

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

The Advantages of Investment Counseling



RALPH E. WEIL, CFA, provides leadership to the investment research process and is also a portfolio manager, with 42 years of experience. Prior to combining his firm with Clifford Associates in 1996, Mr. Weil was President of Sabl Weil Investment Counsel for 16 years. His prior experience includes a variety of investment and portfolio management positions at major west coast banks. He is a member of the Los Angeles Society of Financial Analysts and the Association for Investment Management and Research. He received his BBA from Cleveland State University in 1970 and his MBA from Case Western Reserve University in 1971.

(XAM501) TWST: Would you start with a brief overview of Clifford Associates and what you do there?

Mr. Weil: Most people are not aware that Clifford Associates is the oldest investment counseling firm in the country. It was established in 1915 to manage money for individuals in a manner that focused solely on client needs, rather than generating transactions to earn commissions. Prior to the investment counseling business, the only place people could get help in managing their money was going through a registered broker. Our founder, A.M. Clifford, felt then, and we continue to believe today, that earning a transaction commission creates potential conflicts between what's in the best interest of the client and what's in the best interest of the person who's giving the advice. That's the reason Clifford Associates and the investment counseling industry were created, and we still abide by the principle that was established many years ago: the number one, most important thing is our clients and helping them meet their financial goals.

We manage both fixed income and equities for individual and institutional clients. Our individual clients are usually in a high tax bracket, so we generally need to generate tax-free income where appropriate. For these individuals, our fixed income focus is mostly on municipal bonds. For institutional clients with fixed income needs, we currently lean more toward Treasuries and agencies. From time to time we will use corporate bonds, but we find that, at this

point, the spreads just don't justify the added risk of owning them, especially when compared to agency issues.

Moving to the equity side of our business, we use cash flow and cash flow rates of return as our primary valuing technique. Starting in the late 1980s, we became concerned about the quality of corporate earnings reports. As time goes on, we strongly believe this concern is legitimate and earnings reports continue to lose value as a primary tool in evaluating companies. We do acknowledge that earnings per share, when reported, can have an impact on the market, but over a longer term, the impact is lessened. All you need to do is look back over the last five years to really call into question the value of income statements and earnings as reported by corporations.

While we understand that the cash flow statement is derived from the income statement, it is more difficult for corporations to manipulate because of its ties to the balance sheet. I'm not saying it can't be done, but cross-checks help to raise important questions that may not get answered from the income statement alone. That's why we put more emphasis on the cash flow statement. We've found over the years that this focus has helped us find better investments and avoid disasters.

TWST: What do you like to see companies doing with their free cash flow?

Mr. Weil: What we're looking for are companies that earn a positive and growing rate of return (ROR) over their cost of funds. We like to see these companies reinvest in their own businesses. The oppo-

site is true for companies that have a negative or declining rate of return; we like to see those companies reorganizing their businesses and returning excess cash to shareholders through dividends or share buybacks.

When we say “investing in their business,” we’re looking for managements that have the ability to realize that their current product, or line of products, has a lifecycle. The management should be reinvesting in areas that extend the life of an existing product or create new products/lines of business. We look at how companies reinvest their profits over the years to bring out new products that will continue the life of the company.

An example of a company that is good at reinvesting in the future is **Pfizer, Inc.** (PFE). Over the last 15 years, through new product development and acquisitions, the company has grown from a good middle of the pack pharmaceutical company to the acknowledged leader of the industry. During that time, shareholders were rewarded handsomely. The reverse of this is the situation at **Eli Lilly** (LLY). This company (for a long period of time) was a one-product company in that the majority of the profits were coming from one product. New product development at **Lilly** trailed behind the rest of the industry and, unfortunately for shareholders, so did the price of the stock.

TWST: What other characteristics are you looking for in investment opportunities?

Mr. Weil: Focusing on cash flow forces us to look at a company’s balance sheet and how its assets are utilized. We are looking for positive rates of return on investments, and also looking at how the company takes those assets and works with them. Most rates of return are calculated using historical costs. This can be misleading, so we use an adjustment factor to set up the base to more or less replacement cost.

The model we use has algorithms that have been tested to adjust the asset base up to a replacement cost. A trick a company can use in trying to make their rate of return look better is to not reinvest in the business, but allow depreciation and/or depletion to decrease the asset base over time; if cash flow remains the same, the rate of return increases. In reality, the company is not increasing returns because they’re not reinvesting in the business. Eventually, if you don’t reinvest, you’re going to go out of business, and that’s not the kind of company that we want to own. It all comes back to the idea of being able to reinvest successfully in your company. If you can’t do that, then return the cash to shareholders.

Generally speaking, the companies in our portfolios are well established in their industries, if not the leaders in those industries. These are companies which have exhibited the ability to control their own destiny and we closely analyze the significant role management plays in this process. We evaluate management based on historical returns, current position and plans for future development.

Future prospects for the company are forecast and analyzed using our internal growth and profitability measures. This forecast is then screened by discussions with company management, competitors, and talking with Wall Street analysts. We take these steps to ensure that our expectations are reasonable and within the realm of probability.

TWST: What about your valuation metrics? How do you do the valuation research in your process?

Mr. Weil: For many years, we’ve been using a product from Applied Financial Group (or the prior version of the product) that incorporates cash flow and cash flow rates of return. This software enables us to compare companies within an industry, industry to industry, and country to country. We’re able to bring companies down to a common level so the numbers that we’re looking at are equivalent across the spectrum.

We generally start with controlling three variables of profitability. Then, if we need to, we have the ability to go in and adjust individual line entries (balance sheet/income statement/current cash flow statement) for each company we’re evaluating. The net outcome is that if we believe the economic value of the company is higher than the current price, it becomes a potential candidate for purchase in our portfolios. If it’s a position that we own and the economic value of the company drops below the current market price, it becomes a sell candidate from our portfolios.

TWST: What is the sell discipline that you employ?

Mr. Weil: To begin with, we have no hard and fast sell rules such as up to 50% and out. We start with our economic value price, which is calculated using conservative inputs, and adjust those inputs to reflect our most optimistic scenario. The resulting value becomes our upper range. Once a company’s price exceeds that level, we re-evaluate our inputs. If those inputs are still valid, we believe the company is overvalued and should be sold or reduced from portfolios.

The other sell trigger is if the fundamentals for the company or industry change. This fundamental change would reduce our fair economic value to below its current price and force the sale from portfolios. In summation, each buy or sell decision is really based upon our valuation work. Of course, any final decision to sell holdings in a portfolio are weighed against the tax implications for the individual client.

TWST: What about risk management? How do you try to control investment risk?

Mr. Weil: When managing both equity and fixed income for clients, we have a little more flexibility in managing risk. We start with an evaluation of the client’s understanding of risk and where we should put them on the risk curve. In addition, we need to know any specific income needs. Once these factors are determined, we build a balanced portfolio that reflects those overall risk levels and income needs.

Controlling risk in the equity portion of a portfolio involves two factors: The first is the kind of equities we own and the second is the diversification of holdings. Most of our clients prefer less risk. One of the primary reasons they come to us is for the preservation of their capital, in addition to reasonable long-term growth.

The first level of risk control is addressed by our investment style. We do not put ourselves out as being overly aggressive managers, but invest in larger companies that are established and have long track records. The second area of risk control, diversification, takes many things into account. Depending on the portfolio size, we will have between 20 to 30 different issues in a portfolio. These are general guide-

lines and could vary for extremely large portfolios or small accounts that are part of a larger family of accounts. Not only do we diversify at the company level, we also carefully monitor exposure to industries. It is not our intent to be so diversified we act as a closet index fund. We believe over-diversification dilutes the value of our fundamental work.

TWST: When you have finished your process, what does the portfolio look like? How many securities do you generally have in a portfolio?

Mr. Weil: It varies depending on the size of the portfolio. Smaller portfolios could be in the 15-20 range for equity positions. Larger portfolios might be in the range of 25-35 equity issues. In even larger portfolios, we might approach 50 company names, but that really is getting a little bit too diversified for our purposes. Generally speaking, our typical portfolio is somewhere in the range of 20-30 individual issues.

TWST: You prefer to have a more concentrated portfolio for your clients.

Mr. Weil: Correct. We believe our research really adds value for the client. We want to take advantage of it. Obviously the more names you hold in a portfolio, the less opportunity you have for your better ideas to shine through.

TWST: How do you choose an appropriate entry point for the securities that your process has selected for consideration?

Mr. Weil: That really starts with how an individual name gets onto our list. We have a number of idea sources, including research reports, general publications, clients or other contacts. Generally ideas can come from just about anywhere.

We evaluate a proposed company based on our selection process. Once we have our fundamental work in place, we put that information into our cash flow model and establish an economic value that we feel is the proper valuation for the company. If the economic value of the company is above the current price, it will be presented to our investment team and we will discuss it. At that point, we'll decide if we want to use it in portfolios or not.

We do not have a rule that states the economic value of a company has to be a fixed percentage above its current price to be put on the buy list. We don't have hard and fast number rules, though our discipline itself is robust.

As an example of how an idea can be brought to our table, we just recently added **Popular Inc.** (BPOP), whose main holding is Banco Popular, a bank that's headquartered in Puerto Rico. This is a US bank and holding company so it's covered under all the US banking regulations. The reason it came up on our radar screen is its exposure to the Hispanic market.

It's pretty well known that the Hispanic population here in the United States is the most rapidly growing segment. This banking group is well established in Puerto Rico and now is getting more firmly established in the major Hispanic markets here in the continental United States, such as Florida, New York, Chicago, Houston and Los Angeles. In addition to expanding here, it is also expanding in Latin America. We feel that this company offers great opportunity

within a good banking environment along with the chance to tap into a very rapidly growing segment of the US population.

After we did the fundamental work and became comfortable with the facts, it was approved and put onto our buy list. We've been buying it for a couple of months now.

TWST: Do you do any qualitative work? When it comes to management performance, obviously you can tell from the financials how the company is doing, but how about executing strategy and so on?

Mr. Weil: This goes back to our criteria for investing in companies whose management has a demonstrable track record for success. I referred to this earlier with the idea of a pharmaceutical company being able to reinvest the profits into new products. We look for that in any of the companies that we own or are considering for purchase. As a result, we tend to own mid-cap to larger cap names.

I suppose you can go back to the classic business school example of the buggy whip company at the turn of the 20th Century. You had a number of companies making buggy whips, then along comes the automobile. The best management believes and states, "This is probably going to be the future and I need to figure out something that will allow me to participate in that business going forward." The smart manager looks at his buggy whip and says, "You know what? If I attach the ends of this thing together I make a fan belt; I can then sell this to the automobile companies." Sure enough, the manager who transitioned the company from a buggy whip manufacturer to a fan belt supply company was able to help the company continue to grow. Those are the kinds of managements that we're looking for.

TWST: Can you give us a profile of the type of client that Clifford Associates attracts?

Mr. Weil: The majority of our clients are high net worth individuals who are more concerned about preserving assets and growing assets at a reasonable rate rather than clients who are coming to us to make themselves wealthy by their investments with us. Most of our clients have built their wealth before coming to us.

In addition to high net worth clients, we work with non-profit organizations in the management of their endowment and planned giving programs. These organizations have investment goals which are very similar to our individual clients, mainly to maintain the purchasing power of their capital while keeping pace with their spending needs. We are an excellent fit for the prudent investor.

TWST: What are the concerns or expectations of these individual clients?

Mr. Weil: It's difficult to make a general statement about managing expectations because expectations from clients can depend on a lot of things. One influence of client expectations is what they see going on in the marketplace overall. As I stated earlier, our client base has pretty much established their wealth already. When things are bubbling in the equity markets, expectations do rise, but not to the outlandish levels that you might find with people who are trying to become wealthy off the market.

To manage expectations, we continuously meet with clients. We sit down with them and point out what they hired us to do. Part of the process of signing up a new client or meeting with a client is reviewing what their desires and needs are and where they want to be in two years, five years, and 10 years. Once we establish that, we go back to them at least on an annual basis and review those objectives. It helps to bring them back to reality, which is where we all need to be.

I guess the best example I can give you of how this has worked is that we have a number of clients whose families have been with us for three and four generations. The management of expectations is an ongoing process, but it's certainly worked for us over the years.

TWST: Do you do any top-down work about the market or the economy?

Mr. Weil: We're not a top-down investment house. We clearly have a bottom-up approach. With that said, obviously we need to be aware of what's going on in the economy, what's going on politically and so on, because that's one element within our investment process. We don't take an approach that looks at business cycles to determine where we are in the cycle and then build portfolios that should benefit from that guess. The problem is that if you filled up a room with 40 economists, you'd probably end up with 40 different forecasts for the economy and subsequently end up with that many statements of where we are in the current cycle. How can you build portfolios based on these forecasts when you can't agree as to what's going to happen with the economy? We are aware of top-down analysis and keep it in the back of our minds, but shy away from allowing it to be the primary driver in our selection process.

On the fixed income side, it's a little different. We're not bond traders, but we would call ourselves interest rate anticipation managers. By that I mean we forecast the general trend of interest rates and, depending on the direction, purchase either shorter or longer maturities. We will not try to time interest rate swings, which tend to keep our bond duration fairly short to intermediate term.

TWST: What are the special attractions for a potential client going to a consulting firm as opposed to other money management firms? What are you bringing to the table that others don't?

Mr. Weil: Number one would be our years of experience in the investment business. We have people here who have been in the business for over 35 years. When you add it all up, we have over 200 years of experience among our investment professionals. That experience is really reflected in the fact that we have seen most of the market cycles. We don't have anyone here who was with the firm when it was first established in 1915, but we have people who have been in the business since the late 1950s and the early 1960s. We have seen a lot of the fads come and go and, frankly, they mostly repeat themselves. That amount of experience helps us and helps our clients.

I think two of our greatest strengths are founded in our legacy and the work that A.M. Clifford did when he saw the need to provide clients professional, financial expertise that did not have product or commissions attached to it. You could say that we are fanatical about the objectivity of the advice we give and obsessively focused on the client's needs driving that advice. You don't keep multi-generational clients by being otherwise.

While we are not CPAs, estate planning attorneys or insurance underwriters, we are often in a position to help our clients find this outside professional expertise when needed. At the end of the day, our clients come to us and stay with us because we know our craft and we understand how to use it to provide solutions in their financial lives.

TWST: Thank you.

Note: Opinions and recommendations are as of 8/27/04.

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