

## Seeking balance sheet gold

Companies with strong dividend potential are object of AFBA fund

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The current uncertainty surrounding the equity markets and the overall economy, tied largely to the troubled banking industry, is playing right into the hands of Stephen Goddard, co-portfolio manager of the \$80 million **AFBA 5 Star Balanced Fund** (AFSAX).

"Outside the financial sector, most public companies today are in the strongest financial situation we've seen in decades," he said. "These companies are throwing off huge amounts of cash because so many of them are cash-heavy, with nowhere to put it."

Mr. Goddard is president of The London Company Investment Counsel, a Richmond, Va., firm with \$800 million under management that helps manage the equity portion of the AFBA balanced fund on a subadvisory basis.

The fund, which is available to the general public, is part of AFBA 5 Star Fund Inc., the \$220 million asset management arm of the Armed Forces Benefits Association in Alexandria, Va.

While London is responsible for the \$59 million equity portion of the balanced fund's portfolio, the fixed-income side is managed by Financial Counselors Inc. in Kansas City, Mo.

Overall, the fund is designed to have an equity weighting of 60% to 70%, which ideally includes about 35 lower-risk stocks that have the ability to pay dividends.

Emphasis on the ability to pay dividends, as opposed to actually paying dividends, is no small distinction, according to Mr. Goddard.

"We're looking for companies that are debt-free and have a strong balance sheet," he said. "We look at what a company has on hand today and what they could do with it."

By Mr. Goddard's calculations, mountains of cash, coupled with an underleveraged balance sheet, will eventually benefit shareholders.

"If a company can't deliver by growing the stock price, they will be forced by shareholders to deliver in other ways," he said.

For cash-heavy companies looking to increase shareholder value, Mr. Goddard explained, the two

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primary strategies are dividend payouts and stock repurchase programs.

The research process, which considers companies of all sizes everywhere, begins with an analysis of those firms in the top 1% in terms of returns on tangible operating capital.

"We're looking for the lowest-priced companies in that group," Mr. Goddard said. "They don't have to pay dividends, but they all have the ability to pay huge dividends."

Berkshire Hathaway Inc. (BRK-A), an Omaha, Neb.-based investment management firm, is a stock in the portfolio that does not pay a dividend.

But the company also has "no meaningful debt," according to Mr. Goddard, and \$31 billion worth of cash on the balance sheet.

Berkshire shares closed Friday at \$116,800 per share, down 17.5% from the start of the year.

The Standard & Poor's 500 stock index was down 12.8% over the same period.

Another example of a company in the portfolio with a cash-rich balance sheet is Redmond, Wash.-based Microsoft Corp. (MSFT).

The company has \$21 billion worth of cash, no debt and is generating another \$21 billion in annual operating cash, while spending just \$3 billion on capital expenditures.

"We think Microsoft's stock is undervalued, and there will be more pressure for them to do more to increase shareholder value by buying back shares or increasing the dividend," Mr. Goddard said.

By concentrating first on a company's operating capital, which is essentially a measurement of earnings before interest and taxes, he avoids getting caught up in growth generated by "fads or speculation."

In order to help determine what a company is likely to do with its cash on hand, the analysis also considers corporate governance and what the private market might be willing to pay for a given company.

"With a fortress of cash on the balance sheet, the market is not likely to take a company down," Mr. Goddard said. "But the main question is: Will the cash flow be stable over the next five years?"

The current environment lends itself to cash-heavy balance sheets, said Mr. Goddard. "Companies have been lean with reduced capital expenditures and record operating margins," he said.

One other component of the strategy is the potential for consolidation.

"Typically, when you get to an economy that is relatively mature, the next phase is consolidation to take out some of the excess capacity," Mr. Goddard said.

The fund was down 5.7% this year through Thursday. This compares with an average decline of 7.4% for the funds in Morningstar's moderate-allocation category over the same period.

*Questions? Observations? Stock tips? E-mail Jeff Benjamin at [jbenjamin@investmentnews.com](mailto:jbenjamin@investmentnews.com).*

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