious who the winners and losers will ultimately be, we feel that buying great companies at good prices gives us the ability to position ourselves appropriately.

Two companies that we feel are well positioned to meet these challenges are **Apple** and **Qualcomm** (QCOM). Both of these companies are well established in the mobility space, I think you could argue that one of them actually played a large role in creating it. Beyond their strategic position they both have huge cash piles, offer very respectable dividends and are trading at levels that provide significant room for upside. **Apple** is trading at about 12.5 times earnings, less if you back out the cash, and offers an 8% cash flow yield. **Qualcomm** is a little higher, about 14.5 times earnings, but it has a very respectable cash flow yield of nearly 7%.

We see a company like **Novo Nordisk** (NVO) as a great way to invest in these underlying trends. **NVO** is a Danish drug company that focuses on diabetes. Given the trends that I just mentioned, coupled with the fact that obesity has really begun to take its toll, diabetes is what we would consider to be a growth disease. Globally, there are nearly 300 million people who suffer from diabetes, and in China, where 114 million Chinese have the disease, it has reached epidemic status. **Novo Nordisk** is the world leader in diabetes care, and it has the broadest diabetes product portfolio in the industry.

TWST: Are there areas you are currently avoiding?

Mr. Kallen: We try not to paint things with too broad a brush, but in the current environment we are significantly underweight financial equities. This is in part due to the difficult rate environment and its impact on bank margins. This is a tough time to be a bank. We are also very leery of investing in sectors or companies that have a dependency, or are subject to, high levels of government involvement. I saw that Morgan Stanley has 50 full-time government employees onsite monitoring their operations. Right now, regulators have put a bullseye on the backs of financial institutions, who most blame for the financial collapse five years ago. This is likely to mean higher operating costs, limitations on how these companies manage their businesses, and uncertainty about the future of the industry. Depending on where you look in this sector these concerns can be amplified by factors such as balance sheet quality and risk management. We try to stick to the idea that if we don't understand something, we don't invest in it.

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1-Year Daily Chart of Qualcomm

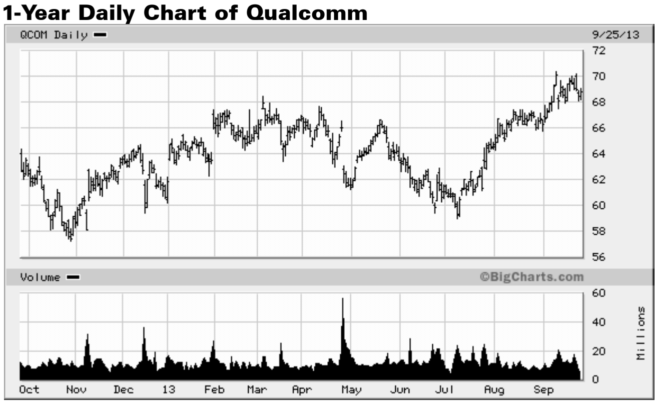

Chart provided by www.BigCharts.com

Another area where we see opportunity is in the health care sector. Echoing what I said earlier, this sector is seeing a tremendous amount of change. Change is being imposed in part by new regulations, but also by changes in demographics. Obamacare is still a question mark, and quite honestly we are not willing to make big bets on this given all of the uncertainty. What I will say is that we do not like to invest in areas where the government has the ability to make large impacts. We are trying to avoid companies with a large dependence on Medicaid or Medicare reimbursements, for example, given that with the stroke of a pen these rates can change dramatically. The demographic changes are more attractive to us. Globally, the population is aging and we are living longer. Coupled with this is the fact that health care continues to be a larger and larger component of GDP.

TWST: Would you tell us about some of your favorite ideas right now and explain why you like them?

Mr. Kallen: In addition to the couple of companies that I mentioned earlier, we have recently invested in **Hertz Global** (HTZ). Most of us know **Hertz** from the rental counters at the airport, but **Hertz** has begun to move beyond just that. Late last year they closed on an acquisition of Dollar Thrifty Automotive Group, which further consolidated the industry from six major players a few years ago to three today. In addition to the cost savings and cross-selling opportunities that this acquisition presents, **Hertz** has been very active in moving into the off-airport rental car business. These rental arrangements are generally longer and more desirable than what is available at the airport. If **Hertz** can recognize reasonable synergies from their DTG acquisition, and the industry continues to see firmer pricing, then **Hertz**, at less than 11x 2014 earnings, looks very reasonably priced.

Another company that we like is **Philip Morris International** (PM). **PM** is the international tobacco company that came out of **Altria Group** (MO). While tobacco use in the U.S. is shrinking, there is still positive growth internationally. In China alone there are nearly 300 million smokers, which equates to nearly one out of every three adults. **PM** is currently yielding about 4%, and their dividend has increased every year since 2008, when it was spun off of **Altria**. **PM** also bought back about 25% of their total shares outstanding over the last five years, nearly $31 billion of stock. Long term, the growth of tobacco is a question, but given the amount of cash that the business generates, opportunities in specific markets and with new technology like e-cigarettes, we think **PM** will continue to be a valuable contributor to our overall returns.

1-Year Daily Chart of Philip Morris International

Chart provided by www.BigCharts.com

TWST: How many stocks do you like to have in a portfolio, and why does that number make sense for you?

Mr. Kallen: We shoot for 20 to 25 individual stocks, with none of them being more than 5% or 6% of the portfolio. We like to have a broad exposure to the economy as a whole, but certainly direct our investments based on macro views about the economy both in the U.S. and abroad. Keeping the individual exposure in the 5% range reduces the possibility that one holding can produce unwanted volatility. No matter how sure we are about the prospects of a company, sometimes things happen and we are wrong.

TWST: What is your sell discipline and how often do you turn over stocks?

Mr. Kallen: For many investors the decision to sell is much harder than the decision to buy. No one wants to sell a stock that has done well for fear of missing additional upside, and no one wants to sell a stock that has done poorly due to the emotional toll that comes from admitting a mistake and locking in a loss. We try to remove emotion from the equation by basing our sell decisions around the appraised values that we have developed for each of our holdings. We generally start the sale process when stocks reach 90% of our appraised value. We frequently sell in stages, which allows us to recapture our investment and then be in a position to capitalize on further gains if a stock continues to appreciate. Sometimes we get it wrong and a company that we have invested in suffers a setback.

Our job is to identify if this setback is temporary or terminal. Temporary setbacks, particularly those that are market driven, can be good buying opportunities. Terminal problems need to be dealt with swiftly and without remorse by selling, taking your losses and moving on. Our clients understand that we aren't always going to get it right, and admitting that you were wrong can ultimately save you from further losses down the road. Given that we are prepared to hold our investments for two to three years when we buy, our turnover is fairly low by most measures, probably in the 15% to 20% range per year.

TWST: In June, you wrote about whether to "cheer or fear" rising bond rates. Where do you come out on that?

Mr. Kallen: Our fixed income strategy of holding short- to intermediate-term bonds to maturity lessens the threat from rising interest rates. The reason is that the drop in prices that bonds will suffer with rising rates will be less evident as those bonds get closer to maturity. The income that we receive will not drop, just the prices, and that will be for a temporary period of time. Remember if you buy a five-year bond for $100, and rates rise after a year, that bond could drop in price, say to $95. But the coupon will stay constant, and as that bond gets closer to maturity its price will rise back to $100, regardless of what interest rates do. As I said earlier, we are avoiding longer-term bonds, and laddering maturities to lessen the impact that rising rates will have on our client's portfolios.

TWST: Is monetary policy important when making investments, and if so, what are you watching in terms of monetary policy over the next several months?

Mr. Kallen: Yes, monetary policy is a very important driver in the development of our macro views on the economy, and ultimately helping to direct where we look to invest. It appears that our economy is in a period of transition, from the loose monetary policies of the last five years, to one where support is being withdrawn and companies will be required to perform on their own merits. The irony of this is that an improving economy is setting the stage for this, yet the markets have reacted negatively when faced with these prospects. Ultimately, the prospects of a slower, but sustainable economic recovery driven by business fundamentals is much more appealing to me than one driven to unrealistic heights based on absurd assumptions. Going forward, we will continue to focus on the Fed and what they are doing, but ultimately the bus is leaving the station and we don't want to be standing in front of it. We are really focused on companies that have the balance sheet strength to weather higher rates, and the business strength to perform under a less accommodative monetary environment.

TWST: What are the greatest strengths you bring to your clients?

Mr. Kallen: What most people in my position would probably say is our expertise in selecting the right stocks or bonds. While I feel strongly that we have an excellent team with a very good track record of doing this, I think that one of the biggest values that we bring to our clients is trust. Our approach to managing money is to do it without conflicts of interest in a manner that provides our clients with high levels of visibility into their portfolios. Our clients have the ability to understand what individual stocks and bonds they own, the price they paid for them and how their portfolios have performed. They understand how we are compensated; the fees that we charge are presented clearly and without confusion. When all of this is laid out there for our clients to see, we have eliminated the potential for confusion and provided our clients with the tools necessary to make well-informed decisions about whether or not we are meeting their expectations. This level of trust and transparency, coupled with successful portfolio management, has served us well over the last 28 years.

TWST: Thank you.

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