

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Balanced Value Investing 2009 Hayek Kallen Investment Management



FRED HAYEK is the founder and President of Hayek Kallen Investment Management, LLC. He is a security analyst and portfolio manager with nearly three decades of professional securities experience. His work has been nationally recognized by *Barron's*, *Money Magazine*, *The Wall Street Journal*, *The Wall Street Transcript*, local newspapers and syndicated national cable television's Inside Money. He received his BA degree from Doane College, where he was a scholarship athlete, and his MS degree from the University of Nebraska. Additionally he was sponsored for the Association for Investment Management and Research by his friend and mentor, the late Sir John Templeton. He serves on the Executive Committee of Here's Life Mission to Africa and has traveled to that continent several times doing leadership training.



ERIC KALLEN is Managing Director of Hayek Kallen Investment Management, LLC. He joined the firm following a career as an investment banker with Morgan Stanley in New York and London as Vice President, Mergers and Acquisitions. His 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*, *The WSJ* and other business publications. He received a BA degree from Washington & Lee University and an MBA degree from The College of William & Mary.

TWST: Would you start with a brief overview of Hayek Kallen Investment Management and your investment philosophy?

Mr. Hayek: Hayek Kallen is a fee-only security analysis and wealth management firm founded in 1985. We analyze and manage custom stock and bond portfolios for clients interested in preserving and growing their capital, while meeting flexible and lifetime income streams. We use a fundamental value investment discipline and our primary responsibility is to allocate capital from where it's overvalued to undervalued, focus on the risks when making investment decisions, and take a long-term perspective. We work with our clients to define and clarify their long-term objectives and then, of course, to act as trusted fiduciaries.

TWST: How did your firm do during 2008 and how have you been impacted by the economic crisis?

Mr. Hayek: Properly functioning markets, which ultimately are a reflection of the underlying economy, are based on widespread trust and that trust has been broken. Think about it this way — when a loan is made, a dual expectation is established. The lender expects to be paid back and the borrower expects to get a return sufficient to pay the loan. The end to this business cycle was a massive credit bubble that burst. Wealth destruction in the trillions has done significant damage to the underlying economy and consumer/investor sentiment. This really may be the toughest one any of us will live through. I can draw parallels to 1980-1982 and the

1973-1974 bear market, but the fear out there right now is that we are in the early stages and that it's going to get a lot worse before it gets better. Are we sliding into a 1930s kind of deflation, renewed protectionism, an end to globalization, and an up-tick in human misery? I don't think so. Central bank and Treasury measures taken so far might help to insulate some of the damage on the financial side, yet damage on the economic side is severe and it's going to take time to rebuild. In theory, the government should have stayed on the sidelines; the reality is they did not.

TWST: What impact has this had on your investing and what changes have you made in your portfolios?

Mr. Kallen: Given the extent to which assets have been re-priced, we have been impacted like everyone else. In this market we didn't just see stocks drop, we saw bonds, commodities and, of course, real estate dropping at the same time. Effectively, the only asset that performed in 2008 was US Treasuries. Certainly we saw our share of the pain in 2008.

What has helped our firm has been two things. First, our equity exposure has been somewhat limited, as the mission of our investments is to focus on value stocks that are trading at a discount to their intrinsic value. Traditionally this discipline has upside that is greater than the downside and that metric proved true to form in 2008. When the markets began to collapse, what we saw in the large majority of our stocks was less of a downward movement than the broader market sectors.

Second, what has really helped our clients is the fact that we used a balanced approach across accounts. Almost without exception, all of our clients had some fixed income and in many cases it is in an equal or maybe a larger percentage than the equity allocation. Now, the bond market has had a rough year. With the financial sector being such a large component of the fixed income market, we have seen corporate bonds trading at deep discounts to par, and in some cases becoming distressed. Fortunately, in the last 12-18 months, as we identified the risks rising, we began migrating to even higher quality. We were able to get into things like US government agencies and certificates of deposit that trade more like bonds than local bank CDs. They pay interest periodically, not just at maturity. They trade with accrued interest and effectively they're issued by banks and guaranteed by the government. We had a large exposure there. We were also maintaining larger than normal cash positions, which has served as a buffer across portfolios.

Mr. Hayek: Portfolio changes start with our client's objective. The question that we're getting is "when will the pain end?" This emotional response is natural and typical at the point we're at in the cycle of market emotions. It is a primary responsibility for us to articulate the risks to our clients and put it into perspective. Some of the events of 2008 are normal at the end of every economic cycle and the good news is that as 2009 is ushered in, we are at the point of maximum financial opportunity. When we walk our clients through their individual holdings and show them how they are allocated and diversified, it goes a long way in rebuilding the confidence that is necessary to move forward and capture what I consider an opportunity of a generation.

TWST: Have you been underweighting or overweighting certain sectors?

Mr. Hayek: The sector question is relevant, but before we go there, we should be thinking about a long-term question: "Will the next 30 years be as good as the past 30 years?" If you begin your analysis there and understand that bear markets are temporary, you begin to get better footing on the sector question. Bear markets create opportunities for resourceful long-term investors, and quality businesses producing valuable products and services go on sale. When the next bull market emerges, there will be no bell ringing, it will sprout out of the despair we are feeling right now. Earnings are likely to be much higher and it will justify higher share prices. With that said, we're anticipating a rotation from businesses with weak balance sheets to those with strong balance sheets. Businesses that have worldwide exposure, flexibility and reach will grab market share from those who don't. Outside the financial sector, balance sheets of Corporate America look pretty good to me. We want to be more defensive than aggressive so, with that said, we're overweight consumer non-cyclical equities like **Colgate-Palmolive (CL)**, **Kraft (KFT)**, **Coca-Cola (KO)**, and both **Philip Morris International (PM)** and the domestic **Altria (MO)**.

In the healthcare sector, we're positioned in **Teva Pharmaceutical (TEVA)**, **Novartis (NVS)**, and **Johnson & Johnson (JNJ)**. Longer term we like the fundamentals in the energy sector. We like **Exxon (XOM)**, **Peabody Energy (BTU)**, **Transocean (RIG)**. In agriculture, we like **Archer Daniels Midland (ADM)**, and **Potash (POT)** looks attractive. In conglomerates, we hold positions in **Berkshire Hathaway (BRKB)** and **General Electric (GE)**. All those companies are characteristic of the fundamentals I mentioned earlier.

TWST: What about traditional growth areas like technology?

Mr. Kallen: With the massive deleveraging that's going on in our economy, we are not bullish on the technology sector. Our expectation is that in 2009 we will see pretty dramatic cuts in capital spending for most corporations and I think the biggest impact there will be felt within the technology sector. The only technology exposure that we are evaluating would be in companies with more annuity stream revenue like **Microsoft (MSFT)** or **Oracle (ORCL)**, where they have a large installed user base and are not as captive to global growth trends. Once again, only the strongest balance sheets will be considered. We're very carefully evaluating the foundations in these businesses. What we saw in this recent crisis has been that the weak didn't survive and that there was a lot of pain felt by those who held companies that had very complicated balance sheets or balance sheets that weren't up to the challenges.

TWST: Are you finding opportunities in this market?

Mr. Hayek: Yes and no. Yes, in that everything is on sale now. The baby has been thrown out with the bath water. Mutual funds and hedge funds were forced into liquidating what they really didn't want to liquidate to meet redemptions. There is blood in the streets and opportunities abound. One problem is the volatility and the risk associated with it. I don't think anyone could say this market

is trading rationally, on fundamentals. We expect volatility to continue until the grease that has been injected in the frozen credit gears begins to work its way through.

Mr. Kallen: In order to understand where the opportunities lie, you need to understand the risks. What our economy and our markets are undergoing right now is really a reassessment of risk. I will say with certainty that we understand the risk much better now than we did three months ago, but that doesn't mean that we ultimately can assign a weighting to the risk. There are still a number of uncertainties and unknowns. Broadly, in the economy, the risks have not been fully identified, let alone resolved. Having said that, there are areas where we are seeing opportunity — for instance, corporate bonds. With the freezing of the credit markets, we see an inability of corporations to get easy access to financing. We are seeing tremendous value in the high credit quality corporate bonds. We're seeing spreads on five-year single A paper 500-550 basis points above Treasuries. That's value and that works for us with our balanced portfolios. Municipal bonds also offer tremendous value. Traditionally municipals have traded at maybe 75%-80% of the yield of a Treasury. Today we're seeing yields on tax-free municipals at 175%-180% of the yield of a Treasury. With a high potential for tax increases, tax free yields for high tax bracket investors are going to present very good investments going forward.

The caveat is that you must be very selective and very careful in your analysis of the underlying credit. We are in the middle of a recession. We are beginning to see budget stress for many states and municipalities. If you're selecting tax free bonds, there needs to be a fair amount of work done to select a very large and stable pool of cash and assets that underlie the bonds, particularly given the lack of credibility that most of the monoline bond insurers have demonstrated. They've expanded their businesses beyond the stable plain vanilla municipal bond insurance market and gone to derivative markets and put themselves in positions where their balance sheets have more risk than the underlying credit, which effectively negates the value of the insurance.

As an example of an alternative, **Berkshire Hathaway**, recognizing the opportunity in the monoline bond insurance market, has begun to underwrite or to insure municipalities. They have recently put together a trust comprised of a number of their issues where as investors we can gain access to bonds which have met **Berkshire's** strict underwriting criteria, but also have assigned their AAA credit rating. So here is an example of our being able to find a tax-free yield north of 5% but also to get the safety of having a solid AAA credit and a company like **Berkshire Hathaway's** analysis and underwriting expertise.

TWST: What do you feel about the international markets and the emerging markets that have also been suffering from economic slowdowns? Do you still think it's good to invest in companies that deal in those areas?

Mr. Hayek: Yes we do. Some people would say we ought to fold our tents and "go long socialism" with all this government interference, but I wouldn't get carried away with that theme. The socialist tide might be coming in a bit now, but look where it was 20 years ago. In the past 20 years, freedom, trade and technology have exploded. Those are very, very powerful forces. There are setbacks, yes, protec-

tionism is a threat, and foreign markets will continue to be volatile, but there is a consumer middle-class developing. Technology is leveraging their economies and free trade is leveraging the whole process. We want to own businesses that have the balance sheet flexibility to take advantage of that and develop/gain market share — every one of the companies I mentioned fall into that category and have business plans that encompass "the new world order."

TWST: On the fixed income side, have you noticed your clients wanting to rebalance their allocations of assets to be more heavily weighted in fixed income than in stocks?

Mr. Kallen: Absolutely. One of our jobs as advisors and money managers is to help our clients see through the emotional aspects of investing. Clearly when stocks exhibit the kind of downside volatility that we've seen, emotions tell you to get out! What listening to those emotions is going to do, after a big selloff, is the opposite of buying low and selling high. What we have tried to do with our clients is put together an asset allocation that fits within their broader financial plan and is able to meet their goals. Those goals are individual and they're dependent on many things within their lives, but we don't want to be in a situation where we are reactively moving between stocks and bonds in an "all in or all out" approach. When the problem is an emotional reaction and not one driven by changes in lifestyle, we work with the client and encourage them to resist their nature, which is to run for the hills, when in reality you are probably at a good opportunity point to be buying.

TWST: You've had a lot to say about the Fed in past interviews. Do you have anything to add to how the Fed is dealing with this economic crisis?

Mr. Hayek: We have a lot to say, but I don't know what good it does to say it. For too many years interest rates have been kept artificially low to fend off various crisis. Artificially low interest rates push capital to be allocated improperly and fewer business decisions are made based on fundamentals. The housing bubble is the biggest and the most leveraged example of that and it has affected the most people. Again, we've got to deal with realities and the reality is we collectively avoided short-term pain (higher rates) and the consequence is more severe pain now.

TWST: Looking ahead into 2009, what are you planning to do with your balanced portfolios? What recommendations are you making?

Mr. Kallen: We are not altering dramatically from what we did in 2008. We are sitting on more cash than we have had historically, most of which is dedicated for the equity markets. Our expectation is that when earnings began to stabilize, we will be able to assess the risk and find value. We are seeing it now across the names we mentioned and many others as well. We would expect that in 2009 if the market begins this bottoming process, we will be able to move our cash back into the stock market. On the fixed income side, we're sticking with the safest credits, high investment grade bonds and municipals. We are actively moving money from cash, which is an overvalued asset, into those areas that we view as being undervalued. Our expectation is to do some investing in 2009.

Mr. Hayek: I think it's a mistake to bet against America. At Hayek Kallen we try to be disciplined about price, think about the risks first when making investment decisions and then allocate and diversify properly. For any investment firm, or individual investor, these basic disciplines and common sense will keep you between the lines.

TWST: What risk management techniques do you incorporate within your process?

Mr. Hayek: On the equity side we use the appraisal method. We appraise the value of a business and compare our appraisal to its current price. The price to value ratio is a key metric. We don't look at stocks as lottery tickets to be cashed in by the lucky. We look at a stock as a small piece of a business that's for sale. We try to buy businesses that are priced at a significant discount to our appraisal. It's not a perfect process, it's not science. The analysis process is a combination of science, art and common sense. When you do it that way and focus on what can go wrong, focus on the risks, you are going to make more good decisions than you do bad ones.

Mr. Kallen: Just to add to that — back to your question about risk management — what we layer on the top of the fundamental analysis that we are doing on each of the investments is an asset allocation strategy. We're not going to allow our portfolios to develop an over-concentration in a particular holding or a particular sector. We want to keep the balance not just between stocks and bonds, but also with sectors and companies, so that if we are wrong in a piece of our analysis, the result won't be felt fully throughout the portfolio; it will be mitigated.

The other point I'll make in talking about assessing risk and risk management, on the fixed income side particularly, is what this latest crisis had taught us is that the rating agencies have proven to be completely ineffective in their ability to assess, evaluate and weigh the risk. When we are investigating opportunities on the fixed income side, we need to do more work than ever and not just rely on what Moody's or S&P or Fitch has to say about a particular credit. That no longer works and I think we could point to a number of examples in this most recent crisis where that proved to be catastrophic.

TWST: What are your views on having a long-term perspective in the market? Do you think one of the problems is too many people having a short-term view?

Mr. Hayek: Short-term thinking is a characteristic of human nature. Compounding this characteristic is the information age. The volume of information these days is like taking a drink out of a fire hydrant. It is often agenda-driven and shallow, geared to get an emotional reaction to "stay tuned." Arguably, things have been as bad or worse in other bear markets, but it's magnified now by the media. We all struggle to be proactive and long term in our thought process, rather

than reactive and short term. The kind of business that we run and the counsel that we give is geared to a long-term perspective

TWST: What challenges do you see ahead for investors in either equities or fixed income that people should be wary of now?

Mr. Kallen: I think what we're facing more than anything is a crisis in confidence. We've seen leadership fail at all levels from the White House to Congress to the regulators to the boardrooms. We've seen fraud and deceit and an inability to get ahead of any of these crises. Investors are gun-shy. The media has helped to make people aware but really serves as a stumbling block for making rational decisions. If you look at what's going on in the economy, the housing market is still struggling, but it's not getting worse and we're on the road to recovery. I think the credit markets are on the road to recovery. As for the stock market, it's anyone's guess where the bottom is going to be, but in general, we're seeing less volatility and fewer of these nuclear events that we were dealing with almost on a daily basis back in September and October. There are still headwinds that need to be addressed, but somehow we will struggle through.

Mr. Hayek: If you look across the sea in either direction it is as bad or worse over there — everything is relative. Every nation, every state, every county, every business, every person has problems. There has never been a time in human history when there have not been problems. I would venture to say we have fewer problems now than we did 30 years ago and 30 years before that. It's how you face the problems that makes all the difference. We are stumbling right now, but we will gain our footing — the best is yet to come.

TWST: Thank you.

Note: Opinions and recommendations are as of 12/29/08.

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