

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Relative Value Investment



FOWLER W. CARY JR., President of CCM Investment Advisers, LLC, is a 36-year veteran of the investment industry. Shortly after he began his career at Wachovia Bank as an equity research analyst, he participated in a research project headed by Professor Sidney Coddle at Stanford University. While at Stanford, Mr. Cary gained exposure to the theory and importance of asset allocation, which later was the foundation for his investment discipline at Bankers Trust of South Carolina where he served as Chief Investment Officer. In 1986, Mr. Cary founded Companion Capital Management (now CCM Investment Advisers, LLC) and has served as President and Chief Investment Officer since that time. He was graduated from Wofford College and received his Master of Business Administration degree from the University of South Carolina. His primary responsibilities at CCM include strategic and tactical asset allocation, oversight of the equity and fixed income research process, fundamental research in the energy, healthcare and finance sectors as well as management of client portfolios. Mr. Cary is active in the community and has served on numerous Boards of Directors. Proficient in investment policy, he has assisted several organizations in the development and implementation of investment programs.



MICHAEL A. BURKETT, Vice President of CCM Investment Advisers, LLC, joined the firm after receiving his Bachelor of Science degree, magna cum laude, from the University of South Carolina. His responsibilities at CCM include portfolio trading and management, information systems and research on fixed income products as well as the consumer non-durable and durable sectors. Prior to his college studies, Mr. Burkett served in the United States Army 82nd Airborne Division, with a later posting to the Defense Language Institute. Mr. Burkett is a CFA charterholder.

(ZCB500) TWST: We'd like to start with an overview of CCM Investment Advisers and what your responsibilities are there.

Mr. Cary: I am the President and Chief Investment Officer. I founded the company in 1986 after spending 14 years on the banking side of the industry. We're an investment advisory firm located in Columbia, South Carolina, and manage money for clients across the US and in the Caribbean.

We have just over \$1.6 billion in assets under management. Our typical client has made their wealth and seeks to grow it versus in-

flation without exposing it to substantial risk. Our clients understand that winning longer term in the money management business means not losing. We participate by capturing 60%-70% of an upside market and try not to participate at all in a downside market because a loss is extremely hard to recover from. Our clients don't like to lose, so they come to us for conservative, risk-averse management.

Our process is driven by relative value. We compare each security and each class of securities to all others in the comparison. There are no absolutes within our investment management process.

Mr. Burkett: We have three core products: equity, with a relative value tilt (which all of our products have), along with a fixed income strategy and a balanced product, which is a mix of fixed and equity assets. The asset mix in the balanced product is determined by each client's risk tolerance, along with our tactical allocation decision.

I've been at CCM since August 1998 and serve as a Portfolio Manager and an Equity Analyst for five economic sectors. I am also responsible for the fixed income and equity trading operations.

TWST: How do you gentlemen define relative value, and what is the investment climate for your type of investment going forward?

Mr. Cary: Relative value is the comparison of a particular security versus its peers, or a class of securities versus another class of securities. Our process works from the top down. The most important decision that any manager makes in the management of a client's wealth is the asset allocation decision — the portion exposed to stocks versus bonds versus money market funds.

It's a two-dimensional consideration; expected returns versus expected risk. If you are only comparing expected returns, you lose sight of one of the most important considerations that you have to make as a manager, and that's risk.

Each client has a different tolerance for risk. We have an Investment Policy Statement for each client and we address each client's investment objectives on an individualized basis. The primary decision to be made is the asset allocation. 80% of the value you can add as a manager comes from the asset allocation decision.

Let me give an example of how relative value works from the bottom up. One of the economic market sectors I cover is energy. We compare an energy stock versus its peers in that group, versus any other stock instrument in our universe of 1,500 companies. Again, it's a relative value consideration.

Mr. Burkett: On the equity side, we begin with about 1,500 names, which are evaluated using a multi-factor model. We're basically looking for those companies delivering the most bang for the buck versus other companies within a given economic sector. Normalized relative p/e is one of the most significant drivers of the model. This statistic compares a stock's historical p/e relative to the market to its current p/e.

A recent example of how this statistic revealed value is **Cummins** (CMI). We added **Cummins** in January 2005 trading at a normalized relative p/e of 0.6, which indicated that the stock was selling at a 40% discount to its normal p/e to market ratio. The stock has appreciated over 30%.

Our model is by no means a black box approach. We rely heavily on company fundamental analysis as well as sector and subsector trend analysis, in conjunction with current economic conditions. All of this analysis comes together at our weekly investment meeting where the collective wisdom of all the investment professionals translates into a unified investment approach.

TWST: Tell us about that tactical asset allocation process and what it involves.

Mr. Cary: The tactical asset allocation process is the first place we start in the search for value. It has been in use since 1981 and is driven significantly by the expected return spread between stocks and

bonds. We then identify the risks associated with each class of investments versus the expected return.

Consider the Capital Asset Pricing Model, with return on the vertical axis, and risk or volatility on the horizontal axis. We're seeking to move toward the northwest quadrant. Whether it is an asset class or an individual security within that asset class, we seek to provide more expected return with less risk. After we determine which asset class is providing the most return per unit of risk, we weight the portfolios accordingly, consistent with each client's individual investment objectives.

Mr. Burkett: Markets tend to be inefficient in the short run and our allocation process works to exploit these inefficiencies. The era of irrational exuberance of the late 1990s was the most recent example of how markets can become mispriced. Our model told us to significantly underweight equities versus bonds. We had two or so years of underperformance during this bull market run as equity valuations continued to expand. Our disciplined asset allocation approach allowed our balanced clients to come out of that 2000-2002 period relatively unscathed. We are very proud to deliver this product to our clients and we know that over the long term it works.

TWST: Compared to your baseline asset allocation, how are equities in your portfolios? Are you overweight in equities at this time?

Mr. Cary: Prior to the bear market of 2000, 2001 and 2002, we began to significantly underweight stocks. We were a little early. We do not stay around for the last dollar; we'll leave that up to somebody else. So we avoided most of the pain during that bear market, but we have been substantially overweight in stocks since early 2003.

We have maintained our overweight in stocks and there is no indication that the undervaluation that existed in the relative comparison of stocks versus bonds has changed much at all, even with the current run-up in interest rates. Obviously, the run-up in rates makes fixed assets more attractive longer term, but it hasn't significantly dented the undervaluation that exists in favor of stocks.

Mr. Burkett: The baseline allocation of our core balanced product is 50/50. We are currently indicating a 65% allocation to equities and 35% to fixed income. We're still 1.2-1.3 standard deviations above the mean, so it still looks very positive for stocks relative to bonds.

TWST: How have your different products performed over the last 12-18 months since we spoke to you? Has this been a good year for you?

Mr. Burkett: In 2005, our equities were up 11.9% versus 4.9% for the S&P 500. Our typical balanced account was up 9.3% versus 3.25% for the 50/50 index. That really only tells part of the story.

The rest of the story is the standard deviation over the last two or three years. Our standard deviation has been lower than the 50/50 benchmark, but we've beaten the returns. As Fowler said before, we consistently strive to be in the northwest quadrant, and our clients have been very pleased.

Mr. Cary: Michael also has the five-year numbers for the equity and the balanced portfolios. For one year, you could just be lucky, right for the wrong reasons or a flash in the pan. But the five- and seven-year numbers really bring out the value we add to our clients.

Mr. Burkett: Our five-year number on the equity portfolio is up 5.7% versus 0.5% for the S&P 500. Our portfolios had a standard deviation of 18.6% versus 19.8% for the S&P 500. We have also outperformed on a

seven-year basis with a 5.9% return for our equity portfolio, with an 18.9% standard deviation versus 1.8% for the S&P 500, with roughly the same standard deviation. On the balanced side, our five-year number is 6.5% with an 11.7% standard deviation, versus the 50/50 index of 3.9%, with an 8.6% standard deviation. The seven-year balanced return is 5.6% with a 10.3% standard deviation. The 50/50 index is up 4.2%, with a 7.4% standard deviation.

TWST: Since you are long-term investors, what is the relative turnover for your fixed income and for your equities?

Mr. Cary: No more than it has to be. Over the last three years or so, turnover has been relatively mild in the portfolio at approximately 40%, as there have been no significant asset allocation changes. But if you go back to late 2002, early 2003, when we were ramping up equity exposure, we were close to 60% or so — maybe even as much as 80%. But longer term, we have a relatively low turnover rate.

Like most managers, there's no incentive to turn over unless you think you can do better in another security or class of securities. We don't turn the portfolios any more than necessary. That's an expense the clients have to endure and it takes away from the net return that we can deliver to them on the portfolio.

TWST: How have you positioned the equity side of your portfolios and how has the emphasis shifted over the past 12-18 months?

Mr. Burkett: The biggest change has been to our technology sector weighting. We began overweighting the technology sector in the fourth quarter of 2005. We are aiming to take advantage of the next capital upgrade cycle that we believe is going to take place this year. There hasn't been a major capital upgrade cycle since 1999. Corporations are flush with cash and we believe that is going to be a major theme in tech performance this year.

The last time we spoke, we were overweight in energy. We've reduced the overweight just a bit. In the capital goods sector, we believe that a weaker dollar and a global economic rebound will benefit that sector nicely.

TWST: Are you all-cap investors? Where do you like to invest?

Mr. Cary: We're all-cap investors. We don't care whether it's large cap value, large cap growth, mid-cap growth or mid-cap value. We will have exposure in the small cap growth and value sectors, which we define as anything from \$250 million up to \$1 billion, with 10%-12% upper limit exposure.

One of the best things a client can do for the manager to get the maximum value out is to hire an all-cap manager who takes the blinders off. Too many times, clients hire a capitalization-specific manager and they get into an all large cap value or growth situation. Eventually, the cycle will turn against them, and that manager is not going to come out of that sector because it's not their mandate.

Our relative value stock valuation model looks at the entire universe and tells us where the value is, and that's where we start digging. We let the relative valuation lead us toward the weightings, whether it's value, growth, large, small or mid-cap. Currently, we're primarily large cap, with an average mid-cap weighting and a below average small cap weighting.

TWST: What are some of the holdings in the portfolio that you feel are representative of your investment approach and the reasons why you were attracted to them?

Mr. Cary: I follow the energy, financial and healthcare sectors. Looking through our names, you quickly find that the names that

jump out at you are in the oil sector. **ConocoPhillips** (COP) has been a fixture in our portfolio for a long time. It's one of the few companies that actually makes a promise on a merger and delivers on it. They've realized the economies of scale as they said they would.

Another one of our energy names is somewhat of a hybrid. **Occidental Petroleum** (OXY) has a chemical division that is integrated with their petrochemical business. We initially bought it as a yield vehicle, but the price has performed so well over the last three years that the yield has dropped to about 1.5%.

On the refiner side, we still own **Valero** (VLO). As you might imagine, when you're set up to refine the sour crude, with barrel prices where they are now, there's an awfully fine profit margin for a company that has refineries for high sulfur oil.

On the natural gas side, we own **Anadarko** (APC) and **Devon Energy** (DVN). The gas stocks have been under a little pressure year to date because the commodity price dropped back to under \$6 per cubic foot. We see this as a temporary situation. The gas supplies and the ability to store it are tightly matched with demand, and any disruption — such as an above average hurricane season — can place the commodity under a lot of pressure.

Fortunately, while we had a nasty hurricane season last year, we didn't have that bad of a winter. It was actually a pretty mild winter, so we were able to get storage back up, and that's why the commodity price has come under a little pressure. But we still think the long-term demand is there and that investors are going to continue to value these stocks higher.

You don't have to be a rocket scientist to look at the demand and supply numbers and see that we may well have peaked out worldwide with regard to energy reserves and production. There are not many other places you can squeeze it from. And yet, incremental demand continues to grow each year, as you get to lesser-developed countries like India and China with their huge populations increasingly demanding the product. Moving up the scale, as they obtain the wealth to move from bicycles to cars and other energy-consuming devices, we think the demand side will continue to pull because the product is just not out there to find that easily. The places they're drilling now are exceedingly deep offshore, and everyone is still beating the bushes for anything they can find on land.

One of the other groups I follow is the financials. We've been less than market weight there for a while. We thought, with the increasing upward pressure on short rates, that a lot of these stocks would underperform. It's been a mixed bag for us, but the two banks that have been core positions for us — **Bank of America** (BAC) and **Wells Fargo** (WFC) — both have great franchises in their areas with decent yields of over 3%.

We've owned a number of the insurers, too, and we've done fairly well with them year to date. **Chubb** (CB) and **CNA** (CNA) are two worth mentioning. Recently, we added **Philadelphia Consolidated Holding** (PHLY). They're a property casualty company that writes a lot of smaller, client specific products.

Under the brokerage financial services area, **Prudential** (PRU) has been a holding for some time. We've made a good bit of money for our clients there.

The last group that I follow is health care. We've had a number of the large cap pharmaceutical companies, and they have not performed that well up until the beginning of the year. We've done well with

Bristol-Myers (BMJ). The stock carries a healthy current yield and it has had pretty decent relative performance year to date.

We own a number of the device manufacturers. **Becton, Dickinson (BDX)** was added last year and has performed well. **Medtronic (MDT)** did well last year but has struggled year to date. It's a fine company with a high quality product mix. They're a device manufacturer, primarily of pacemakers. **Amgen (AMGN)** is one that we've made good money on over the last few years. **Teva Pharmaceutical (TEVA)** is a generic manufacturer and is one of the companies that is giving a lot of the pharmaceuticals heartburn. As patents roll over on big products, companies like **Teva** are ready to go with a generic substitute at a much-reduced price.

This is not really the point in the cycle where you want to have a big healthcare overweight. We've carried a market weighting so far this year and we haven't done much that we can talk about in terms of bragging rights, but we still believe the value is there.

Mr. Burkett: One stock representative of the capital expenditure theme that I mentioned earlier is **Oracle (ORCL)**. It should participate nicely in the next upgrade cycle. It's up 12% since we added it. We think it has a long way to go before it reaches fair value. Europe has been a weak spot for the business, but all indications are that Europe is going to rebound in 2006. We think **Oracle** will participate very nicely.

To give an example of a mid-cap name, **Fiserv (FISV)** is also in a position to take advantage of the cap ex theme. We're not overly positive on the financial sector given the flat yield curve, but banks, brokerage houses and other financial institutions are flush with cash and **Fiserv** is set to benefit. The company helps banks and other financial institutions become more productive. **Fiserv's** EPS growth has been at or higher than all its competitors, while selling at a p/e that is considerably lower. I believe they may be a takeover target and our clients will benefit nicely from that.

One of the names we have recently added is **NIKE (NKE)**. It's been really tough to find value in the non-durable sector, but **NIKE's** valuation stands out. The stock's earnings have surprised to the upside over the last six quarters. One thing that has surprised us is, in spite of higher raw material and fuel costs, **NIKE's** margins continue to expand. **NIKE** is one of those rare companies in today's market that are succeeding at passing through price increases. The stock is easily worth \$100 a share.

J.B. Hunt (JBHT) is another recently added company. Our theory in the transportation sector is, with the rails and truckers at near-full capacity, transports will continue to outperform this year. In spite of higher fuel costs, their profit margins are up about 15%-17% over the last year. Overcapacity will allow transportation companies to demand premium prices to compensate for the higher fuel costs.

TWST: What do you think differentiates your investment approach at CCM from that of your peer companies?

Mr. Cary: I think one factor is the consistence of relative value comparison in everything we do, and another is risk management. So many firms out there are trying to hit a home run every time. Clients know that means assuming extraordinary risk. The sophisticated investor

seldom wants to assume extraordinary risk, and they certainly don't want to stay in an overvalued asset class because it's been a winner for a while. Our objective is to find reasonably valued companies and measure the risk and see if they're attractive versus their peers.

I would sum it up with two concepts. The first is relative valuation. With everything we do, we look at the decision in a relative comparison versus its peers or other asset classes. The second is risk management. If we're managing the risk and finding the value, the returns will follow. Our long-term track record clearly indicates that's a successful comparison.

Mr. Burkett: So many consultants try to place managers in a particular style box or a particular capitalization sector and it really does a disservice to the client. The way we as financial managers add the most value is by taking the emotion out of the client's investment decisions by executing with a disciplined approach. I think our resistance to painting ourselves as a particular style of manager has been the key to our success. We are dedicated to adhering to our investment process through thick and thin. Over the long term, a consistently followed, well-founded investment approach will pay off.

Mr. Cary: I'd like to emphasize a point that Michael made, and he said it very well. Clients come to us as an all-cap relative value manager because they know they've got a steady hand on the bulk of their assets. They might find a few other peripheral or specialty managers that are large cap growth managers, or they may earmark some funds for a hedge fund, but they want to be able to sleep at night. They want a manager who delivers consistently superior results. They're not out there swinging for the fence, but they're keeping the principal where it should be and growing it versus inflation longer term.

That's been the key to our success year in and year out. We built this company from nothing 21 years ago to over \$1.6 billion in assets under management today. Our clients want consistency and security, and we provide it.

TWST: Thank you.

Note: Opinions and recommendations are as of 5/1/06.

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