

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Systematic Valuation Discipline



DAVID POLEN, Founder and CEO of Polen Capital Management, is the firm's Chief Investment Officer. He is the creator of its proprietary Systematic Valuation Discipline. Mr. Polen has a BA from Brooklyn College and over 35 years of experience in the investment business. He has been quoted in Barron's, The Wall Street Journal, Investor's Business Daily and other national financial media. He is listed in Marquis Who's Who in the World and Who's Who in Finance and Industry.

TWST: Would you start with an overview of Polen Capital Management and its investment philosophy?

Mr. Polen: Polen Capital Management is a registered investment advisor and it operates in a very conventional way. We manage equity portfolios for institutional and high net worth investors. This is the 19th year that we have operated our business this way. Personally, this is my 40th year in the investment industry, having done various other jobs as an analyst and stockbroker prior to the 20 years that I have managed Polen Capital's portfolios.

TWST: What is the investment style?

Mr. Polen: It is a purely bottom-up style of large cap growth investing that is very firmly rooted in the intellectual framework provided by Benjamin Graham and Warren Buffett.

TWST: It's a growth style with a valuation basis — is that how you describe it?

Mr. Polen: Exactly. I would say that the terms value and growth have become deeply engrained in the Wall Street vocabulary, but those words do not really tell you much about how people really go about investing. I would say that we are growth investors and we believe that we will benefit from the growth of the underlying value

of the businesses that we invest in over time. The key is to invest in value-creating businesses and to pay no more than a fair price. We go through a very disciplined process of evaluating the facts to determine the underlying or intrinsic value of the business and the rate at which we believe the intrinsic value will grow over time.

TWST: These are turbulent times in the stock market. With the crises in housing and mortgages and everything else, what is the environment like at this time for your type of investing?

Mr. Polen: The old saying is, "The more things change, the more they stay the same." The markets, which are free markets, obviously, are much deeper, wider and more complex than they were in my personal experience going back five, 10, 20 or 40 years ago. I don't think this trend toward greater complexity and variability, which creates volatility, is going to go away. This trend seems to become even more pronounced as the years go by.

We operate basically in the same way that we always have, looking for the intrinsic value and the quality of the businesses rather than trying to deal with the vagaries of the marketplace, as complex as they are. We try to take a simple approach, and this has worked very well over the years. Again, we go back to the roots of

the Graham and Buffett mentality, which tends not to ignore the market, but to deal with it in a way such that the quality of the businesses invested in are a much more important part of the formula than existing trends in the market.

looking at companies that have met our very stringent criteria for very high quality financial statements. We are looking at companies that have very little debt, lots of capital on their balance sheets, and are in most cases very highly rated by the rating services or by any

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TWST: Getting back to your investment process, when we last talked to you, you talked about your Systematic Valuation Discipline. Do you still incorporate that into your process?

Mr. Polen: It is at the core of all of our thinking. It always has been and it always will be. The Systematic Valuation Discipline is really my interpolation (and now the rest of the team that works with me) of the Graham/Buffett mentality and how we apply it to our particular task. The Systemic Valuation Discipline is really the definition of that.

TWST: Would you explain that and tell us what investment criteria you’re looking for in your potential holdings?

Mr. Polen: It’s important to note initially that the concept of margin of safety turns out to be the most important concept in investing. That’s not exactly a secret because it’s all over the books that Benjamin Graham wrote more than 50 years ago. Warren Buffett has also said numerous times over the many years that he’s been a public commentator that the words “margin of safety” are the three most important words in the investment world. To not lose in an equity portfolio or in a particular stock investment is the most important thing. Therefore, to make sure that we do not violate that concept of not losing, we are reducing a large universe of companies down to a much smaller universe that we believe are of the highest quality from an investment standpoint. That is actually how the Systematic Valuation Discipline came about in the first place.

The companies that meet the requirements of the Systematic Valuation Discipline have been screened on various criteria, which I can enumerate for you. First is the balance sheet itself. We are only

1-Year Daily Chart of Abbott Laboratories



Chart provided by www.BigCharts.com

analyst who would be doing an analysis of the business. It would be very clear and immediately apparent just by looking at the balance sheet that this particular company was of very high quality. That is always in place in our portfolio on every stock we look at it.

Second, we are looking at companies that produce a lot of free cash flow. Free cash flow is simply the excess cash that the company is producing net of all costs, expenses or uses of that cash. Kind of a simplistic analogy would be an individual earning and saving a lot of his earnings each year, putting it into a bank account or into an investment portfolio, and then finding out after a number of years that he has a serious net worth. That is how the balance sheet of a business is built up, by reinvesting the free cash flow as I just defined it back into the business.

The next thing that we evaluate in the Systematic Valuation Discipline is the return on equity or return on capital. This is the rate of return that the business is able to earn on the capital that has been employed in the business. Those businesses that over time can continuously earn very high rates of return on their investments, or what's called "capital" and "equity" in the accounting world, are even stronger businesses. If a business can fend off competition and continue to earn high rates of return, then it is likely a very, very strong business. That is the type of business that we look at.

In addition, we are looking at companies that have very high quality management teams that have proven to be veterans of what they do and to be shareholder oriented. In many cases, the free cash flow produced by these high quality businesses is so large that it needs to be returned to the shareholders. Many companies accom-

been pretty narrow. Probably most of the time it's actually been close to 19 to 20. It's actually 19 at the present moment.

TWST: Do you invest in international stocks or do you mostly concentrate on multinational corporations that have international operations?

Mr. Polen: Most of the companies that we own in our portfolio now, which is very similar to what we have owned throughout our history, are companies that are positioned at least to some serious extent internationally. But in all cases, at the present moment, these are American-domiciled companies. As one of the more extreme examples within our portfolio, **Coca-Cola** (KO) earns about 80% of its profits outside of the United States. While **Coca-Cola** is definitely an American company, it is truly an international company as well. In most cases, we are investing in multinational businesses.

"Alcon is the leading eye care company in terms of surgical procedures and eye care pharmaceuticals in the world. Alcon is an extremely high quality company and could certainly be considered in the blue chip category. Alcon has really dominated the eye care space. It has continued to reinvest in their technology and their development programs, and has tremendous growth potential in front of it on a worldwide basis."

plish this by paying a dividend, and it has also become popular over the last 10 to 12 years to use that free cash flow to repurchase outstanding shares in the marketplace.

When you combine all those factors, you're going to be looking at a universe of potential candidates for your portfolio that includes companies that have very, very high quality franchises in whatever industry they may be in. In actuality, all the companies that we have invested in over the years are leaders in their particular industries, certainly on a domestic basis and most even on an international basis. Our intention is to be a long-term investor in these high quality businesses where strong free cash flow produces outstanding returns on capital, and at the same time to take fewer risks than most people do.

TWST: How many holdings generally do you have in the portfolio? Does the number fluctuate according to market conditions?

Mr. Polen: Not that much. We have held as few as 16 positions during the past 10 years and as many as 23. So the range has

1-Year Daily Chart of Alcon



Chart provided by www.BigCharts.com

TWST: Would you tell us about some of your holdings and why you feel they are representative of your investment approach?

Mr. Polen: First of all, we started investing in 1989, and we have not changed our orientation since that day and do not plan

to change it. Our mission is to beat the S&P 500, which we believe is a good proxy for the stock market, and most other money managers, in terms of rates of return over periods of time. In other words, our mission is to produce higher rates of return than the market and most other money managers, while at the same time taking no more than moderate risk. That has been our mission since day one and it continues to be.

As I said just a moment ago, we on average have held 20 stocks in our portfolio, which in the investment management business is considered to be a highly concentrated portfolio. “Concentrated” is not the term that I created and I think it is important to point out that we do not believe that concentrating the portfolio in fewer positions increases risk, as many people may believe. The concept that diver-

and most of the money managers by quite a bit. Now let’s discuss some of our recent stock selections.

One of our recent additions to the portfolio was **Abbott Labs** (ABT), which is a major diversified healthcare company with a substantial pharmaceutical business. **Abbott** would be considered by most to be a blue chip company. We added **Abbott** to the portfolio earlier this year. Just in the last year or so, the company has been very aggressive in the marketplace, making some key acquisitions in the cardiology area. It has also continued to restructure their total portfolio to create an enterprise that’s geared for greater growth than they have had in past years, which has actually been very steady and quite respectable. **Abbott** seems to be prepared for the future in an area that still has a lot of growth potential.

“Bard is a major player in the urological area and also has a significant presence in the cancer care, vascular, and other specialty surgical businesses, selling a broad portfolio of leading products. The company has been very aggressive in terms of increasing research and developments and expanding its product portfolio, and has tremendous growth opportunities in the healthcare setting.”

sification reduces the chance of loss or reduces risk is certainly promoted by some modern finance theories and by the world of insurance. We have a different view and our historical record supports our view.

If one looks closely at Polen Capital’s 19 years of verified statistics, we have actually taken less risk than 99% of all large cap growth managers. As of December 31 of this year, we will have completed 19 years of taking less risk statistically than almost all managers and the market, while holding far fewer stocks than almost all of them as well. That seems to be adverse to the concept of diversification creating less risk.

TWST: What are a couple of the stocks that you have added most recently to your portfolio?

Mr. Polen: If I might, for a second, before I answer that, fill in on what I just said. The reason, I believe, that we have proven to take less risk while having what is considered to be a highly concentrated portfolio is that the Systematic Valuation Discipline itself reduced our choices to only very, very high quality companies. During down markets, Polen Capital has outperformed the market

1-Year Daily Chart of C.R. Bard

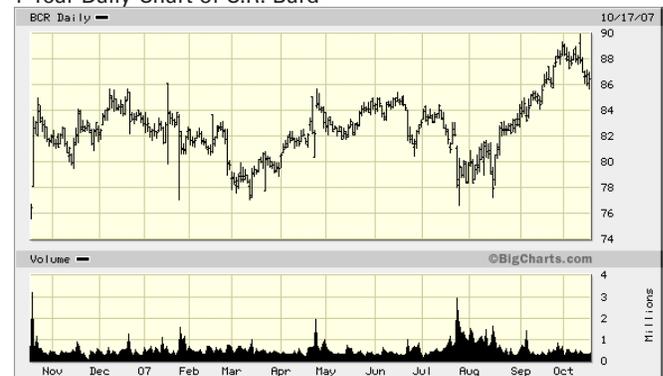


Chart provided by www.BigCharts.com

We have also added, in the healthcare area, **Alcon** (ACL), which is the leading eye care company in terms of surgical procedures and eye care pharmaceuticals in the world. **Alcon**, which is 75% owned by **Nestle** (NSRGY), is an extremely high quality company and could certainly be considered in the blue chip category. **Alcon** has really dominated the eye care space. It has continued to

reinvest in their technology and their development programs, and has tremendous growth potential in front of it on a worldwide basis. It is a major player in the US and throughout the world, with a significant presence in many fast growing emerging markets.

We have also invested this year in a company called **C.R. Bard** (BCR), which is a diversified healthcare products company. **Bard** is a major player in the urological area and also has a significant presence in the cancer care, vascular and other specialty surgical businesses, selling a broad portfolio of leading products. The

computers and cell phones. So **Adobe** and **Autodesk** have tremendous histories in the technology area just over the past eight, 10 years, but the future looks even brighter. We've positioned ourselves very strongly again in both the technology area and the healthcare area, and each one of these companies meets our Systematic Valuation Discipline criteria. Our thought process is that we will be staying with these companies for many years to come as they garner the opportunities that are in front of them at this moment and continue to develop at a very rapid pace.

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company has been very aggressive in terms of increasing research and developments and expanding its product portfolio, and has tremendous growth opportunities in the healthcare setting.

As you can see, we have had great success over many years at Polen Capital investing in high quality healthcare companies, and we continue to believe that the future will bring excellent returns to investors in the right companies over the next five, 10 or 15 years. We've positioned ourselves in that way, as we have in the past.

We have also had great success in the technology area over the years and have added some leading technology companies to our portfolio during the last year or so. By the way, we have been a holder of **Microsoft** (MSFT) for the last 14 years, and it is still one of the major positions within our portfolio. Increasing our rather large position in technology, we added software companies, **Autodesk** (ADSK) and **Adobe** (ADBE) to the portfolio. These are both great companies that are very well positioned for the future. **Autodesk** is a leader in the CAD/CAM area, which is software that’s provided to the infrastructure, construction and design industries. **Autodesk’s** leading products are used all over the world, helping engineers and graphic designers in various industries work more efficiently.

We also added **Adobe Systems** to our portfolio, which is the leading company in the world in desktop publishing and document creation and delivery. **Adobe** is also the leading company in the world in flash, which is the software that is used to create and deliver the multimedia content that we view on the internet through our

1-Year Daily Chart of Autodesk



Chart provided by www.BigCharts.com

TWST: You have to change every so often. What does trigger an exit from your portfolio? What is the sell discipline?

Mr. Polen: The sell discipline in reality is incorporated within the Systematic Valuation Discipline itself. As I said, when I laid it out for you, it is very, very heavily based on the financial statements of the business, on the history of the business, but it is also based on the returns that are being earned currently on their investments, on the capability of the management team and on how well they are treating their shareholders.

Each one of these criteria are important and if the business continues to satisfy these requirements and the price of the stock

remains within a certain range of what we feel is the intrinsic value of the business, then we will typically continue to hold the position unless we find an even better opportunity. Turning that thought process upside down, there are several possible reasons that we would sell a position. For one, if the price of the stock just gets too far ahead

where it is a \$300 billion market cap company that has their product on just about everyone's computer now. This could not have possibly happened 30 or 40 years ago. As the dynamics of marketplaces change, we have to constantly evaluate the landscape and make adjustments to our portfolio that deal with these rapid changes.

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of the value of the business, which does happen from time to time, then we will sell based on valuation. In that instance, you are really selling the stock because it went up too much. That is rare, but it does happen from time to time, and that's actually not a bad thing.

Another reason that we may sell is if a company loses some momentum or credibility in terms of the stringent qualities or quantifications of the Systematic Valuation Discipline. This would certainly light up some yellow lights, if not some red lights, and we would take a very, very close look at the business itself again to see if there is a violation, let's say, of our thought process going forward on that business. That would create a possibility of a sale. While we only invest in very high quality businesses, which rarely deteriorate in any significant way, even great businesses lose a step or two from time to time.

Another thing that requires the constant re-evaluation of our holdings is that things are changing in the economy itself. I believe that the world economy has become more dynamic, that technology itself is driving part of that, and that because change comes more rapidly, the life cycles of even the greatest companies are much shorter than they were certainly 20 or 30 years ago.

Google (GOOG), a world leader today, didn't even exist 10 years ago. Now it's one of the largest capitalization companies in the world and, of course, one of the most popularly traded common stocks. **Microsoft**, which was founded really 25 years ago by Bill Gates, is now a mature blue chip company. We still hold it in our portfolio, but we don't see it is as the same great growth company that it was 15 years ago when we first bought it. Although it still fits in our portfolio as a quality investment, it has certainly matured to the point

1-Year Daily Chart of Adobe Systems

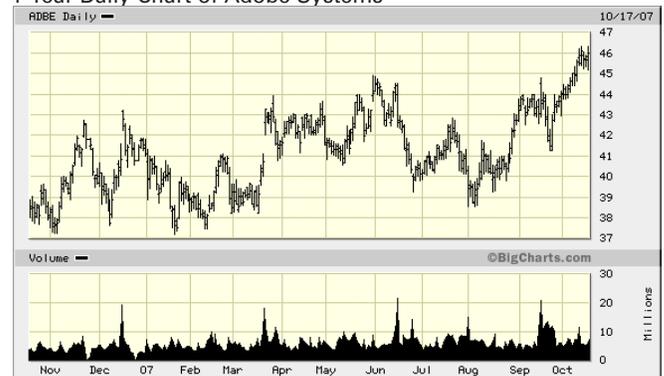


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TWST: What do you think differentiates or distinguishes the investment approach at your firm from that at other firms with a similar style?

Mr. Polen: I would say the absolute discipline that we abide by, the Systematic Valuation Discipline, is not just a model or just a statement. It is a belief. It is the root of everything that we do, and I believe that in the 19 years that we have been employing it, we have not violated our discipline. I believe that investing is basically an intellectual exercise that is constantly being challenged by the emotions. The intellectual part of it is doable by people who are trained and have the experience to make investment decisions, and the way that we do it could probably be done by many other people. But if you do not have the discipline to deal with the emotional aspect of it, then you are going to have difficulties in this business.

I believe that when one studies the track record of Polen Capital, and looks at the incredible statistics we have in terms of protecting capital on the downside in relation to the entire group of large cap money managers, and really all money managers, one will see why we are in the top 1%. This is a function of the discipline that we have, which we continue to exercise every day. Consistently maintaining this discipline is the most difficult part of the formula, and I think that is what we have excelled at the most.

TWST: What advice would you give to investors about entering the market at this time?

Mr. Polen: I think that this time would be as good as any other time or as bad as any other time. I have, as I said, been at this business for 40 years now, so I have been through all kinds of times. That's a long time to be at one trade, and I have done it every day. I couldn't tell you that I knew any particular day, whether it was today or 10, 15, 20 or 40 years ago that actually would have been the right day for someone to invest. The right thing to do is to enter the investment scene, whether you are just an individual investor, someone who might be approaching it on a career basis, or a professional investor already working to hone your skill set.

I don't believe that it is that difficult to design or follow a basic investment process. You just have to take that part of it very, very seriously and at the same time you have to embrace the margin of safety concept and make sure that whatever it is you are doing does not allow for the chance of loss to any greater extent than is necessary and certainly relevant to the reward that you are looking

for. I think the importance of maintaining a margin of safety in investing is an area that most people underestimate because there are times when the market is doing very, very well and you can buy some stocks and they're going to go up whether there is a margin of safety or not. When this happens it is even more tempting to believe that investing is easier than you thought and then you find that you have put yourself in a bad position when the reverse happens, which can create disasters. We have all read about it or even personally experienced it. One of the great problems of the investment world is that people enter it, whether on their own or through managers or mutual funds or whatever, but really do not clearly understand the risk that they are taking.

TWST: Thank you.

Note: Opinions and recommendations are as of 10/17/07.

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