

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Investing in Small Cap Value



STEVE SCRUGGS is the Director of Research and Senior Portfolio Manager for Bragg Financial Advisors, Inc., which manages the Queens Road Small Cap Value Fund and the Queens Road Value Fund. Mr. Scruggs is directly responsible for the daily oversight of all investment research activities. He advises on more than \$250 million in assets. Prior to his work with Bragg Financial, Mr. Scruggs worked as Product Manager for GMAC Insurance and Reliance Insurance Companies. He received his BA from North Carolina State University in 1992 and his MBA from Wake Forest University in 1996. Mr. Scruggs has earned the right to use the Chartered Financial Analyst designation and is a member of the CFA Institute and the North Carolina Society of Financial Analysts.

(ZAT504) TWST: Would you begin by telling us about Bragg Financial Advisors and what you do there?

Mr. Scruggs: We are a family-owned advisory firm. We oversee about \$450 million in assets. Primarily, those are in separate accounts for high net worth individuals. About three years ago, we started a couple of mutual funds, the Queens Road Small Cap Value Fund and the Queens Road Value Fund, as vehicles to package our asset management process and make them available on a wider basis. Our investment philosophy is based on the philosophy of Benjamin Graham. We seek to buy companies below our measure of their intrinsic value and hold them until they're trading at or near intrinsic value. Typically, that will lead to us having lower turnover, although in the markets that we've had over the last couple of years, there has been a higher than average turnover because of significant appreciation in a lot of our holdings.

Our tagline is "diligence, discipline and patience." That's really what we think the best investment processes are built around. A lot of times folks will try to use brilliance as one of their cornerstones; we're not afforded that possibility. We do know that we can be diligent, disciplined and patient. If you look at the best investors over

long periods of time, virtually every single one of them will have either explicitly or implicitly stated those three criteria in their investment processes, whether it is Benjamin Graham or Warren Buffett.

TWST: Do you invest in all-cap stocks?

Mr. Scruggs: In our separate accounts, they are primarily mid- to large cap, about \$10 billion market cap and above. One of our mutual funds, the Queens Road Value Fund, has all caps but generally will invest similarly to our separate accounts of \$10 billion or higher. The Small Cap Value Fund invests primarily in \$2 billion market cap companies or below.

TWST: What is the outlook of value investing at this time?

Mr. Scruggs: We think that it's always best to be a value investor. We're bottom-up investors, so we don't really make any macro or theme-type calls. But if you look over time at which asset classes have done the best, it's the value asset classes in absolute terms as well as on a risk-adjusted basis. While we know that we'll have good times and bad times relative to our growth or index counterpart, we are very confident that over the mid- to long term, value stocks and value investing are going to provide a higher expected return with a lower level of expected risk.

TWST: Would you describe your investment decision-making process?

Mr. Scruggs: The first steps of the process are very quantitative in nature and the type of financial attributes we're looking for vary by sector. For a non-financial type of company, we look at discounted free cash flow, discretionary cash flow and cash flow to the firm, which are all related. We have several different models that we'll use. We'll pull numbers from the balance sheets and cash flow statements and then come up with certain assumptions that we have to make with regard to growth rates and cost of capital.

The first step is for it to make it through our model to show that the present price of the company doesn't fully reflect the intrinsic worth of the company. Once we do that, we dig deeper into more qualitative aspects of the company to see why there's this disconnect, whether there's a good reason for it. Perhaps some of our assumptions were incorrect or there's a psychological headline risk-type issue that we feel is being overestimated by the market. At that point, we go in and listen to the conference calls that the management has made. We like to see the management able to clearly state a strategy and then show us steps on how they execute to achieve their objectives. It's relatively clear cut whether they're doing that or not. For some managements, you can listen to their calls and listen to what they'll say they're going to do and what they actually do. You can see a pattern.

We don't really follow quarterly earnings numbers. Those aren't of great interest to us because there are so many things outside of management's control that will affect those. We like to see that they layout a strategy, tell us what they're going to do and then take the steps to achieve that. Within the financials, we can clearly see progress toward achieving those objectives. So once it's gone through our valuation model and we see the market price is lower than our first glance estimate of intrinsic value, then we go in and dig deeper into the annual reports and earnings calls to see if there's a reason for this disconnect. If not, it becomes a buy candidate.

TWST: What is the benchmark by which you judge your performance, and how has your track record been?

Mr. Scruggs: For the Queens Road Value Fund, our primary benchmark is the S&P 500 value. For the Queens Road Small Cap Value Fund, it's the Russell 2000 value. Both have done pretty well against their benchmarks. The Value Fund, the mid- to large cap fund, has performed slightly better than the benchmark with a little less risk, which is what we'd expect. The Small Cap Value Fund has performed considerably better, with less risk, which we're very pleased with. We think that both of those are consistent with our view on market efficiency in that the larger cap areas of the market tend to be more efficient. Prices are going to clearly reflect intrinsic value better than in the smaller cap stock asset class.

TWST: Are you overweight or underweight in any areas compared to the benchmark?

Mr. Scruggs: We do compare our sector weights to our target benchmarks. We are bottom up so that at any time we'll be under

or overweight relative to the benchmark, but it's not a call on that sector. It's just a matter of the valuations of the underlying companies. Specifically, if you look at small banks or savings and loans, we come out underweight in those. It's not a call on interest rates or anything like that, it's a result of just looking at the universe of smaller banks that we look at.

TWST: What are some of the stocks you want to talk about that you feel are representative of your comments?

Mr. Scruggs: One of the things that we really like are boring companies. They tend to be more stable and don't attract as much competition. There's a lot of them out there, and I don't think they're as much fun to follow so they don't get as much coverage as the biotech stocks. Having said that, one of the companies that we recently bought is **Matthews International (MATW)**. They make bronze markers for cemeteries and also have a division that makes caskets. They have a graphics imaging segment that makes printing plates for corrugated packaging. These are very boring products and they've been doing this for a very long time. They do it very profitably and have a management that's been there for a while with a very strong balance sheet. They generate lots of discretionary cash flow. They've been buying back shares and they pay a small dividend. They have all the attributes of a company that we really like to see.

Another one is **Smithfield Foods (SFD)**. They are the largest hog producer in the world. We own it in the Small Cap Value Fund, but it's a little larger than our typical holding there. It has about a \$3.1 billion market cap. They have a 17% share of pork in the United States, 6% of beef and 11% of turkey. So they're diversified across the different proteins, but they are the most efficient hog producer in the world.

1-Year Daily Chart of Smithfield Foods

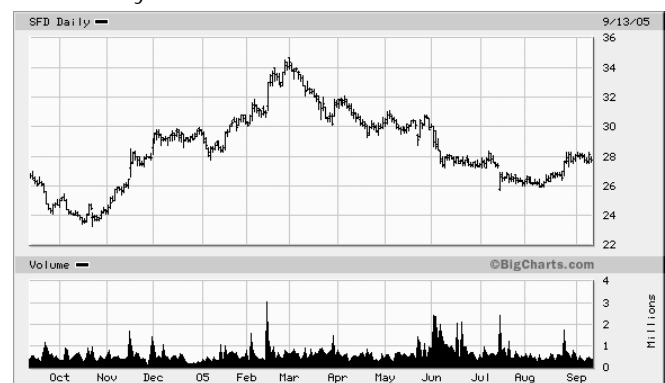


Chart provided by www.BigCharts.com

The current CEO has been there for over 30 years and his grandfather founded the company. They know the hog business as well as anyone, and they've executed year in and year out since he came in and turned the business around in 1975. The company is probably not as cheap as it looks because hog prices are very cyclical and they're at the high end of the cycle right now. Hog prices have doubled from their lows that they hit in September 2002. We

like that they don't manage around the hog cycle, they look straight through it and manage for the long term. They've done a great job of doing that in the past, and we expect them to continue to do so. Not only that, they're very forthcoming on their financial data and talk very openly and honestly about company performance.

Another one that we've owned for quite a while that has done very well for us is **K-Swiss** (KSWI), the shoemaker. Their flagship product is the Classic, which accounts for about two-thirds of their sales, and it's a shoe that has been around for 40 years. It has turned from a very tennis-oriented shoe to more of a fashion-oriented one. Their strategy is to play off of the Classic and launch these different fashion models that are based on the Classic but are slightly different. These are shorter run shoes than the Classic would be; they don't make as many of them but they're very trendy and are hit or miss. They have good merchandisers, so they tend to have more hits than misses. This year they haven't been doing quite as well as they have in past years. We're very confident in the fact that they can create trendy shoes, market them well and sell them well.

1-Year Daily Chart of K-Swiss



Chart provided by www.BigCharts.com

Their goal is to be the most profitable vendor for their retailers. They're very customer focused and they work to give their customers a higher net per shoe sold, which shoe sellers really like. **K-Swiss** is a very cheap sourcer of shoes, using Asian manufacturing solely. They also have a unique design in their shoe. It has fewer seams than a typical athletic shoe has, which reduces cost. Their efficiency is borne out in their gross margins, and in the athletic shoe business, the gross margins target is 40%. **NIKE** (NKE) is usually around 40%, **Reebok International** (RBK) is usually just under 40%, and **K-Swiss** is usually in the low to mid-40% range. Last year they were over 45%, which is unbelievable. They have no debt, tons of cash and Steve Nichols, the CEO, has been in the shoe business forever and his conference calls are great to listen to. He's very matter-of-fact about things, he'll tell you the good and the not-so-good. He's just a really straight shooter.

TWST: A lot of value managers like to have a contrarian bent or opportunistic investment. Do you have anything like that in your portfolios?

Mr. Scruggs: One that we've been buying in our separate account side and in our mid- to large cap fund is **Merck** (MRK). That is controversial, especially with the Texas judgment coming out, which was a surprise. We feel that that judgment is going to be lowered, but the fact that **Merck** lost that case was not a good sign. There's a huge cloud caused by this litigation. We realize that, but we don't see how the market is reflecting the reality of it. **Merck** is now trading at 8 or 9 times discretionary free cash flow, whereas their peers trade at anywhere from 22 to 30 times discretionary cash flow. If you do the math and see what the Vioxx litigation is going to cost them, it looks like the market is overdoing it. So that's a contrarian, somewhat controversial stock that we've been buying lately. We think that in six to eight years, this litigation is going to be put to rest, settled fairly, and **Merck** is going to continue to be one of the great pharmaceutical innovators that it has been for the past 70 years.

TWST: What triggers an exit from your portfolio?

Mr. Scruggs: It's primarily valuation, which means that the stock has appreciated in price. Ideally, we recognize an undervalued stock, then the market recognizes it and prices it closer to intrinsic value. If we feel that the stock is fairly valued, we'll sell it. However, sometimes it doesn't work that way, perhaps the estimates that go into our modeling and our qualitative process might be wrong. We're making judgment calls, and invariably we'll make some wrong ones. If facts come out to prove that we've made a bad estimate or judgment, we'll correct ourselves and leave a stock. We're not going to sell a stock just because it goes down. We'd be much more likely to purchase more if it goes down in the absence of some new facts that will shed light onto our previous estimates.

TWST: Do you have any examples of stocks you've sold or trimmed back over the last few months?

Mr. Scruggs: One that comes to mind is **Universal American Financial** (UHCO). They're a supplemental health insurance and life insurer. It's in our small cap fund and is up right at 100% over the last 12 months. When we first started buying that on a valuation basis, it looked attractive relative to what we thought the future earnings would be. They are in supplemental Medicare insurance, and with the changes in the new Medicare law, it opened up a lot of new potential markets for them. I think the hype around some of that has really lit a fuse under the stock. We still hold it, and on a valuation basis we still like it. But it is trading near our estimate of intrinsic value, and we did sell about a third of our position. But we're comfortable with its valuation; we just thought it was time to take some money off the table.

TWST: What is the general turnover?

Mr. Scruggs: For the Value Fund and for our separate accounts, I would estimate it at below 20% in a given year.

TWST: So you like to hold on to them for the long term.

Mr. Scruggs: We certainly do. The Small Cap Value Fund has been a little higher than that because of the wonderful market that small cap stocks have had over the last few years. It has caused quite a few of our holdings to exceed our estimate of their intrinsic value; therefore, we

sold them. That obviously impacts our turnover. As a general rule when we buy a company, we're looking five or 10 years out. We want to be confident that we have a reasonable expectation that the company will be worth considerably more in five or 10 years than it is today.

TWST: In what ways do you attempt to control investment risk in the funds?

Mr. Scruggs: We do that through sector and industry diversification and limiting position size. We look at the index sector weights and take a clue from those, but we're not bound to them. This isn't an index fund, but we do want to be broadly diversified across every aspect of the economy. That leads us to holding oil stocks when oil stocks aren't in favor, financial stocks when interest rate predictions are dire, and consumer discretionary stocks when consumer sentiment may not be high. It's all the bottom-up process, so we don't pay attention to the big picture things that I just mentioned.

We do pay attention the diversification across the economy, and we're really pleased with the amount of volatility that our portfolios have exhibited over the last three or four years when we've had both really strong bear and bull markets. In a bear market, we hope our portfolios will outperform and in a bull market we expect they will slightly underperform. We hope to overperform in the bear market by more than we underperform in the bull market so that over longer periods of time, we're going to have a higher return with a lower level of volatility.

TWST: In what ways do you think your investment approach is differentiated from that at other companies with a value orientation?

Mr. Scruggs: I think it goes back to what I mentioned about our tagline, "diligence, discipline and patience." We're not the only ones to proclaim that that's our cornerstone, but at times it's really difficult to execute and actually do it. One thing you can look at is turnover. I haven't seen the statistics lately, but if you look at what the average turnover is on an institutional portfolio, most institutional investors aren't nearly as patient as they would claim to be. Also, I think the fact that we're removed from Wall Street and Boston gives us an independence and objectivity and a main street view of both business and investments that is very helpful in making security selections and managing portfolios.

TWST: What advice would you give to our readers who are entering the market for the first time? Are there still good opportunities out there?

Mr. Scruggs: There always are, and I think the advice is to make sure that you do your homework, pay attention to valuation first and never pay more for anything than what you think it's worth. I know that sounds silly, but there are a lot of folks giving investment advice who don't stress that enough. If you go back and look at the guys who have done this for the longest periods of time and have

been the most successful at it, that's what they'll tell you. Don't take my word for it, at least take theirs.

TWST: Do you have anything else to add?

Mr. Scruggs: I have another company here, **Dorel Industries** (DIIB). It's headquartered in Canada, but most of their sales are in the US. They recently purchased the Schwinn and Mongoose brands of bicycles. They have a juvenile products division which includes Cosco and Safety 1st, and they have a home furnishing segment which includes Ameriwood Furniture, which is ready-to-assemble lower-end furniture. They've got a nice portfolio of very strong brands. They market them primarily through mass merchandisers, which gives them great scale and allows them to source cheaply. The big box merchandisers really enjoy doing business with them because this is their focus, and those guys really like to put a lot of restrictive terms on the way they do business, which **Dorel** can do. They can meet their stringent requirements for how they do business and they frequently get awards from these mass merchants for being really easy to do business with.

The Pacific Cycle acquisition in 2004 has really helped sales with the Schwinn and Mongoose bicycles, but they've been hurt by commodity prices. They plan to generate about \$100 million in free cash flow this year, which for a company that's about \$1.2 billion market cap and growing, is an attractive valuation. The biggest problem with this stock is that it's not very liquid. There's not a lot of daily volume on it, so it takes a while to build a position. But we think it's worth being patient and acquiring.

TWST: What about dividend yields? Is that an attractive investment criterion for you when you look at companies?

Mr. Scruggs: It absolutely is. We don't have a fast and true rule, but for companies that pay a dividend, it's a commitment by management that they have earnings visibility to be able to offer a regular payment as a return to shareholders. But we see it as more of a lower level attribute. It's not a requirement for us to purchase a stock, but it sure is nice to have.

TWST: Thank you.

Note: Opinions and recommendations are as of 9/13/05.

STEVE SCRUGGS
Bragg Financial Advisors, Inc.
100 Queens Road
Charlotte, NC 28204
(704) 714-7711