THE WALL STREET
TRANSCRIPT
Questioning Market Leaders For Long Term Investors

Hayek Kallen Investment Management, LLC

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 is a "fee only" multi-cap 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. For Hayek Kallen and our clients, wealth management also means offering counsel on ancillary financial and estate issues surrounding the core assets and implementing solutions to meet those needs. Currently, we're managing $215 million for roughly 200 "families" on a custom, separate account basis.

We're value equity analysts, in that we view stocks not as lottery tickets to be cashed in by the lucky, but as small pieces of a business that is for sale. We appraise the value of the business as if we were going to become partners or acquirers, and we then buy at a significant discount to our long-term appraisal. If we are reasonably successful in our appraisals, it builds in a "margin of safety" for our clients and minimizes risk. Appraisals are moving targets based on the dynamics of the economy and the individual business, and it is our experience that pricing is sometimes irrational, creating opportunities for resourceful investors.

Hayek: We anticipate high levels of volatility to continue because the issues driving the volatility haven't been resolved. Within portfolios, we are trying to be diligent when we put money to work, by not reacting or overreacting to swings within a day or within a week.

TWST: How was 2007 for you?

Mr. Hayek: It's been a very good year. On the whole, we were properly positioned and had generally anticipated the risks that were yet to be widely recognized and that's paid good dividends for our clients. Entering 2007 we were at a crossroad. At this time a year ago, corporate earnings were robust and economies across the world were accelerating. At the same time, short-term interest rates were rising, the Fed was focused on the risks of inflation, and yet the yield curve was flat (even slightly inverted as recently as six months ago), signaling to some an economic slowdown. Subprime loans, SIVs and CDOs weren't in the headlines and were known only to a small number of market participants.

The stock market opened the year continuing the buoyancy that characterized 2006 (total return 15%). In February and March it suddenly collapsed (8%) within a couple of weeks. Then, when headlines focused on impending disaster, it turned on a dime. After testing the lows in March, the market simply "melted up" — a gain of about 11% (S&P 1300-1540) and established an all time high. Credit spreads tightened significantly until the credit crunch "made landfall" in June and the market went down 10%. The Fed, forced to lower interest rates before it wanted to, summed up the box it was in (November), stating that it would "act as needed" to foster sustained economic growth and low inflation. The stock market is taking direction from the Fed and volatility is back with a vengeance. Eric likes to say that risk is being re-priced and that is very true, but it underwrites the futility of trying to gain a consistent timing advantage over the market.

As the risks were rising, well before the melt-down, we became more defensive and quality conscious. We have a lot of exposure to domestic companies with significant foreign earnings. Foreign sales translated back into a weaker dollar which helped earnings quite a bit. Our consumer non-durables and healthcare stocks have done well, and we were overweight in the energy sector, which provided "jet fuel" for portfolios.

TWST: Since 2008 is an election year and the market usually does well in a presidential election year, do you take any political factors into account when investing?

Mr. Kallen: Yes. We're not going to make huge changes based on speculation about the outcome of the presidential race, but I will say that Democratic administrations have a bias for raising taxes and that does give us some cause for concern. That is one thing we will be very focused on, given that things like the capital gains and dividend tax cuts were not made permanent. That would be the first issue and then, yes, I think there are certain sectors that are going to do better or worse based on what color the flag is over the White House. Under a Democratic administration, it's focused on government solutions versus market solutions to healthcare reform. We're going to have to be very careful about how we invest in that sector and that is a sector we have some interest in. Right now, it's a little early for us to be reacting to straw polls, but it will be a priority as we enter 2008.

TWST: You mentioned volatility is likely to be here to stay. Could you expand on how volatility impacts your investing?

Mr. Hayek: We anticipate high levels of volatility to continue because the issues driving the volatility haven't been resolved. Within portfolios, we are trying to be diligent when we put money to work, by not reacting or overreacting to swings within a day or within a week. For instance, when we take new positions, we're doing a little bit more transitioning into the position instead of buying the full allotment within one trading session. As I said, we're trying to spread the risk out a bit more.

TWST: Do you think that we've seen the last of the problems with the credit markets and the lack of liquidity or do you think that this is going to continue throughout 2008?

Mr. Kallen: Our economy is facing a significant amount of pressure from a number of areas, all of which will have implications for both the equity and debt markets next year. Foremost among these is the ongoing housing recession in the US. For too long, homebuyers were able to take advantage of loose, cheap credit and lax underwriting standards to gain entry into homes that historically would have been beyond their reach. As this dynamic worked its way through the system, it served to expand home ownership to levels significantly higher than the long-term average, drive up the value of virtually all real estate and encourage the development of structured loans (many with reset features), in essence, creating a real estate bubble. Today, even with a significant drop in housing starts, the pace of home sales has dropped off dramatically and the inventory levels of unsold homes continues to remain very high. With this and the fallout from the subprime fiasco and a severe disruption in the credit markets, it appears that the slowdown in the housing markets will extend well into 2008 and likely into 2009.

Mr. Hayek: The problems that the housing market is causing in the economy will continue to pressure the consumers (who account for 70% of GDP) and likely force down the pace of economic growth. The consumer is not only dealing with deflating real estate values (in the best case, defaults and evictions in the worst case) but higher energy prices and inflationary pressures caused by the weakening dollar and its corresponding impact on imported goods. So far the consumer has held up against what many may calculate are insurmountable odds, but how long can this continue? With job and wage growth now showing some signs of slowing, this becomes a very real and important issue. It's been a very long time since we have had a consumer-led recession, and I'm not sure that with the Fed and other central banks acting proactively, this will occur, but the implications are for slower growth going forward.

Mr. Kallen: I think we will see credit market problems well into 2008 and perhaps 2009. The market has reacted to what is known, so it really depends on what else is out there. If we see a limited number of major announcements, then I think we will start to see some of the volatility ease. It's still too early from our point of view to tell whether the mark-to-marketing was done in a way that is conservative or aggressive and what other bombshells might be out there within different pockets of the financial markets.

TWST: You have written that you shifted the emphasis of your equity portfolios and became more defensive, investing in quality companies. Would you expand on what you consider to be quality companies in this market?

Mr. Hayek: Quality companies are those that have strong balance sheets and cash flows that can insulate the impact of rising interest rates and tightening credit conditions. These are also companies that have exposure to areas of the globe that are expanding at a higher rate than the US economy, which was entering a slowing period, and then they translate those foreign earnings in the face of a weakening dollar.

Mr. Kallen: The other aspect we always focus on, but now more than average, is that consumers in the US are dramatically stretched. We want to find companies that are more non-discretionary in their makeup versus discretionary. We don't want to own companies that are selling things that can be put off, because our estimation is that even though we are great at borrowing money with less liquidity, that won't be an option going forward. Those companies are probably going to see at least a couple of choppy quarters in 2008's forecast.

TWST: You've been adding to your energy and commodity positions. Would you explain why you're adding to those areas?

Mr. Kallen: We've been following the energy theme for a number of years. **Valero** (VLO) was a company we mentioned three or four years ago in one of our interviews with you as one that we had sold, but now we are looking to get back into that. To summarize, we do feel that long term we're in a bull market for energy and what we're trying to do is get exposure across the spectrum. We do have exposure to the large cap integrated oils, but we're also looking downstream with refining capacity being very tight. We are getting exposure to companies that have a lot of leverage to refining margins and we're also looking beyond the traditional plays. We're looking into the exploration and production arena. **Transocean** (RIG) is another one of our holdings. They are a deepwater driller with expertise in equipment that their competitors don't have. They've got a huge advantage, particularly with oil at $90, $80, $70 a barrel, by being in harder to reach places.

Also, we're looking into other types of energy. **Peabody** (BTU) has been a company we've mentioned before and we continue to hold. **BTU** is North America's largest coal company with mines in Australia and significant markets on the Pacific Rim including China. We're also invested in nuclear with **USEC, Inc.** (USU), a company that we've mentioned before. USU enriches plutonium for power plants around the world. When their new enrichment facility is completed in the first part of the next decade, they will be the low cost producer. We're trying to get more than just one dimension of exposure and to continue to capitalize on what we're seeing as a long-term bullish energy picture.

group of assets and a really good franchise. The turmoil in the boardroom is still not resolved, but I think you've got some really good people in there who ought to be able to work their way through the crisis. I think the money center banks should be in a position to weather the storm. The smaller banks or the banks in single lines of businesses that don't have the balance sheets and the product breadth are to be avoided.

Mr. Hayek: Also regarding **Citigroup**, when a business is experiencing significant problems, we have to ask the question, are those problems temporary or terminal and is management taking a common sense approach in addressing the issues? With **Citigroup**, I really feel that is happening. First, they've got a well-known public figure in Robert Rubin in there to assist with the transition, and I don't think that he would be wasting his political capital on a lost cause. Secondarily, they tried to set aside their structured investment vehicle pools off the balance sheet, and when things were not moving fast enough, I think the new CEO, Vikram Pandit, made the right move — taking that balance sheet hit and disclosing where they stand. Their tier 1 capital is still quite strong. I'll say this, the last go around, in the early 1990s, when this kind of thing happened, banks in particular and corporations generally, were not nearly as strong as they are today. Remember, in the market crash of 2000, corporations on the whole learned their lessons and repaired and strengthened their balance sheets. Even though there are significant headwinds, I think the problems are being worked out and we're finding a bottom in here.

Kallen: We do feel that long term we're in a bull market for energy and what we're trying to do is get exposure across the spectrum. We do have exposure to the large cap integrated oils, but we're also looking downstream with refining capacity being very tight. We are getting exposure to companies that have a lot of leverage to refining margins and we're also looking beyond the traditional plays.

TWST: You've lightened up in the financial sector, and you mentioned you wished you could have done more. What is the outlook for the money center banks and the problems that they have with the subprime?

Mr. Kallen: It's a tale of two Citi's. On one hand, the stated write-downs appear to be relatively conservative from our analysis. With investments or assets that are hard to value, you don't want to say that with too much conviction, but we did sell all of our **Citigroup** (C) in taxable accounts. That was one position where we did have some losses and we were able to do some tax loss harvesting. We will investigate re-purchasing the position again in 2008. I think with a 7% dividend yield and a single-digit earnings multiple, even with the headline risk, **Citi** has a great

TWST: I also want to touch on your views of the international markets. I take it you prefer to invest in companies that have operations overseas.

Mr. Kallen: Yes. What we're seeing in the developed economies internationally is less robust growth prospects than we would like in order to really focus on that area. I think the prospects in some of the developed, particularly the European economies, are not a whole lot better than ours, to be honest with you. With the euro trading at all-time highs versus the dollar, I think that adds more headwinds. We don't really see prospects dramatically different from ours in the developing world. Even though we have a very strong group of countries that have very large foreign reserves and they are exporting billions of dollars of products, it's a valuation issue. These markets have assumed bubble-like valuation metrics and as a value investor, even though we do like the long-term growth prospects, it's just hard to get comfortable taking the kind of risk that you take when you're buying companies at 60, 70 times earnings. Also, you are limited as a foreigner to not just your corporate control, but also the share control. There are instances in some of the markets, like India, where foreign ownership is severely limited. You're paying a premium to the underlying value of the share just to get it on a US exchange. When you put all that together, it just makes a very difficult investment case for fundamental value analysts like us.

Kallen: Citi has a great group of assets and a really good franchise. The turmoil in the boardroom is still not resolved, but I think you've got some really good people in there who ought to be able to work their way through the crisis. I think the money center banks should be in a position to weather the storm.

TWST: What about the fixed income side of things? Are you still recommending equities stronger than fixed income?

Mr. Kallen: Our approach is to look at asset allocation as a long-term proposition that defines how we're going to invest our clients' monies relative to their objective. It's not necessarily driven by what's going on in the markets. Our clients that have an allocation for fixed income will be appropriately allocated because fixed income provides stability and cash flow to portfolios. Asset allocation from our point of view is driven by what's going on in the client's specific situation rather than what we think is happening in the market. Now, what we are expecting in the fixed-income markets is a continued flight to quality. As uncertainty unfolded in the credit markets, we've seen the bid on the 10-year Treasuries under 4% again. We've actually benefited from that because we don't invest in lower credit quality names, so we've continued to put forth the higher credit qualities and the shorter- to intermediate-term maturities. We're not looking long term — 10, 15, 30-year bonds — and seeing a lot of value there.

1-Year Daily Chart of Citigroup

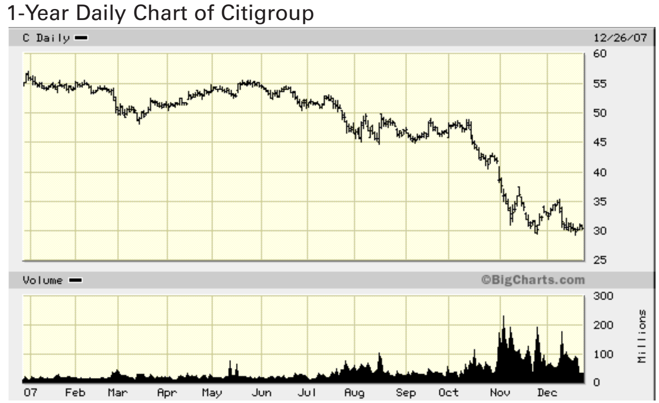

Chart provided by www.BigCharts.com

TWST: I'm interested in the sentence that you wrote about asset allocation. You said that asset allocation should be driven more by an investor's risk profile and life events than predictions about what the market may or may not do.

Mr. Kallen: Right.

TWST: That's a good idea for customized portfolios, but what about in general?

Mr. Kallen: I would make the same comment in general. I'm not talking about minor shifts and weightings between either sectors or different asset classes. What I'm really referring to is more of the "all-in" or "all-out" mentality that you see a lot of when you have volatility at these levels, where people are going to make predictions that 2008 is going to be a lousy year, so go to cash or the markets are dramatically undervalued, buy stocks! What studies have shown and what I've found very interesting is over long periods of time, you don't have to miss a lot of the really good trading days to see a dramatic hit to your performance. I recently saw a study geared at quantifying the impact of market timing. The results were eye-opening. If $1,000 was invested in the stock market in 1963 and left untouched it would have grown to $75,000, reflecting an average annual return of 10.8%. But if the best 90 trading days were missed, the return would shrink to a mere $2,700. Missing only 90 of 10,573 trading days during those 42 years, that is less than 1%. That is very little margin of error, and I think that you would find very few gamblers in Vegas willing to take those odds.

Look at what Warren Buffett's company has done over this volatile period. It has seen a tremendous rise in its performance. I think that's largely because people look at **Berkshire**'s balance sheet and Buffett's investment style and flexibility. So the companies that have overstretched balance sheets and liquidity problems are now distressed sellers and Warren Buffett is in a great position to take advantage of that. We, to a lesser extent, follow the same theme where market volatility provides good opportunities, as long as you follow what we would call our fundamental value approach to analyzing the security.

Mr. Hayek: We are at another inflection point. The problems were there all along, but only recently have come to light. Risk has been reappraised and there was a lot more risk in the marketplace than what was recognized. The Fed has shifted its focus from the risks of inflation to the risks of recession and they're doing the appropriate thing. Frankly, they're being creative in the way they're attempting to get central bankers around the world to coordinate their efforts and there is not much more that they can do that would be productive.

Mr. Kallen: I would add that a good sign in my mind that the Fed is doing their job is, the Fed gave us another 25 basis points in December and the market didn't like that. That tells me that the Fed is following some level of discipline in their actions. I don't think anyone really wants the Fed to rapidly lower rates and dramatically increase liquidity to just appease the equity markets.

Mr. Hayek: The thing that Eric and I worry about more than Fed action is the political risks that become more and more apparent as the crisis deepens. If the politicians here or around the world do something hasty, that could really upset the applecart. Something hasty in the way of over-protectionism, big tax hikes, over-regulation — they have unintended consequences that just roil the markets and have long-term impacts.

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Mr. Hayek: When you focus on individual business fundamentals and use an appraisal method to value those businesses, you're going to work around a lot of the macro analysis that tends to paralyze the decision-making process.

TWST: You believe that we are at another inflection point. Why is this an infection point? What would you like the Fed to do?

TWST: How are you specifically positioning the portfolio now for 2008? You said that you're looking for the quality companies and being more defensive. What investment ideas are you looking for now?

Mr. Kallen: On a sector basis, I'll try to be somewhat broad. We're overweight energy. We talked about some of the different ways that we're investing in energy — it's not just in oil. We are underweight financials; we have very little exposure there. That may change. A lot of bad news has been priced into these valuations. We have exposure to a number of multinational corporations that are selling into the overseas markets — **Coca-Cola** (KO) is a good example, and **Wal-Mart** (WMT), **Altria** (MO), **Colgate** (CL). We have very little technology exposure with the exception of a company like **Microsoft** (MSFT), which in our mind is a cash flow generating machine more than a growth-driven software company.

TWST: What do you think gives Hayek Kallen Investment Management its edge? What are the defining features of your investment approach that makes it distinctive compared with other firms?

Mr. Kallen: I think the single biggest advantage that we have is that our clients are not requiring us to look at performance on a quarterly or monthly basis. We have discussed and agreed to take a long-term perspective on the markets. That enables us to have a tremendous amount of flexibility in how we invest. A value investor is generally buying the things that other people are selling, and selling the things that people are buying. The people that I'm referring to are the people in our mind that have the shorter investment horizons. We have the ability to not just weather these storms, because we're not having to make rash decisions selling into panics or buying into large bull runs; we're able to circumvent some of that with a longer-term perspective.

Mr. Hayek: I would add that we use a fundamental approach that enables us to look at the businesses, instead of charts, abstracts or quantitative models. To really understand the business is

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TWST: What about health care?

Mr. Kallen: We are looking for exposure in non-traditional ways. Traditionally, value investors would look to get exposure to health care through the large cap pharmaceutical arena but I'm very concerned about the direction that sector is going. Generic competition has been brutal. It has resulted in directional changes in a lot of these large cap pharma names, and I don't think that you are going to find a receptive ear on Capitol Hill to the problems that they have.

So we've shifted our focus; we're looking at the trends in our aging population. **Zimmer Holdings** (ZMH) is a new addition to our portfolio. **Zimmer** is the nation's largest pure-play maker of orthopedic devices and should benefit from an aging population that's living longer and better and is in a better position than any generation in the past to afford quality health care. We'd like generic pharmaceuticals. **Teva** (TEVA) is one of our larger holdings that we've held for a number of years. **Novartis** (NVS) is our large cap pharma name. They also, in our mind, are a generic player because they have, I think it is, the largest or the second largest generic provider. **Johnson & Johnson** (JNJ) is another good example. They are really a very well-diversified consumer company operating in and around the health-care arena with extremely high cash flow generation. Most of these companies are paying dividends and they fit well into the long-term growth prospects within that sector.

1-Year Daily Chart of Microsoft

Chart provided by www.BigCharts.com

a competitive advantage because it takes a lot of the emotions out of the decision-making process.

Mr. Kallen: When the markets are going crazy, what Fred and I do is take a look at our portfolio of companies and really make sure we understand what's going on with those individual names. I think the biggest problem today in the financial markets is that there are a large number of investment disciplines and a tremendous amount of money that is invested following a quantitative approach, and no one can really predict how it will react given certain events. What we are able to do is really look at what makes up our portfolio, the individual companies, and then have a much better idea about decisions we need to make based on market, economic or company-specific dynamics.

TWST: Looking at 2008, what advice would you leave with investors?

Mr. Kallen: Prepare for volatility and position yourself accordingly within your particular investments. On the fixed-income side, I still think that we're going to see wider spreads that we're seeing today even though they have already widened significantly. I would be cautious about taking risk within specific credit names. On the equity side, my advice is to follow our investment approach. Align yourself defensively, focus on cash flow, make sure that in valuing the companies that you're looking at the quality of the earnings and understanding what earnings may be at risk. Multiples seem very low now because the earnings part of that equation, in a lot of cases, is going to be compromised. A superficial analysis is probably not going to do it in 2008. What we are going to do and what we'll continue to do is really dive deep into the analysis and make sure we understand not just what's coming through on the income statement, but also on the balance sheet.

Mr. Hayek: Really what we're saying is to focus on the risks when making investment decisions and then take a long-term perspective.

TWST: What is the average turnover in your portfolio?

Mr. Kallen: 10% to 15% on average.

TWST: That's long-term investing!

Mr. Hayek: Yes.

TWST: Thank you.

Note: Opinions and recommendations are as of 12/21/07.

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