

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Balanced Value Investing



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 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, 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.

Mr. Kallen: Currently, we're managing \$165 million for roughly 175 families on a custom, separate account basis.

TWST: Is the asset allocation different for every individual portfolio?

Mr. Hayek: Working within the aforementioned context, yes. Let's begin with the equity component and then expand on the fixed-income allocation. By doing so it should clarify what goes into the asset allocation decision-making process.

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 acquirors, and we then buy at a price 40%-

Mr. Hayek: Absolutely, but the core analysis is bottom-up, must be mindful of the risks, and our appraisal method captures that. In the short term, the economy is impacted by politics as usual, terrorism fears and unrest in the Middle East. That's what's grabbing the headlines — along with high energy prices and natural disasters. The unfolding ramifications are guesswork at best. Meanwhile, the Federal Reserve continues to grapple with speculative excesses and seems to be determined to continue with its program of gradual, 25-basis-point rate increases to dampen inflationary pressures. In June 2003, the fed funds rate was at 1%; now it's 4%.

Kallen: We decided to look at a basket of stocks, using an exchange-traded fund, iShares MSCI Pacific ex-Japan. We saw this iShare as a low-cost way to get diversity. We're looking to go in without hedging the dollar, given our view on the longer-term trends with the dollar. With EPP you have low cost, diversity, and something that is abiding by US GAAP, trading on a US exchange.

50% below our long-term appraisal. Doing so builds in a margin of safety for our clients and minimizes risk. It requires patience and a long-term perspective. It must be understood that appraisals are moving targets based on economics and fundamentals, and it is our belief that markets are often irrational, creating opportunities for resourceful investors. Price and value are two different things.

On the fixed-income side of the scale, we're currently in a rising interest rate environment, and as a result, our focus is on mitigating the risks. We're taking a stepped approach and also hedging fixed-income positions using variable-rate coupons and step-up notes, while adding shorter-term notes and investment-grade credits.

There are really three levels to asset allocation. One level is the percentage of stocks and bonds that go into the allocation. Looking at our clientele, visualize a normal distribution within a bell curve, i.e., 75% of them are in the asset preservation stage of their investment lives, so depending on individual circumstances, they have an allocation of 40%-60% stocks and conversely, 60% to 40% bonds. There are outliers who are younger or have different (more aggressive/conservative) long-term objectives, but the point is, we are balanced value managers.

The second level is to determine what sectors of the market/economy we want to overweight, equal weight or underweight. Our final bottom-up component is what individual securities are appraised, purchased and sold, using the value methodology within those overweight/underweight sectors.

TWST: Does this entail any top-down macro look at the economy and the market?

The good news is that because of better risk dispersion methods, the economy has greater stability than it had, say, during the 1970s when we were facing similar kinds of headline events. The bad news is that rates are still rising, and the yield curve is flat and could be signaling an economic slowdown. The point is, we don't know what the outcomes will be and to make long-term investment decisions based on short-term events is a speculative proposition fraught with risk. Bottom line, we want to buy good businesses that provide a valuable product or service that is needed and that have some competitive advantage, a moat if you will, that is stable or growing.

It's our view that there is some inflation already baked into the economic cake, and beyond that, we think the economy is facing some structural challenges that have to be addressed. Structural problems carry more political risk and take a long time to turn around. Picture turning around an oil tanker; it can't be done on a dime. The budget and current account deficits, a weakening dollar, little dry powder left to offer tax or other fiscal stimulus, high levels of consumer debt, Social Security, health care, and pension reform all need attention. What the headlines and structural problems do is cast a shroud over the markets, and the evidence is the abysmal returns they have delivered for the past five years.

TWST: What are the characteristics of the companies you want in your portfolios?

Mr. Kallen: We look at companies both from a top-down macro perspective and from a bottom-up micro perspective. Our analysis is done on the fundamental level, but we take our direction from the macro picture.

Right now, given the headwinds and structural problems that Fred outlined, we're focusing on companies that have strong cash flow, are high-return generators (whether that's on assets or equity), and that are looking to enhance their share price through buybacks or dividends. Dividends and buybacks help to capture some return in markets that haven't provided a lot of capital return or capital appreciation. Point two, we're presently looking at companies primarily in the mid- to large cap range. That is where the value is in recognition of the risk in the market right now, both in terms of whether we're headed for inflation or deflation and whether US consumers are headed toward bust with a real estate bubble and zero or negative savings rates.

Mr. Hayek: I might add that not all sectors are underperforming. In our visit with you last year, we mentioned we had positioned ourselves in the energy sector and moved downstream to the integrations and some ancillary energy plays. Those have paid off handsomely for our clients. We still think that technology faces some pretty strong headwinds.

Corporate earnings have been robust. After a couple of rounds of belt-tightening, corporations are seeing a lot of cash on their balance sheets, but they're not finding opportunities to grow organically. A macro theme would be that there is going to be not only more dividend increases and share buybacks, as Eric mentioned, but also more robust merger and acquisition activity than we've seen since the stock bubble burst.

Hayek: We have always been international in our investment universe. We're migrating to a more globally diverse model by using domestic businesses that have significant international sales in addition to some structured products that give us some leverage with the weakening dollar, which we think is a longer-term trend as well.

TWST: Do you have a benchmark against which you judge the performance of your equities?

Mr. Kallen: Given that we have clients with a range of objectives — from 100% fixed income to 100% equity and everything in between — we present our clients with three equity benchmarks and one fixed-income benchmark. Then we extrapolate what a return would be based on their asset allocation. For example, the three equity indices we use are the S&P, the Dow and the NASDAQ Composite. The bond index that we use is the Lehman Brothers Intermediate Corporate/Government Bond Index. For someone who has a 50/50 allocation, we would look at a blend of the Dow and the S&P, average that, and then average it against the Lehman Bond Index.

TWST: How is the portfolio structured this year compared with last year? Have you made any alterations?

Mr. Kallen: It hasn't undergone dramatic change. Last year we were continuing to add to our energy positions, including gaining exposure in a few different areas. **Peabody Energy** (BTU) was a company we took a very large position in. We also looked at adding to other integrated oils — **Marathon Oil** (MRO), **Exxon Mobil** (XOM) and some others. We also, through the course of the year, have been buying some stalwarts that have been in our portfolios for a while that are still within our valuation ranges — **Citibank** (C), **Bank of America** (BAC), **Microsoft** (MSFT) and **Colgate-Palmolive** (CL).

Today we are reducing positions in some of the energy stocks we've held and seen appreciate significantly. Particularly in situations where a single position might account for 15% or 20% of the total portfolio value, we've pared that down.

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Overall, we think the cyclical rally in the stock market is getting long in the tooth, and we're still in a secular bear market as mentioned in prior interviews.

TWST: What are some of the stocks in your portfolios that you feel are representative of your investment approach?

Mr. Kallen: Our desire for more international exposure, as Fred mentioned, specifically in the Pacific Rim, is a key focus area for us. We look at the US dollar as being a currency that's going to struggle. Though it's had a good year this year, we still think, long term, given huge current account and budget deficits and other structural problems in our economy, we're going to see a weaker dollar going forward. We also look at some of the Pacific Rim economies as higher potential in terms of their growth and increased stability.

We went through an exercise of evaluation, trying to find the best investment vehicles or investment opportunities in the region, focusing not just on the reward but also on the risk — and risk,

I think, is a key point because investing in emerging markets can be a difficult proposition for investors. There are the obvious risks such as the political risk, as we saw in Russia with **YUKOS**, and we've seen it in some of the smaller Asian economies with huge volatility in their exchanges through the course of the last several years. That's an obvious one. Valuation is also a concern. After all, this idea isn't a new idea by any stretch of the imagination, and I think there are certain camps that would view many of the markets and the companies in the Pacific Rim to be pretty fully valued, at least based on an historical basis. But we also want to look at the less obvious risks in trying to determine the best way to invest over there.

One of those things is clarity and visibility. Internationally-listed stocks are going to abide by international GAAP, which provides some comfort level with their reported numbers. However, in buying domestically listed foreign stocks, you're not necessarily getting the same clarity, either from a corporate governance or from an accounting standpoint, and that presents a tremendous amount of risk — particularly as we have countries like China and India that are really just beginning to emerge as capitalist economies.

Hayek: Wal-Mart is a low-cost provider and that doesn't hurt in an economy that's slowing down, yet not all of its 100 million customers are low end. Wal-Mart continues to convert its stores into supercenter format with higher-margin offerings, and they're dolling things up over there. In a slowing economy — or even a recessionary economy — that's going to draw some formerly high-end customers.

Another factor is the currency risk. Certain funds and companies are going to have a different approach to this, but it needs to be a decision an investor makes: "Do I want to hedge my currency exposure or do I want to keep it?" Among other points we consider, one is the cost. Investors with the desire to get into these countries find in some areas inefficient markets. For example, ADRs of Indian-listed companies traded in the US frequently will trade at a premium to the value of the underlying shares. So there's a lot of cost associated with getting into markets where foreign investment is sometimes regulated.

Given the risks outlined, we decided not to follow a specific recommendation, but to look at a basket of stocks, using an exchange-traded fund, which is **iShares MSCI Pacific ex-Japan (EPP)**. We saw this iShare as a low-cost way to get diversity. We're looking to go in without hedging the dollar, given our view on the longer-term trends with the dollar. We also thought there was additional stability here because the countries that are represented here are more developed countries selling into less-developed countries.

The weighting is probably two-thirds Australian companies, about 20% Hong Kong and about 10% Singapore, the residual being spread out into New Zealand and a few other countries. With **EPP** you have low cost, diversity and something that is abiding by US GAAP, trading on a US exchange. It embodies a lot of the themes that we see with growth, with currency views and also with our long-term views on that region. It also has good diversity among sectors with a large portion of the investment coming through materials companies, a sector we view favorably.

TWST: That is an interesting change in your focus. What other companies do you want to discuss here today?

Mr. Hayek: I wouldn't call it a change in focus, but more of "that's where the value is." I think every serious investor should, as Warren Buffett said, "buy a great business at a fair price rather than a fair business at a great price." So at the risk of boring your readers, I want to bring up a great business that's at a very fair price right now, **Wal-Mart Stores (WMT)**. The reason **Wal-Mart** is trading at a fair price today is that there are several known problems with the business. The first being we could be entering the first consumer

1-Year Daily Chart of Wal-Mart Stores



Chart provided by www.BigCharts.com

recession in 15 years. Consumers are highly vulnerable to the price of fuel, and as CEO H. Lee Scott said, “High fuel prices are the most regressive tax that we have — \$10 a week more for gas is money that a consumer can’t spend at **McDonald’s** or **Wal-Mart**.” Broadly speaking, the second issue is that **Wal-Mart** has stumbled. It’s migrated from serving mostly rural areas to focusing on suburban and urban customers and lost competitive ground on higher-end customers to **Target** (TGT) and **Best Buy** (BBY). The third problem that’s well known is that **Wal-Mart** has had some management turnover. Turnover has occurred when it needs its resources to compete in the UK, expand in China and shore up its US base. Subjectively, the question to ask is, “How is management addressing the

requirements for listing. The Walton family owns about 40% of the stock, so when the S&P made this adjustment, it lowered **Wal-Mart**’s weighting from 2% of the Index to 1.3%. When that adjustment is completed it may put a floor underneath the stock price. What may also be a surprise is US expansion. CEO Scott said that there’s room for 4,000 more supercenters and expansion of 1,200 existing stores. Meanwhile, foreign sales are gaining momentum. They’ve got \$60 billion in foreign sales, which matches **Target**’s total sales! Again, that has weak-dollar implications. Then on the high-end to low-end trend I spoke of earlier, industry statistics are pointing to a reverse wealth effect, with the result, I think, that more customers are going to be going “down” to **Wal-Mart**, not fewer.

Hayek: In the regional bank mode, there’s more and more competition for fewer and fewer acquisitions, which is how they’re growing their business. They’re paying ever-higher prices to grow their businesses, and they don’t have as many pockets to dip into when interest rates rise, margins are squeezed and the economy turns down.

problems that confront it?” If they’re doing it in a common-sense way — and if the problems are temporary, as opposed to terminal — we think this creates a good buying opportunity.

I think **Wal-Mart** has attacked these problems with bold solutions. Number one, it is a low-cost provider and that doesn’t hurt in an economy that’s slowing down, yet not all of its 100 million customers are low end. **Wal-Mart** continues to convert its stores into supercenter format with higher-margin offerings, and they’re dolling things up over there. In a slowing economy — or even a recessionary economy — that’s going to draw some formerly high-end customers. With respect to management, **Wal-Mart** is positioning their story as “management development,” and I like what they’ve done. At their June shareholders meeting, they announced management reorganization, which we view as a good thing and a developing story. Mike Duke, the former head of US operations, is going to take over international, and John Menzer is going to switch from international back to US. Store expansion in China and Japan is gaining traction. They’re learning how to effectively operate in these cultures, and they’re ahead of the competition in doing so. Both men have been promoted to Vice Chairman. The Chief Operating Officer, Eduardo Castro-Wright, is going to take over as US President and CEO. On the whole, they’ve got the problems identified, and they’re taking rational steps to overcome them. Can they execute — that’s the question.

There may be some pleasant surprises as well. Something I don’t think is widely known is that the S&P Index adjusted their re-

On a valuation basis, the current price earnings ratio or discounted cash flow (DCF) is below their 10-year median and near their all-time lows. At their recent analyst meeting, “change” was the theme and a focus on return on invested capital that has historically been better than their peers.

As a side note, I’ve been following **Wal-Mart** since they went public, and as a value investor I’ve never been able to buy it at valuation levels this reasonable. The fundamentals support our \$60 appraisal. Sales, earnings and comps continue to stay in the upper end of their range. And if you look at almost any financial measure, you’re seeing steady, growing increases at the same time maintaining a Class A balance sheet.

As to the risks, **Wal-Mart** is a little underleveraged and a very liquid stock, but it’s also a high-profile litigation target and viewed by the press as a love to hate company — remember the Kathy Lee Gifford mess accusing **Wal-Mart** of slave labor? That brings a little furrow to my brow. Size, of course, hinders growth, to some degree.

TWST: Do you invest in turnaround situations?

Mr. Kallen: Yes, there’s another company we’re looking at in a similar light, one we view as a pretty attractive restructuring or turnaround opportunity. That’s **Morgan Stanley** (MWD). The press has been pretty active in covering the story. Philip Purcell was forced out of his role, and John Mack made a triumphant return to the company that he ran for a number of years — individually and then jointly with Purcell after the 1997 merger. We view

his return very favorably, particularly given that the institutional securities business that John Mack ran is a key driver for value. Mr. Mack has done a very good job of slowing down the exits and motivating key producers. In a business like institutional securities, people are the key assets. We are very excited to see John Mack back in place.

We're also happy to see the focus of the analyst community as well as the media going back to the operations and not the sensational stories of the boardroom fights that were erupting. We view the management turmoil as being largely over. Zoe Cruz who is acting as president — and we think likely to become president — is a highly qualified individual, and we have a lot of faith in her ability to run the institutional securities part of the business.

But there's also downside. As Fred said earlier, these businesses are available at reasonable prices because there are known problems. **Morgan Stanley** has several. One, and probably the largest, is the retail part of the business, the former Dean Witter business, which has underperformed for a number of years. It's lagged its peers — particularly **Merrill Lynch** (MER) — pretty significantly, which was in part responsible for Philip Purcell's ouster from the company. With new management in place now, there's a push to shed underperforming brokers; they shed around 10% of their brokerage

a share, and look at a very favorable breakup valuation at **Morgan Stanley** because we see probably \$5 or \$6 a share in the retail segment, the core business being worth probably upward of \$50 or \$60 a share on a long-term valuation basis. We see lots of potential when they get a clear and coherent strategy in place and some of these underperforming units either sold, which is what they did with their aircraft leasing business, or turned around.

TWST: What about the stocks that you have trimmed back on or sold outright over the past 12 months?

Mr. Kallen: The one that's been the most recent — and probably the most significant — was the company we talked about last year, **Peabody Energy**. It is the largest North American coal producer. **Peabody** was a very large position of ours when we bought it, and we saw a fourfold increase in it over the 18 months that we held it. Two things struck us. One, it had come within range of our valuation target, and two, it had become an asset allocation and concentration issue, resulting in portfolios with significantly large portions of their equity exposure in that company. We recently sold roughly a third of our position globally. We still like the company long term and think there's tremendous potential, both domestically and internationally, and this is a company that sells a lot of coal into China through their Australia holdings.

Kallen: Peabody Energy is the largest North American coal producer. We recently sold roughly a third of our position globally. We still like the company long term and think there's tremendous potential, both domestically and internationally, and this is a company that sells a lot of coal into China through their Australia holdings.

force. And they put **Merrill Lynch** in their sights as the benchmark for performance, targeting a product mix geared more to the wealthy, including what could be considered traditional banking products. So the company is going to be broader in its reach. While we're very comfortable with the changes that have been put in place and the upside that's available, we recognize that this is not going to be a quick turnaround story, and we would expect it to take some time to get the battleship righted and on course.

The Discover credit card business was a business that many thought would be either sold or spun off. John Mack surprised a lot of people when he decided to keep it, at least for now. We're assuming that he knows something we don't know. My guess is that it has something to do with the fact that business on its own against the 800-pound gorillas, MasterCard and Visa, is probably not going to enjoy the same economics and results that it has as part of a large organization. We look at that business as being worth probably \$9-\$10

1-Year Daily Chart of Peabody Energy



Chart provided by www.BigCharts.com

Mr. Hayek: Another situation that we feel pretty strongly about is the breakdown of the regional bank model. We sold our regional bank positions. One was the result of a merger. **Wachovia** (WB) purchased SouthTrust at a 20% premium to an already fully valued price. The other was a collection of some regional bank stocks that we had chosen to hold from roughly year 2000 through this year. In the regional bank mode, there's more and more competition for fewer and fewer acquisitions, which is how they're growing their business. They're paying ever-higher prices to grow their businesses, and they don't have as many pockets to dip into when interest rates rise, margins are squeezed and the economy turns down. We like the international bank model better and migrated our holdings into companies like **Citigroup** and **Bank of America**.

In a previous interview we mention a company called **ProAssurance** (PRA). They're a niche insurance company providing medical malpractice for doctors, dentists and hospitals. Litigation winds have switched from a headwind to a side-wind. The stock ran up considerably, and we sold our entire position. That was strictly on a valuation basis. The stock actually exceeded our valuation target (appraisal), and it was time to sell.

Mr. Kallen: I think that's one of the things that our clients value the most, the sell decisions that we make. Given the emotional tie that many people bring to their portfolios, it's not uncommon for them to see a roller coaster ride of low valuation to high valuation back to low valuation again. They thanked us for being able to pull the trigger. It's hard to part with what we think are fantastic companies that have provided tremendous returns, but if the company gets to 10%-15% of our valuation target, we seriously consider a diversification process, and if it reaches 100%-110%, we'll normally sell the whole position.

TWST: What differentiates your investment approach from other firms that customize portfolios? And what advice would you give to potential investors seeking to set up one?

Mr. Kallen: One of the things that we really have focused on is the risk. In selling investment ideas or investment advice, I think the trend in the industry is to sell return and the potential for return — but that, as we all know, is only half the equation. It's at what cost, and that cost is in terms of the risk. So what we strive to do with our clients is, in very specific terms, highlight the risk inherent in anything that we do and use that and their response to that to help drive investment decisions in terms of the asset allocation, in terms of the securities that we buy, and in terms of the sale decisions that we make. All of that should be driven by risk, and the risk needs to be both understood and communicated.

Mr. Hayek: Another characteristic that distinguishes us in the marketplace is the way we deal with ancillary issues surrounding the

core positions and core assets. When you're dealing with individuals and small institutions, you have special situations that arise — for example, inherited or concentrated positions that have tax ramifications associated with liquidation. We deal with these situations in a custom way using strategies that spread the risk and the sale process over time.

We also deal with situations where people are asking for investment counsel on matters not directly related to their portfolio of stocks and bonds, like estate and legacy issues. People want independent, knowledgeable third party counsel. The ones that have been coming up over the past couple of years have been related to real estate. Our clients have some concerns there, and when they bring up questions, our responsibility is to point out to them the risks given various investment strategies that they have and how that relates to their core portfolio — keeping things in balance, in other words.

Mr. Kallen: More and more, people aren't looking only for investment advice as it relates to their portfolios. That's what they're going to pay you for, but they're going to look to you for other advice and they're going to want and expect you to know about other matters in their financial lives that aren't directly in front of you in their portfolios. We've expanded the level of service that we provide — not necessarily at a cost or a charge, but we feel that if we're going to provide investment counsel, it's important for us to be at least in the loop on a number of these other significant areas in the financial lives of our clients.

Mr. Hayek: We're focused on our clients, their interests and providing a kind of holistic service to them. Results have been good, our client base is growing.

TWST: Thank you.

Note: Opinions and recommendations are as of 11/1/05.

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