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THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Investing in High Quality Value Companies

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TWST: Would you start with an overview of Delta Asset Management and its investment philosophy?

Mr. Conaway: Delta has been in business since 1989. Two of the principals of the firm, Myron Mall and I, started the firm. We came out of a bank environment. In 2001, we sold a majority interest to WealthTrust based in Nashville, which owns interests in a number of other investment management firms. With the principals here still owning a significant portion of the company, we're currently managing $450 million, of which about two-thirds is in stocks and another third is in bonds.

We have approximately 300 relationships, and about half of our accounts are purely stock portfolios, another 40% are balanced and the remaining 10% are bond portfolios. So we've got a good asset base that gives us the resources to pursue our research objectives. We've had good growth over the years. We're primarily a high net worth firm; over 90% of our accounts are individuals, IRAs or IRA rollovers. The remaining 10% are typical pension plans and endowments.

As far as our stock philosophy, we always begin with our goal in managing stocks for our client base — to provide a competitive, long-term return while minimizing the risks of achieving that return. We view risk in a couple of different ways: the risk of encountering absolute loss, as well as the volatility of the returns of the portfolio over time. If you look at 10-year periods, we've been able to achieve our objectives. We've generally had a long-term return in our stock portfolio that has been in excess of the S&P 500. At the same time, our standard deviation of returns has been much less and we have avoided absolute losses such as those experienced by technology stocks coming out of the late 1990s. In practical terms, this has meant that on average over the last 25 years, we have protected principal in flat to down markets and have held in there in up markets.

The reason we've been able to do that is really wound up in the kinds of stocks we purchase, the kinds of companies we invest in and the buy/sell decisions we use to structure our portfolios. In terms of the kinds of stocks we purchase, we are looking for good companies with stocks that are selling on an out-of-favor basis. We think that this type of stock gives us a better risk/return metric, the reason being that we believe there's a basic inefficiency in the market.

Investors are generally myopic. They tend to overemphasize the short term, especially recent information, and they typically ignore very valuable, long-term information. Short-term information would be the typical things the market focuses on — earnings guidance and related misses or outperformance versus that guidance over the current or next quarter. The type of information we think the market pays less attention to is the type of information that we use to analyze companies, basically competitive position and management quality. So we try to take advantage of what we consider to be inefficiencies in the market over time. The types of stocks that we consider out of favor are those in which recent events or perceptions have been fairly negative over the last 12 to 18 months. In most cases, the stock price has declined relative to the market.

When we find those kinds of situations, we try to focus in on it, and that takes us to our second point — the kind of company we invest in. We're looking for a strong competitive position. We think that this is very important; we certainly don't want to invest in a company that is at a disadvantage in terms of their products, either versus their suppliers, buyers, potential entrants or substitute products, or with the companies they compete against. We want to see a company that has a sustainable, competitive advantage at best, and at worst, is not at a disadvantage.

At the same time, we will accept execution issues where the company, for one reason or another, has not executed well recently. If we think that it is not a long-term trend, we also will accept companies that are undergoing economic turbulence from their end markets, or cost factors that we consider temporary. We think these kinds of events are generally short term in nature and a good management is usually able to overcome them, whereas a competitive position that is not of a strong nature is tough to overcome and can take a very long period of time to do.

We also want a company that we can understand. This is sort of the Buffett criterion. We want to be able to understand a company from an operational, financial and a strategic standpoint. We have our five-year test. If we think the company is going to look very different in terms of their business model, competitive dynamics or position in five years, we don't want to invest in that company. It doesn't mean that the company needs to be static, but the basic nature of the company needs to be pretty much the same in five years.

We also need to be able to construct a financial model, which we do on every company we invest in. This weeds out a number of businesses that we just can't understand and put into numbers because of some operational or financial situation. We're looking for a shareholder-oriented management. What we want to see out of the management is a good culture, aggressive business people and a good game plan or strategy that they can articulate well. Finally, we're looking for good financials relative to the industry structure, and that really relates back to the balance sheet and includes debt or any type of contingent liability that might be on or off the balance sheet. We also like to see companies with strong free cash flow.

In terms of the buy/sell decisions that we use to structure our portfolios, we create a long-term free cash flow financial model for every company we invest in. We use normalized assumptions over the long term; we know that no one model is going to be right. We try to use some variability analysis to get a range of outcomes on any particular company, but we focus on what our most expected outlook is in terms of the long-term fundamentals of the company and get a stream of free cash flow that we think the company can produce over the long term.

Using this, we look at that information in two different ways. Either we discount it back at an appropriate discount rate and come up with what we believe is a fair value of the company, or we look at the free cash flow stream and create an internal rate of return, given the present stock price. Either way, we're trying to buy companies that are at a discount to our valuation or have high internal rates of return. When the company's stock price exceeds our value, we want to start selling that stock. By the same token, if the internal rate of return is very low on that free cash flow stream — say, approaching a bond rate — we want to start exiting that stock.

We typically scale in and out of our stocks. As we have analyzed our way of going about things, we have found that we have generally been early, both in entering investments and exiting. So we try to scale in and scale out to solve that problem. We limit our position size on any one company to 4% at cost and we don't generally invest more than 8% at cost in any one industry.

That's a summary of how we go about investing in stocks and putting our portfolios together. We are a low turnover manager. Our turnover has averaged under 20% per year over many years, and we're also an all market cap manager. We buy both small and large cap, as well as mid-cap companies. We go wherever we identify value, and I think that gives us a significant leg up.

TWST: You've given us a great description of what you're looking for in potential holdings. What is the investment climate like for your type of investment?

Mr. Conaway: As you can probably ascertain, we're not a macroeconomic driven firm — we're a bottom-up value firm. So the investment climate for us is driven primarily by the valuations in the stock market at any point in time versus what we think the appropriate value is in our collection of companies. We don't make a lot of macroeconomic predictions and then adjust the portfolio.