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Questioning Market Leaders For Long Term Investors

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MONEY MANAGER INTERVIEW

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Concentrated Portfolio Investment

STEPHEN M. GODDARD, THE LONDON COMPANY



STEPHEN M. GODDARD is Principal and Founder of The London Company, an SEC Registered Investment Advisor. He has nearly 20 years' investment experience, beginning his career as an Analyst in 1985 for Scott and Stringfellow, followed by senior portfolio management positions at CFB Advisory and Flippin, Bruce and Porter. Mr. Goddard founded The London Company in 1994. He earned a BA in Economics from VMI in 1983 and an MBA in 1985 from the University of Richmond. He is a Chartered Financial Analyst and

member of the Richmond Society of Financial Analysts and former Board member of the Virginia Management Investment Corporation. Mr. Goddard currently serves on the VMI Alumni Association Finance Committee and is President of The New Market Fund.

SECTOR – GENERAL INVESTING

(WAU500) TWST: Tell us about The London Company and your responsibilities there.

Mr. Goddard: We just completed our 10-year anniversary, managing equity assets for institutions and individuals, as well as a mutual fund (New Market). We are known as a low risk, large cap manager with consistent results. The firm has grown about 25% per year on average through client referrals over the past seven years.

TWST: Do you have an overall philosophy or strategy for your investing?

Mr. Goddard: We're primarily a large cap core/value money manager with a strong focus on risk and downside protection. We typi-

cally concentrate more than the typical manager, with our top 10 names being anywhere from a third to half of the portfolio. We believe in order

Highlights

Stephen M. Goddard is a low risk, large cap manager who has had consistent results over the past decade. The New Market Fund has been around for six years and is a concentrated portfolio of no more than 25 holdings, with the top 10 names taking up well over half of the portfolio. By focusing on the best ideas, he gives investors the ability to outperform consistently over a full market cycle. Historically he ends up ahead of a full five-years cycle. He considers major pharmaceuticals as a reasonably valued sector right now, and he is avoiding technology names. He invests in undervalued, predictable, well-managed companies and takes a long-term businessmen's approach to investing. Companies include: White Mountains (WTM); Berkshire Hathaway (BRK); Markel (MKL); Gillette (G); Ambac (ABK).

to outperform the market, you have to take meaningful positions. You can't just add two of everything like the typical fund does and expect to outperform the market over time.

Despite our concentration, though, if you look at our volatility and standard risk measurements, especially in our Fund, you see that our risk is almost half that of the market in terms of volatility and our downside is only half the market,

which defies the traditional wisdom that the more concentration you have, the more volatile and risky your portfolio will be.

TWST: I believe the New Market Fund was recently launched. What were your portfolios or funds prior to that?

Mr. Goddard: The New Market Fund was started in August 1998, so it's been around for almost six years. The firm itself has been around since 1994. Prior to 1998, we were just managing separate accounts for institutions and so forth. We launched the mutual fund right at the height of the technology/Internet craze, which led us off to a slow start for the first 18 months, due to lack of interest.

“We don't pay as much attention to reported earnings as we do to cash flow. We look at operating cash and tangible capital needed to produce the cash. We're primarily looking for shareholder-oriented companies that generate predictable high cash returns on tangible operating capital.”

TWST: Tell us how the Fund developed since its beginnings and, in particular, tell us about your recent performance.

Mr. Goddard: We underperformed the market significantly when we launched the Fund because we refused to purchase the technology/Internet stocks leading the market at the time. We were focused longer term on reasonably valued, predictable companies, which we caught an enormous amount of criticism for. But once the market and the tech bubble crashed in early 2000, we more than made up for the lack of performance in subsequent years. Now, for three and five years, at least according to Morningstar, we lead in our category with the lowest risk rank.

TWST: What is your performance this first quarter and what is the outlook for 2004?

Mr. Goddard: We outperformed the market modestly. The market going forward will be a fairly modest environment, where appreciation

will be in the low single digits, and the majority of your return will come from increasing dividend payouts, the opposite of the past 20 years. Normally, markets revert back to the mean, and given an extended bull market where you've had above average appreciation, it is not unreasonable to expect the opposite going forward.

When you consider that the market is trading at 20 times earnings, which is almost 50% above its historic norm, you can't expect much more appreciation from here, unless you think the market is going to be trading at 40 times earnings over the next couple of years or growth is going to accelerate to 15%-20% year overall. However, 10% low risk, after-tax returns in a low inflation economy is not that bad considering most of the alternatives, where many have far more inherent risk than investors appreciate.

TWST: Tell us about your investment decision-making process and what characteristics you're looking for in your investment selections.

Mr. Goddard: We don't pay as much attention to reported earnings as we do to cash flow. We look at operating cash and tangible capital needed to produce the cash. We're primarily looking for shareholder-oriented companies that generate predictable high cash returns on tangible operating capital.

Cash ROI is what really builds value in a company long term. It's not necessarily growing top-line growth as much as it is how much cash you can derive out of a company over its lifetime. If you look at our stats, you'll see that our returns on capital and cash flow growth are much higher than the market. But if you look at standard GAAP measurements in terms of earnings growth compared to the market and so forth, we're fairly in line. You have to dig beyond reported earnings because GAAP can be

easily manipulated to the point where it's not necessarily a reliable indicator of how well a company is building value, especially shorter term.

We prefer companies where we can predict 10 years out within a reasonable range using modest growth assumptions, which are normally a third or less of consensus five year growth forecast. If we can purchase at half to two-thirds of the company's full intrinsic value, then our margin of safety is adequate for investing. We have a long-term, rational businessman approach to investing versus jockeying a portfolio of stocks around every quarter, trying to buy what the recent short-term fad is. You have to take a long-term approach to be successful.

TWST: Generally, how many stocks do you have in the New Market Fund?

Mr. Goddard: Normally, we've have 23-25 positions and our top 10 positions are probably well over half of the portfolio.

TWST: What are the advantages of the focused, concentrated portfolio as opposed to a marginally diversified one?

Mr. Goddard: Most studies show that once you get beyond 15-20 securities in the large cap universe with exposure to major sectors, the additional benefit of adding more positions to your portfolio really does not materially reduce the risk or volatility, but begins to rapidly dilute overall portfolio returns. If you buy 50 different companies in 10 different sectors, you are basically buying the market and paying active management fees for subpar average returns longer term.

By focusing on our best ideas, we give our investors the ability to outperform consistently over a full market cycle. We run the risk over a given one to three years where we may be out of sync with the current market fad, but historically

we end up ahead over a full five-year cycle. Of course, we have to be careful of what we're buying, but it makes us focus on understanding the risk of what we own and making sure we don't make large mistakes. The practice is not popular in our industry, but it's necessary to outperform longer term, especially in an inflated market going forward where above-average returns will be more difficult to achieve.

“Some of our major positions are White Mountains, Markel, Berkshire Hathaway, Ambac and Gillette. In all those positions, we have above-average return on capital, ability to throw off ample cash, predictability and shareholder orientation. They all have a long-term value building approach to shareholders and are fairly predictable over a three-to five-year time frame. And most important, they trade at reasonable valuations compared to the market.”

TWST: Tell us some of your core holdings, your recent purchases and the reasons you were attracted to them.

Mr. Goddard: Some of our major positions are **White Mountains** (WTM), **Markel** (MKL), **Berkshire Hathaway** (BRK), **Ambac** (ABK) and **Gillette** (G). In all those positions, we have above-average return on capital, ability to throw off ample cash, predictability and shareholder orientation. They all have a long-term value building approach to shareholders and are fairly predictable over a three-to five-year time frame. And most important, they trade at reasonable valuations compared to the market.

In the Fund, we don't have much activity from month to month. We try to hold on to our positions for three- to five- year periods. In fact, our turnover is probably less than 25%. With **Markel**, **Berkshire** and **White Mountains**, I have held for five to 10 years. They're all growing at about 3

times what the market's growing at in terms of cash capital, yet trade at valuations that are below the market. Why trade them for inferior companies for the sake of window dressing? If you look at their price relative to their tangible capital, they trade at even more attractive valuations. Because they are not in a closely watched benchmark and/or misunderstood, the opportunity is presented.

“If I had to pick certain sectors that are reasonably valued today, I would say the major pharmaceutical companies. They're trading at a larger discount to the market than they have in the past seven years. Some are trading at 10 times cash flow. Even though they're not growing top-line as they historically have grown and pricing is being eroded, they still generate very lucrative margins and high cash returns on capital.”

We've sold a few names. We've been selling technology such as **EMC Corp.** Even though fundamentals are improving dramatically, we've started to reduce technology overall as valuations become speculative. One has to assume growth of 12% and 15% a year for the next 20 years to justify current valuations. That's just not going to happen, especially for companies as large as **Intel** (INTC), **Cisco** (CSCO), **EMC** (EMC) and so forth. We're starting to get an element of craziness back into the technology sector like we had back in 1998-1999. That's one sector where we've been underweighted and reducing positions further.

TWST: What is your sell discipline?

Mr. Goddard: Simple. If the fundamentals deteriorate where returns are below cost of capital, we get rid of the position. If the company has a change in management that we're not comfortable with or management's actions are inconsistent with shareholders, we will eliminate the position. And if the valuation just gets extremely high, like the

technology sector we spoke about earlier, then we will certainly reduce the position.

TWST: From your selection of stocks, are there any particular sectors or areas of the market that you think will show growth going forward?

Mr. Goddard: There are few areas that I think are more reasonably valued and should show above-average growth. I really can't say there's one particular sector that's grossly undervalued right now because you've had such wide participation in this market rally in the past 12 months. But give it time and the market will present further opportunities.

But if I had to pick certain sectors that are reasonably valued today, I would say the major pharmaceutical companies. They're trading at a larger discount to the market than they have in the past seven years. Some are trading at 10 times cash flow. Even though they're not growing top-line as they historically have grown and pricing is being eroded, they still generate very lucrative margins and high cash returns on capital. Aggressive capital allocation and strategic decisions could unlock value in many of them over the next few years. It's one area in the market we are comfortable with.

TWST: Conversely, what are you considering as areas to avoid in the market at this time?

Mr. Goddard: Again, technology is the one area that sticks out to us like a sore thumb. The valuations are so excessive that we think a 30%-40% drop over the next couple of years is not unreasonable. Other high beta, lower quality companies that have appreciated 60%-100% or more the last 12 months are potentially very dangerous.

TWST: How do you attempt to control investment risk in the Fund?

Mr. Goddard: By buying companies that are well managed, trade at reasonable valuations and are predictable. Sounds simple, but difficult for managers to have the discipline to practice consistently when they are under the pressure of being measured against a benchmark every quarter and expected to outperform every 12 months. We are fortunate to have long-term oriented clients who understand that investing is not a six-, 12- or 36-month derby, but a well planned marathon. Clients who have stuck around with us for five years or more have usually been pleased.

“If the fundamentals deteriorate where returns are below cost of capital, we get rid of the position. If the company has a change in management that we’re not comfortable with or management’s actions are inconsistent with shareholders, we will eliminate the position. And if the valuation just gets extremely high, like the technology sector, then we will certainly reduce the position.”

TWST: When you have approximately 20-25 companies in a portfolio, does this give you an opportunity to study the management of each company more closely?

Mr. Goddard: You have to know your companies better, and it certainly gives you more opportunity to focus on what you own versus owning 50-100 positions. One of my favorite Buffett quotes on traditional diversification is, “If you have a harem of 40 women, you never get to know any of them very well.”

TWST: Who are your typical investors and what are their concerns at this time?

Mr. Goddard: Most of our investors on the separate account side are institutions, as far as foundations, corporations and pension plans. We do have some high net-worth families and individuals in our portfolio. But if there’s one overriding concern out there in the institutional arena, it’s the

mass flow of funds into alternatives. Investors think they are getting a low risk, hedged investment with little downside risk. Reminds me of 1986-1987 when investors thought their portfolios were protected by hedged contracts. Only works in an orderly market which you can’t always assume.

In addition, many are trying to jump back on the momentum bandwagon again, chasing the performance of the sectors that have been the hottest over the past 12 months, biotech, tech commodities and so forth. It just seems to be human nature to chase the top-performing assets of the past year or so. You’ve had some sectors and funds that are up 100%-200% over last year, and most of them in sectors that are extremely speculative and have high-risk characteristics.

TWST: What makes the New Market Fund different from similar funds at other money management firms? What do you bring to the table that others don’t?

Mr. Goddard: There are only a handful of concentrated funds, at least as concentrated as we are. I don’t know how many mutual funds there are out there in our category — maybe 2,000, 3,000 or even more. But I bet you can count on one hand the number of funds that have the focus that we have, especially with the low risk attributes. I think that’s the main factor that differentiates us from others. We don’t claim to be any smarter, but probably more realistic in terms of having a longer-term focus, not over diversifying, and sticking with what we understand. I have observed many investors get in trouble by being overconfident about their ability to predict the future, especially if they have been successful elsewhere. In the words of Harry Callahan, “A man has got to know his limitations.”

TWST: Where do you find your research?

Mr. Goddard: We do our own research. While we collect information from Wall Street as far as factual data, most of our research analysis is internal. We look at public documents, listen to calls, look at shareholder reports and talk to competitors. For every 100 companies we look at, there might be only one or two that we're interested in, so we're very, very patient and selective.

When you run a concentrated fund, you can't afford to be wrong on your major positions. We really look down before we look up. We're looking for companies where we're fairly confident that they're not going to lose us money.

The key to successful money management is not necessarily hitting home runs so much as it is avoiding big mistakes. Our whole process is really about trying to avoid disasters. Then the portfolio takes care of itself over the long haul.

TWST: Are you concerned with tax efficiency?

Mr. Goddard: We're naturally tax efficient just because we have very low turnover in our portfolio, so you're never going to have a major tax cut in our portfolio because of realized gains. If you take into consideration that the average turnover in a mutual fund is 75%-80% and then account for transaction costs, fees etc., it can amount to 3%-7% a year of your return being cut. The best investors won't be able to make up the difference longer term from superior stock selection. But it's a real hidden cost that's not reported or appreciated. We try to minimize all these cost components. Because our Fund is still relatively small, we as advisor, have waived all management fees on the Fund for the past five years. The ad-

ministrative expenses are still high as a percentage of the Fund, and we are working with the fund administrator to reduce them as the fund grows.

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TWST: Do you see yourself as a contrarian manager in any way?

Mr. Goddard: I think that in order to get an undervalued position, there usually has to be some type of controversy. Being contrarian for contrarian's sake is not the right way to go, but in order to find positions that are undervalued, usually there has to be some type of disagreement or controversy behind the sector or the company itself by the general consensus.

If you buy a position where everything is going right, nine times out of 10, it's already reflected in the market price. A former industry veteran who I used to work with used to say, “If you discuss a stock recommendation with the investment committee and everybody shakes their head in agreement, you better go back to the drawing board, because it is probably not a good idea.” So you do have to be somewhat contrarian in most cases. Every once in a while, you find a position where it's just a company that's not understood or undiscovered, but it is increasingly rare.

TWST: Do you follow Wall Street research closely or do you like to strike out on your own?

Mr. Goddard: Usually Wall Street follows the pack, so if everyone is recommending a particular stock, then it's hard to find positions that are undervalued. Analysts tend to follow the herd on Wall Street and love the same stocks where fundamentals are going well and hate the ones that are not. They always seem to tell you after the fact.

We use Wall Street information but really rely more on fixed income side than the equity research because it tends to be more number and facts oriented. It gives you the raw fundamental data and trends versus the Wall Street equity sellside research that usually gives you the selective "pep rally" information from recent management presentations.

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TWST: Do you have fixed income at your firm?

Mr. Goddard: We do some preferred, convertible management for selective clients. We also run an equity income product for our most conservative clients focusing on generating total return versus trying to chase a benchmark. Our primary emphasis is to generate 5%-6% income upfront and add a few of our best growth investments for another 2% or 5% plus return. We're looking for at least an 8%-10% average return, with two-thirds of the return from interest and dividends. It is designed to avoid loss and to participate in half of a bull market. We think the returns will be very competitive in the modest market environment going forward.

TWST: What advice would you leave with investors today who are contemplating entering or re-entering the market?

Mr. Goddard: I would recommend being very careful. You're entering a market that has appreciated 60% plus over the last year in the small caps and tech, and the overall market has risen 40%. Valuations are full and grossly overvalued in the more speculative sectors. If you're going to buy into the market, I would invest very gradually, and stick with far more conservative funds versus buying more aggressive funds that have gone up dramatically over the last year and a half.

One thing I would say about the market going forward is we're entering a very extended, long period where the equity markets will be almost like a surrogate bond market, where most of your return will come from dividends. You see almost daily where companies are announcing higher dividend payouts because they're not finding any opportunity to reinvest for growth. Virtually every industry has overcapacity except for a few selected commodity sectors, and management is being forced to return capital to shareholders in the form of higher payouts.

If you assume a low-inflation environment, then a 7%-8% total return is not bad in real terms, especially when removing the volatility that we've seen in recent years. Back in the 1940s and 1950s, investors purchased stocks for purely dividends. They didn't buy on speculation of appreciation. I think it will lead to more rational market behavior going forward.

TWST: Are you seeing more interest on the part of your institutional investors and high net worth individuals about wanting more yield at this time?

Mr. Goddard: Yes. Especially a year ago, it was far more important. Now that we've had a recent significant rally, there's more focus on appreciation again. But I think that longer term, the reality is setting in that the markets are going to have very modest returns and companies will start focusing more on absolute return versus trying to match a equity benchmark that's not going anywhere. If you can give an investor a 6%-9% return every year net aftertax, I think they should be pleased in the future.

TWST: Is there anything that I've overlooked?

Mr. Goddard: I think the main thing is that we really try to structure and focus a portfolio to outperform as opposed to "hugging" a benchmark

with 50 different odd positions. But at the same time, we are conservative and try to do what we say we are going to do. We simply invest in undervalued, predictable, well managed companies and take a long-term businessman's approach to investing.

TWST: Thank you. (PS)

Note: Opinions and recommendations are as of April 29, 2004.

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