

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

“Margin of Safety” Growth Investing



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TWST: Would you start with an overview of Polen Capital Management and your responsibilities there?

Mr. Davidowitz: Polen Capital Management is a registered investment advisor. For 20 years we have managed one product, which is a large cap growth portfolio for high net worth individuals and institutional clients. I'm a co-portfolio manager with David Polen, who is our CEO and Founder. I'm also a research analyst along with two other research analysts that we have internally.

TWST: Tell us about your investment philosophy and about your definition of growth.

Mr. Davidowitz: We believe that by investing in great growth companies, we can outperform the market and most other money managers while taking only moderate risk. We invest our portfolio in a concentrated way. That is to say, we only own between 15 and 25 stocks at any particular time. We take the Ben Graham and Warren Buffett margin of safety principle and apply it to growth stock investing, which we believe differentiates us from our peers. We invest in the best growth franchises available in the market as a way of compounding wealth for our clients.

When David Polen started our firm about 20 years ago, he developed the Systematic Valuation Discipline, which is the core of our investment philosophy.

TWST: Would you tell us about the Systematic Valuation Discipline?

Mr. Davidowitz: After a long period of continuous learning about what works in investing in common stocks, David Polen figured out that there are certain hallmarks to identifying great businesses that grow for long periods of time. These characteristics embody the Systematic Valuation Discipline. They are exceptionally strong balance sheets, meaning little or no debt; very high and sustainable returns on equity; tremendous free cash flow, well in excess of what is required to run the business; vibrant earnings growth; and a trustworthy and shareholder-oriented management team. If a company possesses each of these criteria, it most likely has a competitive advantage and it is our job to figure out if it is indeed sustainable and defensible.

Then we use various valuation techniques in order to determine whether or not these great growth companies are available at an attractive price.

TWST: What are those metrics? What do you specifically look for in growth stocks?

Mr. Davidowitz: We use a couple of different ones. We look at absolute and relative valuation on an earnings or free cash flow yield basis. We also have our own proprietary models that basically act like discounted cash flow models that force us to make an assessment of what the likely growth rate of a company's earnings will be for the next five to 10 years. Theoretically, a company's return on equity would be the rate at which it compounds its earnings growth. Unfortunately, most companies cannot reinvest all of their earnings at their return on equity so we have to make conservative

The companies that we are investing in, for instance, **Varian Medical** (VAR) or **Alcon** (ACL), are not going to be substantially affected by what's going on in the economy. Even in technology, most companies are at least somewhat cyclical, but when you look at a company like **QUALCOMM** (QCOM), it is really a secular growth story right now. While there are some cyclical elements to it as well, that is really dwarfed by the industry's move to their third generation wireless technology. Most of the companies that we are investing in are less cyclical than the average business out there. Overall, in a portfolio construct, we tend to have more stable, secular growth versus cyclicity.

"Varian Medical dominates the radiation equipment business for treating cancer. We did a lot of work on the company's technology versus its peers and the purchase process of hospitals and determined that Varian's dominant market share was set to accelerate."

assumptions on the earnings growth rate into the future in order to assess whether or not the current valuation is indeed a good deal or not. We put all of the companies we cover on a level playing field by doing this for each of them. We also have other cash flow based models that assess such things as whether or not an LBO would be economically feasible based on a company's current cash generating capacity relative to its current valuation. In the end we are looking for robust and sustainable earnings growth.

TWST: This last 12 months, even high quality companies, like the ones you are looking for, have been suffering. How is the climate at this time for your style of investing?

Mr. Davidowitz: Certainly in a market like we are in now it's hard to be totally impervious to what's going on. The reverberations of the difficulties in the financial markets, the credit markets specifically, are now bleeding into the consumer sector and so much of the US economy is concentrated in those sectors. It just so happens that we haven't had a material exposure to those sectors because our research effort has not turned up anything in those areas that we believe is a great growth business with little risk of capital loss.

We have actually done very well. Over the last 12 months, our portfolio has had a positive return, which is certainly far in excess of the market. This is a testament to the underlying franchises that we invest in. The businesses that we invest in are not very cyclical for the most part; they are secular growers. We invest a lot in health care and technology companies because that's where a lot of the great growth companies happen to be, and we've done that throughout the 20-year track record of Polen Capital. We've always had some pretty decent exposure to those sectors.

1-Year Daily Chart of Varian Medical



Chart provided by www.BigCharts.com

TWST: How have you shifted in emphasis to reflect the events of the past 12 months and have you gotten rid of any companies and bought others?

Mr. Davidowitz: Our historical turnover has been relatively low. As long as David has been running this portfolio, our average annual turnover has run in the 20% to 25% range. Recently it's been a little bit higher than that, which really has a lot to do with market volatility, giving us some new, wonderful opportunities. Certainly we've had a lot of volatility in the market over the last year. It's given us the opportunity to shed some companies that we thought had limited upside left and to trade up into some better opportunities. I believe the moves we have made will add significant value over time.

TWST: What are some other companies that you have bought over the last 12 to 18 months that you feel are reflective of your margin of safety growth investing?

Mr. Davidowitz: I will give you three examples of businesses that we bought in the last 12 months that are definitely exceptional growth companies. The margin of safety in each case relates to our confidence in the earnings growth of these companies. The first

advertising, and search specifically, is far overdone by the market and we are getting one of the best growth companies out there at a very, very attractive price. Our research shows that search advertising, which is **Google's** bread and butter, should at least double worldwide over the next five years as ad spending online catches up with people's time spent online, and no one is seriously challenging **Google's** dominance in any way.

“QUALCOMM had a whole bunch of patent issues and royalty disputes with customers and competitors, and we thought those were more than overly discounted in the marketplace. We bought it at a price where we felt there was very little downside, even if some of those legal issues went against them, and significant upside if they didn't. The company recently settled its biggest legal battle with Nokia, as we expected.”

two of these I previously mentioned. We bought **Varian Medical** this past year. It's a company that dominates the radiation equipment business for treating cancer. That stock has been swung around pretty heavily on some temporary market share shifts in their business and concerns about whether or not the credit crisis would impair hospitals' ability to purchase radiation equipment that is expensive and often requires financing. We did a lot of work on the company's technology versus its peers and the purchase process of hospitals and determined that **Varian's** dominant market share was set to accelerate. We also concluded that hospitals were not having any problems financing radiation oncology equipment because radiation procedures are very profitable and the payback for the new machinery is very quick. We bought the stock and have continued to add to it. It is now our largest holding.

We also bought **QUALCOMM** about six months ago. The concerns here were not so much about the economy with **QUALCOMM**, but their legal issues. They've had a whole bunch of patent issues and royalty disputes with customers and competitors, and we thought those were more than overly discounted in the marketplace. We bought it at a price where we felt there was very little downside, even if some of those legal issues went against them, and significant upside if they didn't. The company recently settled its biggest legal battle with **Nokia (NOK)**, as we expected. With the **Nokia** dispute out of the way, the company can now completely focus on its strong growth opportunities in its wireless royalty and chipset businesses.

Another stock we recently purchased, which I think is beaten down more than deserved, is **Google (GOOG)**. We watched **Google** for a long time, but purchased it for the first time about two quarters ago. We think the concern about a slowdown in Web-based

1-Year Daily Chart of QUALCOMM



Chart provided by www.BigCharts.com

1-Year Daily Chart of Google



Chart provided by www.BigCharts.com

Those are three examples of recent purchases that we have made where we have taken advantage of the volatility in the marketplace to buy great franchises at attractive valuations. The margin of safety is in their competitively advantaged businesses and in each case the discounted purchase price gave us another margin of safety, a belt and suspenders, if you will.

TWST: You also mentioned Alcon, which is the ocular health company.

Mr. Davidowitz: Right, we have held **Alcon** for about a year and a half now, it dominates the markets for ophthalmologic pharmaceuticals, surgical equipment and contact lens solution. No one else is even close.

TWST: Do you have any representation in your concentrated portfolio of financials or consumer stocks that are in decline right now?

Mr. Davidowitz: Not really. The only exposure we have right now to the consumer at all would be **MasterCard** (MA), which we bought about a year ago. Obviously, US consumers are heavy users of their cards and a slowdown in spending will have some effect on **MasterCard**, but **MasterCard** is a processor, not a lender. They get paid a small amount for each transaction processed on its network and have no exposure to credit risk. This is another one of

of 50% over the next few years. That will provide exceptional earnings growth for this company in an industry that has virtually insurmountable barriers to entry. It is somewhat consumer and maybe somewhat financial, but with no credit risk.

TWST: What about the industrial companies that have been benefiting from globalization? Are they represented in your portfolio?

Mr. Davidowitz: Not really. We haven't had much in the way of industrial companies in the last couple of years and not at all in energy and materials. In the history of Polen Capital, I don't think we have ever owned a materials or energy company. Certainly those have been headwinds to our relative performance, but we have done very well without them. We run a concentrated portfolio. We are bottom-up stock pickers. We do not try to match our portfolio's exposure to that of any index. We've had exceptional performance over a very long measurement period, regardless of which industry or sectors are doing well, just by consistently picking good stocks. As an example, if you look at **MasterCard**, which is up almost 100% from where we bought it, we didn't consciously go in looking for exposure to a sector of the index or anything. We constructed an investment thesis and thought there was a lot of upside. We will never really look like an index with a 20 stock portfolio and we believe that is a huge

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these secular growth stories. The shift from paper-based payment via cash or checks to credit or debit cards really drives the growth story with **MasterCard**, especially outside of the US. There may be some cyclical slowing, but it's still going to be growing very quickly on this secular trend.

The real boost to **MasterCard**, though, is coming from margin expansion. It was not a publicly traded entity up until about two years ago and while previously owned by a consortium of banks, there was no incentive to maximize the processor's profit, only to generate credit card receivables for the banks. Now management has the incentive to let the true economics of **MasterCard** flow through. This is a fixed cost business, with big-time operating leverage. When it came public, **MasterCard** had margins of about 17%. It is now about 35% just two years later and we believe margins can get north

1-Year Daily Chart of MasterCard



Chart provided by www.BigCharts.com

advantage for us. In the 20-year history of Polen Capital, it has been a big, big benefit.

TWST: Why have you not been interested in energy and materials? Is it because of the margin of safety issue or because you consider them cyclical?

Mr. Davidowitz: They are kind of tied together. We actually don't have a top-down bias against energy or material stocks. If we thought that there was a really great sustainable growth fran-

10% that you can count on year-in and year-out. That sustainable growth and the length of growth is just as important sometimes as the rate of growth.

We don't own them today. We realized some nice gains from them during the last few years, but we simply found some better opportunities that we felt had more upside over the next five years. Our sale proceeds went into the names that I mentioned before, the **Varians** and **QUALCOMMs** and **Googles** of the world.

"There are some wonderful consumer franchises out there. If we can get companies that meet our rigorous thresholds, we will invest in them, even though sometimes the actual earnings growth may be a little bit slower than what we would normally look for. A company like Coca-Cola is doing a little bit better than 10% earnings growth year-in, year-out, but it is 10% that you can count on year-in and year-out. That sustainable growth and the length of growth is just as important sometimes as the rate of growth."

chise in one of those companies, we would definitely include it. In fact, in our coverage universe, we do cover a few energy and a few materials companies that do meet our criteria for investment on a statistical basis. But we have to really be sure that there is sustainable growth there. We think like business owners, we tend to hold stocks for at least five years, and that's our intention when we go into them. If we thought we were buying a stock where things are going great, but five years from now might not look anywhere near as good, it would be very hard for us to invest that way. We have to be very sure that there is a sustainable growth engine and we just haven't found one that we totally believe in yet but it doesn't mean we won't.

We maintain an open mind and if we think there is something there that is sustainable in energy or materials or industries that feed into those sectors we would consider it.

TWST: Do you invest in consumer staples as opposed to the discretionary stocks?

Mr. Davidowitz: We have historically. There are some wonderful consumer franchises out there. We were in **Coca-Cola** (KO) and **PepsiCo** (PEP), which I would consider staple-type stocks. If we can get companies that meet our rigorous thresholds, we will invest in them, even though sometimes the actual earnings growth may be a little bit slower than what we would normally look for. But the sustainability and the length of growth sometimes can be the overarching factors. A company like **Coca-Cola** is doing a little bit better than 10% earnings growth year-in, year-out, but it is

1-Year Daily Chart of Alcon



Chart provided by www.BigCharts.com

TWST: What triggers a sale from your portfolio? Do you set price targets?

Mr. Davidowitz: No, we don't set price targets because we don't want to put any false precision around valuation. We have a general idea of what each one of our companies should be worth, but we don't set a hard and fast target. We have a range in mind. And as far as selling, we normally run pretty fully invested most of the time. By far the most frequent reason we sell anything is because we've come up with a better idea. Since we typically own about 20 stocks, if we come up with one or two new ideas, then we usually have to sell or trim something to make room in the portfolio. That is by far the most common reason we sell.

There are three other reasons we might sell a position. First there is valuation. If we think something has just gotten way ahead of itself, we would sell it. We will also sell something if the situation has deteriorated. If our investment thesis on the franchise or the growth of the business turns out to be wrong or if situation has gotten remarkably worse for some reason, we will exit the position immediately. Then last is really just for risk management. We do run a concentrated portfolio, so a big winner may grow to be a substantial position. We won't typically let any individual position go over 10% of the portfolio. We did have one instance of that last year when **MasterCard** got right up against that 10% area and we trimmed it back. Those are the reasons we usually sell something.

TWST: Do you invest at all in international companies, any ADRs?

Mr. Davidowitz: We do invest in international companies. We own **Alcon**. While not an ADR, it is a Swiss company with a listing on the New York Stock Exchange. We have actually considered investing in several ADRs in the past. We have to make sure that we understand the accounting when it is not reported according to US generally accepted accounting principles (GAAP) and that we understand any country-specific regulation that would affect the business. If there are issues that we just cannot get our arms around, we won't pursue it, but if we can get comfortable that we understand the accounting and that the business is a great franchise, we will take it very seriously.

Mr. Davidowitz: I think most of the way that we control risk is at the individual security level. As I've said, we are bottom-up stock pickers and we do take them one at a time. We are consciously looking at these franchisees, to figure out which are the best 20 to own. We are always looking at what is our opportunity set out there and how can we best capitalize on it. It's a one-at-a-time process, thinking about the next five years. We always start with, "Is it possible that we could have a permanent capital loss on this investment?" and if the answer is yes, we don't move to step two. It just kills the idea right there.

If we think there is very little chance of a permanent capital loss, then we say, "Okay, now what's our upside here?" and we measure the magnitude of the upside, but also the probability of the upside to figure out which 20 to invest in. That's where most of our risk management comes in. Secondly, of course, you may end up with a lot of ideas that are fairly similar based on something that's going on in a particular industry. We will always be careful not to have too much overlap between our companies. Even though we do have a heavy concentration in health care and technology, the underlying companies are driven by very different factors. We will always be cognizant of that. We also won't let any particular sector be over 50% of the portfolio. Those kinds of things come in afterwards, but it's mostly a one-at-a-time, stock-by-stock thought process and also thinking strategically about where the business is going. That provides the bulk of the risk management.

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We will consider companies that are not based in the United States. The other thing to remember is that most of our companies are global in nature anyway. Where they are domiciled is really not much of a concern. As long as we can understand the company and the accounting and such, we will consider it.

TWST: Clearly with the Systematic Valuation Discipline and the margin of safety metrics that you employ, you are very conscious of controlling risk as much as possible. Are there other ways that you try to control risk at the portfolio level or at the individual security level?

TWST: What do you think gives Polen Capital Management its edge? What is distinctive about your approach to large cap growth investing that differentiates you from other peer companies?

Mr. Davidowitz: It's really simple. I think there are very few people that apply the margin of safety concept to growth stock investing as we do. We believe most people who talk about margin of safety are well steeped in a discipline that is solely valuation driven. I think we apply the margin of safety concept more in the sustainability of the franchise and the likelihood of robust earnings

growth. We spend a lot more time on competitive dynamics than valuation. Valuation is still very important, but first we have to determine the quality of the business, then how much it's worth. So I think the way we apply that margin of safety concept may be different than most people do it, because we really limit the potential for loss. We think that the concentrated nature of our portfolio allows the winners to really make a meaningful impact on the portfolio.

If you apply a margin of safety to great growth stories that compound earnings at a high rate for a long period of time, you minimize your chance of loss. In that case, you should concentrate on your best ideas and allow the winners to run and we do that. If you combine the two, concentration and the margin of safety in growth stocks, you're kind of unique. There are not that many people who do that.

When you think about Polen Capital, we've been around for 20 years doing the same thing, with a track record since inception that puts us in the top decile, probably in the top percentile versus our large cap growth peers, while taking less risk. That is, if you look at the risk metrics for the same time, they also put us near the very top of the pack in terms of least risk taken. It seems kind of counterintuitive that you could have a concentrated portfolio of growth stocks with high returns and that you could also have taken less risk, but that's exactly what we've done.

TWST: Are there any potential problem areas or challenges ahead that investors should be wary of now as we reach the last four months of this year?

Mr. Davidowitz: I think we just always have to keep in mind the lessons of the past. We've seen time and time again that excessive greed leads to bad outcomes. From the Nifty Fifty, to the Internet Bubble, to the Housing Bubble, people keep making the same mistakes over and over. It's actually normal human behavior that leads to bubbles based on greed and the comfort of the crowd. I think it is important to always be mindful of those types of things and not to get caught up in them. Certainly, the market is now paying the price for the excessive greed in the housing market and for lax credit standards over the past decade. But I think prudent investing in high quality companies is a time-tested approach and should succeed across market cycles and I think if investors do that, they will get through just fine. It is a harder discipline to stick to than it sounds.

TWST: Your advice is to be prudent, but there are still opportunities out there in large cap growth stocks.

Mr. Davidowitz: Yes, absolutely. We are still finding good ideas out there and if you only invest in great companies, especially at good prices, you'd be hard pressed to do poorly given a long enough time frame.

TWST: Is there anything that you want to add?

Mr. Davidowitz: I would just say that we've been doing one thing and one thing only for our entire history and we continue to do the same thing today. Our investment philosophy is based on the lessons of Ben Graham and applying them to great growth stocks. We are looking to compound wealth through earnings growth, but we make sure that we are doing it in companies where there is very little chance that advantages will be competed away to impair their growth. We believe we are taking less risk than most while earning a very strong return. It really comes through in bear markets like this. The market is punishing a lot of companies right now, but our companies are outperforming. Our downside is likely limited because we are investing in high quality companies that will continue to grow. It's been our discipline for 20 years and will continue to be for the next 20.

TWST: Thank you.

Note: Opinions and recommendations are as of 9/10/08.

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