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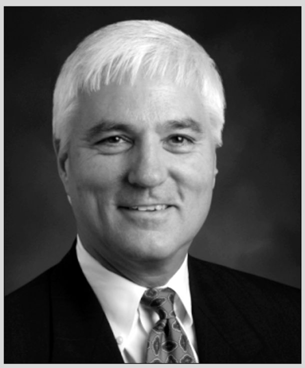
THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

An Investment Outlook for 2007



FRED HAYEK, President and Founder of Hayek Kallen Investment Management, LLC, 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. Mr. Hayek received his BA from Doane College and MS from the University of Nebraska. Additionally Mr. Hayek was sponsored for the Association for Investment Management and Research by his friend and mentor Sir John Templeton.

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

TWST: Would you please start by telling us about Hayek Kallen Investment Management and your investment philosophy?

Mr. Hayek: Hayek Kallen Investment Management is a "fee only" multi-cap security analysis and portfolio management firm founded in 1985. We analyze and manage custom stock and bond portfolios for individuals and institutions that are interested in preserving capital first and growing it second, while meeting flexible and lifetime income requirement streams. We use a balanced value management discipline. Using individual securities, our primary responsibility to our clients is to allocate capital from areas of overvaluation to undervaluation, to 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 objective and then, of course, act as trusted fiduciaries for their monies.

TWST: What are your thoughts on investing in this environment?

Mr. Kallen: As 2006 draws to a close, we find that it is time to take a step back and evaluate the factors that are driving our economy and financial markets. In essence, we find ourselves at a crossroads, with change happening at a fast and furious pace. For the last couple of years, we have seen the Fed take creditable action against loose monetary policy and inflationary pressure by instituting a gradual program of 25 basis-point rate increases (17 of them, to be exact). With a recent pause, our new Fed Chairman has indicated a willingness to wait for a clear signal as to whether the economy needs additional tightening, or conversely, if just enough steam has been let out to allow for a soft landing. To gain a better understanding of the issues and their impact on the financial markets, it's best to address them one by one.

Kallen: Our focus is to identify companies that possess a valuable business model that will reward us over time with steady growth and sound financial decision-making. We like the combined potential for multiple expansion, steady earnings growth and dividend yield to create a favorable total return.

Mr. Hayek: This benign cyclical crossroads is one without any traffic lights, and it makes me want to slow down a little and look both ways.

TWST: What is the investment climate like for your investment strategy as we approach 2007?

Mr. Kallen: The debate over the health of the US economy is centering on growth. While it is clear that economic growth is slowing, giving rise to less concern about inflation, the data has not presented a clear picture. Clearly, falling energy and commodity prices have lessened inflationary pressure and provided much needed support to over-extended consumers who are even more at risk, given the slowdown in the housing market. But, strong wage growth (the average wage was up 3.9% from a year earlier compared to the average annual growth since 2001 of 2.8%) and a robust labor market (October unemployment dropped to 4.4%) are serving to keep the Fed on inflation watch. The stimulus for future growth remains a large question. With a government that is running huge budget deficits, tax cuts that have already been manifested and a currency that is getting weaker by the day, there is little hope that our government is in a position to stimulate the economy.

So if we are to see renewed economic growth, it's going to come from the US consumer — that's nothing new here. Recently, the US consumer has been willing to forgo savings and spend all disposable income with little concern for the future. In fact, given the large amount of equity available through our appreciated real estate, we are able to borrow against those assets and spend even more. It's not a pretty picture in either case.

Mr. Hayek: Globalization is the mega-trend that makes business cycle outcomes so difficult to read these days. The disinflation forces of globalization can't be denied, nor can technological revolutions in communication and software that stimulate productivity. At the same time, the tensions between capital and labor, and consumption and saving, keep tightening. Liquidity-driven markets have gone from bubble to bubble, new highs to new highs, and my sense is that the potential for disruption is growing.

Given that we believe we are in the first stage of a real estate down cycle and all that implies, the real conundrum for the Fed could be that renewed talk of deflation takes hold.

That said, we always want to be minority owners in core businesses that provide valuable products or services that are needed and have good management teams when they are available at attractive prices.

TWST: Tell us about the financial markets.

Mr. Kallen: The financial markets are flush with liquidity today. This has been driven in large part by the central bank's desire to provide liquidity and stimulate the economy, but it has been compounded by the use of leverage by investors/speculators. This presents problems for investors, particularly value investors, because our goal is to invest in areas where capital is scarce. The less demand there is for an asset, the lower the price required to acquire it, and vice versa. Evidence of this phenomenon can be seen in virtually all asset classes, from stocks and bonds to real estate and private equity.

TWST: What does this mean for the equity markets?

Mr. Kallen: Underlying the hype, we find that corporate balance sheets are very strong and companies in general appear to be in very sound financial shape. Following the spending that capped the last decade, many corporations have focused on removing excess capacity and paying off debt and adding cash to the balance sheet. With many companies flush with cash, a push has developed to return cash to shareholders either through dividends or share buybacks. The implication of this is that corporate investments that can achieve a higher return on capital are not available, so returning cash to shareholders will provide the highest return.

This is a discipline that has not always existed. The implication of more cash being accumulated and/or returned to shareholders is that there are fewer opportunities for investment, so slower growth is likely to be the result. In a market that rewards high growth companies with higher trading multiples, many of these cash-rich, dividend-paying stocks are available at levels that have not been seen for a very long time. The irony here is that when companies such as **Microsoft** (MSFT), **Wal-Mart** (WMT), and **General Electric** (GE) were trading at 50 times or 60 times earnings in 1998 and 1999, and everybody wanted to own them. But today with multiples at half those levels and with balance sheets that are significantly stronger, they are out of favor.

Our focus is to identify companies that have many of these criteria, but that also possess a valuable business model that will reward us over time with steady growth and sound financial decision-making. We like the combined potential for multiple expansion, steady earnings growth and dividend yield to create a favorable total return.

Mr. Hayek: We try to have the discipline, perspective, and patience to recognize these fundamental qualities common to superior investments and construct a core portfolio that is designed to benefit from these basic characteristics.

TWST: What is your strategy toward fixed income markets?

Mr. Kallen: From a macro point of view, the most significant debate centers on whether or not the yield curve has predictive powers. Those who believe it does would argue that the economy is in trouble and bound for recession. The debate rages on, with the opponents of this arguing that the tremendous demand for US debt by Asian countries is the true driver for these low rates. Our view is that regardless of the drivers, with spreads being so compressed, there is very little incentive for investors to reach for yield and take on credit risk that they aren't being compensated for. Further, despite the relatively high yields that cash and short-term bonds are providing today, we think it is prudent to begin to increase duration to protect against future rate cuts, which would drive down the short-term yields.

Mr. Hayek: Again, the predictive power of an inverted yield curve is less certain than history might suggest, but it appears that the economy is slowing and the central bank's foot on the brake pedal is helping. Will they press too hard? I don't know, but I do know that speculators are not being rewarded for taking extra credit risk.

TWST: Tell us your views on the weakened US dollar and its impact on the markets.

Mr. Kallen: One of the biggest challenges facing the US today centers around the fate of our currency. The dollar's recent tumble has been attributed to growing sentiment that the US economy is overextended and growth is slowing. This has led to speculation that central banks in China and elsewhere will stop accumulating dollars and diversify into other currencies, the euro and yen primarily. With such a large trade deficit, the US relies on this foreign demand for our currency to fund our shortfalls. If the economy shows greater signs of weakness, the demand for dollars could shrink even more, particularly as the gap between our economy and more sound European economies begins to widen. And while a weaker dollar will help our exports and serve to lessen our trade deficit, a rapid devaluation of the dollar could add to inflationary pressures and make it harder for the Fed to cut rates and cushion a struggling housing market and further threaten over-extended consumers.

Mr. Hayek: The fundamentals suggest that a weak dollar is a longer-term trend. The symbiotic trading relationships between "us and them" — they produce, US consumers buy, and then they save in US-denominated securities — is troublesome and gives us little flexibility if things go wrong. I think that is why the Secretary of the Treasury and Fed Chairman were over there recently — to make sure nothing goes wrong.

Hayek: We favor international banks with larger, more diversified business lines and less dependence on spread-based products. Our two favorites in this space are Citigroup and Bank of America. The impact of a real estate slowdown could pose significant problems for regional and community banks that are more dependent on the mortgage and other lending businesses and that are more at risk from increased delinquencies and defaults.

TWST: What are the investment themes you are following at this time?

Mr. Kallen: With so much risk and uncertainty in the markets today, we have positioned our portfolios in line with the following themes.

Be careful of the consumer. With the US consumer so overextended and the real estate market playing such a large role in the consumer's wealth creation, we see lots of risk here. We are already seeing mortgage-related defaults and delinquencies rising, with several sub-prime lenders closing their doors recently. If we begin to see long-term rates rising, we could see even more pressure on an already weak real estate market. For the consumer, this would mean not only the impression of less wealth and lower confidence, but real hardships could follow. The net result would be less desire and less ability to spend. Big ticket and luxury purchases would go first. We like the idea of substitution (new customers for **Wal-Mart**) and are comfortable with consumer staples.

Mr. Hayek: We favor international banks with larger, more diversified business lines and less dependence on spread-based products. Our two favorites in this space are **Citigroup** (C) and **Bank of America** (BAC). The impact of a real estate slowdown could pose significant problems for regional and community banks that are more dependent on the mortgage and other lending businesses and that are more at risk from increased delinquencies and defaults.

Mr. Kallen: Look for stability and cash flow. With the potential for instability in the markets, we want to own companies that are well positioned to weather a downturn. These would include large cap over small cap, companies with strong and developed brands that have strong balance sheets and strong cash flow.

1-Year Daily Chart of Altria Group

Chart provided by www.BigCharts.com

Mr. Hayek: Even though tobacco, in the form of **Altria Group** (MO), has moved way up, it is operating in a more benign litigation environment, producing buckets of cash flow with the ability and flexibility to buy back shares, raise dividends and restructure. Take a look here if there is a pullback.

Consumer non-durables with significant foreign sales are interesting, like **Colgate** (CL). **Johnson & Johnson** (JNJ) is another player that has a foot in health care and in disposable products.

Mr. Kallen: Identify companies that have the potential for total return. Look for companies that are trading at significantly lower multiples than historically available that offer an opportunity for multiple expansion. Underlying this, we look for strong cash flow and steady earnings growth to support this multiple expansion theme, while avoiding high earnings growth models that are trading at significant premiums to these names. To supplement these returns, we look for high cash flow generation with a significant portion being returned to shareholders, either in dividends or share buybacks.

Mr. Hayek: Companies that fit this model include **General Electric**, **Verizon**, **Microsoft**, and **Wal-Mart**.

Mr. Kallen: Keep some exposure to international markets. We are seeing relatively stronger economic growth in a number of international markets than is available in the US. Coupled with the weaker dollar, we feel it is important to have international exposure.

Mr. Hayek: We are looking favorably on US companies with strong international sales. Examples would include **Altria** and **Coca-Cola** (KO). These companies not only have access to higher growth markets, but a weak dollar will result in a higher return on repatriated profits. We are also looking selectively at foreign companies and will invest overseas where value exists and corporate governance meets international standards.

Mr. Kallen: We still feel that the commodity and energy sectors offer favorable long-term potential. But cyclical industries like these are likely to see continued volatility and potential weakness in the near term, particularly as new capacity comes on line.

Mr. Hayek: Energy prices will flux around a higher long-term benchmark, so profitability should stay up. Ancillary investments related to the energy sector make sense. Even railroads are making more money with higher commodity benchmarks.

TWST: Thank you.

Note: Opinions and recommendations are as of 12/20/06.

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