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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Building an International ADR Portfolio with a Focus on Dividend Yield

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SECTOR — GENERAL INVESTING

TWST: Please start by giving us a background of Logan Capital.

Mr. Buchwald: Logan Capital manages approximately $2 billion, is just over 20 years old, and its original partners, who started the firm as a growth shop, are still here. Marvin and I joined Logan in 2000 and have since become shareholders. We are value managers, and when we came aboard, we helped diversify the investment products the firm offered. Since 1996, we have been managing a domestic large-cap value dividend strategy. That was doing very well, and we had been getting requests from clients to think about doing something similar internationally.

So around 2004 to 2005, Marvin and I started doing research on those factors that worked domestically and applied them internationally. We found the results were similar, meaning that high-dividend-yielding, very large-cap companies with solid balance sheets and strong cash flows tended to do better over time, and hold up better in difficult markets than relevant indexes or benchmarks. At the end of 2006, we started managing our Logan International Dividend ADR portfolio, which at the end of the third quarter had a gross dividend yield of 4.2%.

We've been running it since then with very good results. We now manage more than $100 million in this strategy; just over three years ago, that number was less than $10 million. So we're gaining traction, and we hope that will continue. That's a brief background on who we are and where we've come from.

TWST: Did the translation of the model from a domestic fund to an international fund happen smoothly, or did you have to make tweaks as you established the international fund?

Mr. Buchwald: Domestically, we're running for the most part a very concentrated portfolio and still do. And we've found that to get the same benefit in the international portfolio, we can't be as concentrated. There are 20-some odd countries in EAFE, and we only have 10 to 12 stocks in our domestic portfolio. So you can see having a very few number of stocks doesn't work very well in an international portfolio.

Then, if you want sector diversification, that means at least 10 positions, since there are 10 sectors in the EAFE index. So it didn't quite make sense to have the international portfolio as concentrated as the domestic portfolio. Our international portfolio generally has 35 to 45 names. That is still very concentrated by some standards, though not for us, but it is a number that we think makes sense and that has worked well.

TWST: What are some of the trends that you are seeing that are impacting your investment decisions in the international market?

Mr. Kline: One of the trends internationally that is clearly impacting our international portfolio this year is the strength in the dollar. We are now speaking to clients about our third-quarter performance, which relative to the market was a very good quarter for us; the market as measured by EAFE was down about 6%, and our performance was down about 3.5%. On a relative basis, Logan International tends to hold up very well in down markets, which is what occurred in the third quarter. But the dollar has had a large impact on the market.

The international benchmark that we compare our performance against is the MSCI EAFE Index, net which in local currencies was actually up 1% for the quarter as compared to down 5.9% for the quarter when measured in dollars. So the strength of the dollar has impacted dollar-based investors because so many currencies around the world are weak relative to the U.S. dollar. A lot of that is clearly policy-driven.

For example, Japan has been trying to weaken the yen because it wants its exports to be more competitive, and they want to have some inflation after being in a deflationary environment for so long. Europe also is trying to become more competitive by having a weaker euro. None of that impacts our investment strategy. The types of companies we invest in are primarily large multinational companies that are investing in many countries throughout the world, and sometimes when currencies are fluctuating in some of the countries they operate in, it helps their earnings, and sometimes it doesn't. But we're not in the business of forecasting currencies. It's something we don't do well, and it's not really part of our investment process at all.

Mr. Buchwald: I would add that if you're an investor thinking about your overall portfolio, currencies become a further diversifier within that portfolio. So while currency exposure didn't help this quarter, there are other times when it will. In the long run, that added layer of diversification probably helps the individual investor, although sometimes it may be painful.

Highlights

Richard E. Buchwald and Marvin I. Kline discuss their strategy for managing the Logan International Dividend ADR portfolio. As value managers, Mr. Buchwald and Mr. Kline use a dividend-yield strategy to build their portfolio with large multinational companies. Their process is numbers-driven, and in order to select stocks, Mr. Buchwald and Mr. Kline rank a company's dividend yield in relation to the overall universe, to its sector and to its home country. Mr. Buchwald and Mr. Kline find their approach to be effective because they implement it consistently over a long-term basis; they don't react to market forecasts or day-to-day fluctuations.

Companies discussed: Tesco PLC (TSCDY); VINCI S.A. (DG.PA); Toyota Motor Corporation (TM); British American Tobacco plc (BTI) and BNP Paribas SA (BNP.PA).

We start with approximately 1,000 ADRs, and we screen those down by developed markets and market cap. Our current market-cap minimum is $10 billion, and that gives us between 175 and 200 companies to look at. In the end, dividend yield is the most important criteria for us in our stock-selection process. But we begin by weeding out financially weak companies, and we do that by looking at payout ratios. We want strong free cash flow coverages of dividends, and we want strong balance sheets.

For any company we are interested in, we will review the financials and do other due diligence. We are very numbers-driven when we are evaluating stocks. The universe that we start with of 175 to 200 gets down to about 100 after we eliminate the ones that aren't strong financially, or ones where we have concerns about their business or where we have concerns about regulation of their businesses. We then rank these companies by dividend yield relative to the entire universe. We also rank them within each sector, and we rank them within their home countries.

To be in our model portfolio, a company has to have a dividend yield that ranks high among either the overall universe, its home country or its sector. As of the end of the third quarter, the yield on EAFE was 3.2%. So in terms of the overall universe, generally a stock in our portfolio is going to have a yield above 3%, but it's not a minimum because there are countries, such as Japan, where yields are generally lower.

As I said, we also rank within the sectors, so we'll rank yield within health care, financials, etc., and we also rank within each country. If we did not rank countries separately, we wouldn't own any stocks in countries that have low dividend yields. Also, if we only look at high yield, probably most of our stocks would be in Australia because it is the highest-yielding country by far.

As far as minimums regarding sector and country representation, we require at least eight countries be represented and at least seven sectors. Currently, we are invested in all 10 sectors within EAFE and in 10 countries. We cap emerging markets at 15% of the portfolio. We have only had one stock in emerging markets in the last seven years, and so we really pretty much have zero weight in emerging markets.

"Dividend yield is a primary criteria, as I mentioned, but we do look within sectors at valuations and prefer stocks with low price to earnings, low price to book and low price to free cash flow ratios. In addition, we prefer companies that are buying back their shares and growing their dividends."

TWST: Talk a little bit more about the strategy. As you said, you like large multinationals, but what really makes something a strong stock for your portfolio?

Mr. Kline: First, as Rich talked about, Logan International is a dividend-yield strategy, and what we have found from both our own research and research published by others is that yield strategies work well in practically every country around the world. As a result, we want to focus on high-dividend-yield stocks, and we want to focus on companies with strong balance sheets and strong cash flows. Our process starts with a screen of the universe of all ADRs that are traded in the U.S. We only invest in ADRs, not in local stocks or ordinary shares because our clients currently aren't set up for that.

In terms of sector constraints, our maximum sector weight is the greater of two times the sector weight in the EAFE index, or 20% the portfolio, with an overall maximum weight of 35%. Country weights are limited to the EAFE index weight plus 10%. The overweighted or underweighted sectors and countries are the residual effects of relative valuation. So if a certain sector has a lot of high-yield stocks with strong cash flows that are growing, we are going to have more weight in that sector than a sector that doesn't have those characteristics.

Dividend yield is a primary criteria, as I mentioned, but we do look within sectors at valuations and prefer stocks with low price to earnings, low price to book and low price to free cash flow ratios. In addition, we prefer companies that are buying back their shares and growing their dividends. Position sizes initially are typically 2% to 3%, and we will let them get up to a maximum of 6%. If a stock no longer meets our yield criteria, because the yield is too low by virtue of the stock appreciating, or because the company has or is likely to cut the dividend, it will get sold and replaced by a more attractive stock in our screening and ranking process.

Now, lest you think it is all quantitative, we do look through the businesses and the financial statements. Last year, one of the stocks we were considering for our portfolio was **Tesco** (TSCDY), which is the largest supermarket chain in the U.K.; I believe they're second to **Wal-Mart** (WMT) in retail in the world. When we looked at it last year, it had a very attractive dividend yield, above 4%. It had also historically grown the dividend, but when we looked at the financials, we were concerned that a very high percent of the cash flow that was covering the dividend was coming from selling stores, which they owned and which they were then leasing back.

"However, for the energy companies in our portfolio, we are confident that first of all, they are large enough that they can sustain periods where oil prices are weak. They are generating cash flow, which we think will sustain the dividends and therefore make the high-dividend yields very attractive."

1-Year Daily Chart of Tesco PLC

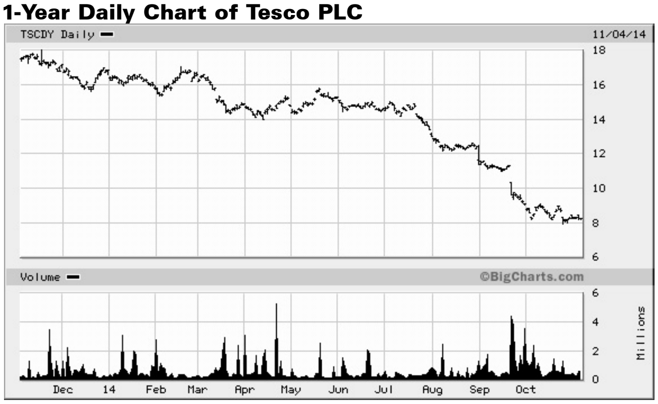

Chart provided by www.BigCharts.com

In analyzing the safety of the dividend, we took out the cash flow from the sale of stores because we knew it did not come from the operations of the business, and therefore, it was nonrecurring. So we didn't buy the stock because of that reason, and cash flow has continued to go down. This year, the company fired the former CEO and replaced him.

Mr. Buchwald: It's now down quite a bit more from where we originally were considering buying it, in part because they also recently found some accounting irregularities. Sometimes, as we like to say, good performance is more about what you don't own than what you do own, and **Tesco** is a good example of that.

TWST: In the third quarter, you added VINCI. Why did you make that addition?

Mr. Kline: VINCI (DG.PA) is a French company. About 86% of revenues are from construction, and that business generates 49% of net income. About 14% of revenues are from the concession business, and that generates 48% of net income. So in terms of sales, by far, the majority is construction, but it only provides half of their income.

In France, concessions are in stadiums and airports, like they are here, but they also operate most of the highways there. We like the concession business. It has high margins and strong cash flow. On the construction side, they are one of the largest construction companies in the world; they do a lot of work for governments, building things like highways and dams. Although there is a lot of price competition in construction, they have less competition at the high end in which they operate.

Mr. Buchwald: We bought **VINCI** after its price had come down substantially. They had missed earnings in the previous quarter, and there were some concerns about what was going to happen in terms of government spending, and those concerns remain. However, that part of the problem, relative to the entire company, was relatively small. **VINCI** still generates a lot of free cash flow, and the dividend yield became attractive to us as it broached 4%. Consequently, we added it to the portfolio.

TWST: In the second quarter, you added Toyota. Is that still a company that you like?

Mr. Kline: Yes, **Toyota** (TM), at the time we brought it, had a 3% yield. They announced that they are buying back stock. One of things people may not be aware of is that a substantial part of **Toyota's** balance sheet is comprised of cash and marketable securities. So the company has a lot of asset value there in addition to the operating business. If you subtract the value of the company's investments from its market value, it is selling at a very low multiple of earnings. At the time we bought the stock, **Toyota's** stock price had been knocked down because it announced a major recall of 6.4 million vehicles. So at the time of purchase, we found the stock attractive because of the dividend yield, the strong balance sheet and its earnings growth.

Mr. Buchwald: And **Toyota** probably will be a beneficiary of a weaker yen since a lot of their business is in the U.S.

TWST: What about British American Tobacco? Why do you like that company?

Mr. Buchwald: Well, the tobacco industry, which is hated by many, still manages to generate substantial cash flow, and **British Tobacco** (BTI) is no exception. They generate a lot of cash flow, and they pay a very nice dividend, which is growing. They operate in a low-expectation environment, and they often tend to outperform those expectations, although there are occasionally bumps in the road, like their most recent quarter. Its dividend yield is currently near 4.5%, so it is very typical of the kind of stock we like to have in the portfolio — strong margins, strong cash flow, rising dividends and a generous dividend yield.

Mr. Kline: Approximately 68% of **British American Tobacco's** revenues are from emerging markets. A lot of people ask us about emerging markets, and we prefer to get the growth from emerging markets by investing in large multinational companies domiciled in developed countries that are diversified across many emerging markets, but which have a strong transparent legal system similar to the U.S.

TWST: You also have several energy companies in your portfolio. That is another sector that seems to get a lot of attention. Can you tell us about those holdings?

Mr. Buchwald: If you look at what sectors jump out at you in terms of dividend yield, the energy sector is front and center. The energy sector has been beat up a little bit over the last couple of weeks, first and foremost because oil prices have come down, and if oil prices keep going down, I would suspect those stocks will keep falling.

However, for the energy companies in our portfolio, we are confident that first of all, they are large enough that they can sustain periods where oil prices are weak. They are generating cash flow, which we think will sustain the dividends and therefore make the high-dividend yields very attractive. If you look at the energy stocks in our portfolio, some of their yields are now between 5% to almost 7%.

And what I think we are also seeing in the energy sector in large multinationals is a reversal in terms of how they look at their business, meaning that they are no longer just saying we're going to grow our production at X%, which is what used to be the magic bullet. These companies are now more closely looking at improving returns on capital, which means they are shutting down or selling properties that aren't meeting minimum returns on investment criteria.

1-Year Daily Chart of British American Tobacco plc

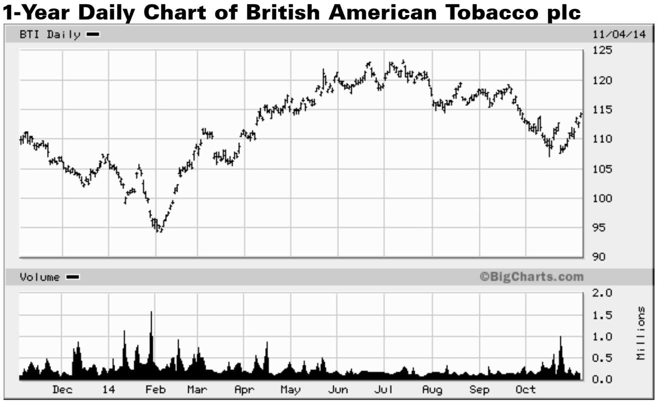

Chart provided by www.BigCharts.com

Their balance sheets are getting into better shape because of that, and their capital expenditure levels are coming down. It is a better model for the investor going forward. It is an industry that is in flux, but in a good way I think in terms of management oversight and discipline. They will have issues as long as OPEC remains undisciplined and doesn't adjust production levels, but at some point, that likely will change.

TWST: You talked a little bit about when you sell stocks, but can you expand on your sell discipline a bit?

Mr. Kline: We sell based on relative valuation, meaning we find something that's more attractive on a yield basis. Additionally, we will sell if an event or events affects the business in a negative way that may have implications for the dividend. For example, this year we sold **BNP Paribas** (BNP.PA), which is the largest bank in France. They had been in the news quite a bit because it was alleged they had violated U.S. sanctions on doing business with Iran.

At the time, in *The Wall Street Journal*, there were reports that fines could be as high as $9 billion to $10 billion. There were others who estimated the fine would only be $3 billion to $4 billion. We were concerned if it was near the higher level that they would have to cut or eliminate the dividend, and also, there was a possibility that they would lose their U.S. banking license. France warned that this could bring down the banking industry in France and lobbied against harsh sanctions of course.

Nevertheless, because of our concern of what would happen if there was a large penalty, we sold the stock. After we sold it, **BNP Paribas** was the first banking company ever to have to pay a criminal fine, around $9 billion. They didn't lose their U.S. banking license, but they are restricted on what transactions they can do in the U.S. for at least a year. They have said that they have enough capital to pay the dividend, and we will see, because since that came out a few weeks ago, there were significant changes in the management of the part of the business that was doing illegal trades with Iran.

So I don't know whether new management will decide to build up capital to a higher level before they continue to pay out the same dividend level. Certainly, we don't expect the dividend to increase, and they pay the dividend once a year, so we are not going to know for a long time what their plans are as far as the dividend. The stock has sold off somewhat since we sold it, but we're still keeping our eye on it.

Mr. Buchwald: And I would also add that part of the reason we sold it was because our initial thesis was that the dividend, which was only marginally above our minimum threshold when we bought it, was likely to be raised substantially over time because they appeared to have excess capital. But once this financial penalty became an issue, the excess capital essentially disappeared, which meant the dividend wouldn't be going up and possibly would be going down.

TWST: In the second quarter, you commented that there was a lot of liquidity in the markets and level of compliance seemed high. Is that still the case, and does that impact your investment decisions?

Mr. Kline: We don't manage the portfolio based on our expectations for what the markets will do, which doesn't mean we can't have opinions about it. But we make sure that we do not make any investment decisions based on a market forecast. It doesn't take much for something to suddenly come up that people don't expect, whether it is ISIS or troubles in Ukraine or a slowing economy. All those things can change investor perceptions quickly and are completely unpredictable. We are seeing that now. We don't know if that is going to continue or not, but volatility has certainly picked up in the last couple days from where it was.

TWST: What do you see as the most important strengths of your firm and your process?

Mr. Buchwald: I think probably there are two things. One is I think our general approach has been a high-dividend-yield approach. We are still one of only a few international managers that do that. History has proven that is an effective strategy, but for that approach to be effective, you have to be willing to live through some times when perhaps you're underperforming. Stated differently, you have to have a long time horizon.

We work at a firm where we are fortunate enough that day-to-day or quarter-to-quarter fluctuations are not going to change anything for us in the way we manage our portfolio. So we think being able to implement our approach on a consistent, long-term basis gives us an advantage over those who perhaps are under more pressure to perform under a much shorter time horizon. Our portfolio turnover is only about 10% to 20% annually, which means we are not being hasty in our decisions, and we are not reacting to the winds of change.

TWST: Thank you. (LMR)

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