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THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

A Fundamentally Driven Investment Approach to Finding Quality and Value

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SECTOR — GENERAL INVESTING

TWST: Give us a little bit of background on Bernzott Capital Advisors.

Mr. Bernzott: I started the firm in 1994 after a stint as CEO of a multigenerational family office. It was a very auspicious time, and we have grown nicely since then. I credit our success to the smart people who are working here, like Scott and Tom and the other folks on the staff. We have two strategies, U.S. Small Cap Value and U.S. All Cap Value. Half of our business is institutional. The balance of our business is wealth management or high net worth, however you want to characterize that, and for those clients we provide a single, robust comprehensive investment solution.

TWST: You have different strategies for different types of clients, but do you have an overriding investment philosophy that encompasses the strategies?

Mr. Bernzott: We do. The overall investment philosophy is fundamentally driven. We do all our own research in-house, we're not interested in what the sell siders on Wall Street think, and we are looking for quality and value. We have a long-term outlook and are uninterested in companies that are not managed with that same long-term view. There is never a bad time to buy a good company at the right price.

TWST: When you say quality and value, how do you define that, and what are those metrics that you are specifically looking at?

Mr. Larson: We try to buy the right companies at the right price. For us, the right companies are high-quality companies that possess various quantitative and qualitative traits. We look for general traits like market leadership, transparent accounting, predictable cash flow, consistent performance, financial flexibility and businesses that are not highly cyclical or highly regulated. Then we screen for specific traits like high operating margins, high returns on capital, high returns on equity, low capex intensity, reasonable leverage and long-term track records of increasing EPS and/or dividends. Investing in these kinds of companies provides a measure of downside protection for the portfolio and smoothes out the ride for our clients.

TWST: You have noted that you like companies that perform well regardless of the external market conditions. Because of that, do you tend to select established companies rather than newer companies? Is there a bias that way?

Mr. Derse: We want to own companies that have long periods of identifiable consistent cash flow, and consequently we generally gravitate to well-established companies. We are not particularly interested in emerging technologies. While the companies we own continually innovate and have a growth component, most have long track records and established competitive advantages that give their management teams the ability to maintain and grow cash flow in the future.

TWST: I want to talk specifically about the U.S. Small Cap Value strategy and the U.S. All Cap Value strategy. Is the primary difference between the strategies the cap size?

Mr. Bernzott: Yes. Our U.S. Small Cap Value strategy contains market caps from $250 million to $5 billion. It is accessible in a separately managed account format (SMA), three UMAs, and via Bernzott US Small Cap Value Fund, our proprietary mutual fund. Our U.S. All Cap Value strategy contains market caps greater than $250 million. It layers large- and mega-cap companies on top of the small caps to provide exposure to the entire domestic stock market, excluding micro cap. The U.S. All Cap Value strategy is only available in a SMA format.

TWST: In your opinion, what are the advantages of separately managed accounts?

Mr. Bernzott: Separately managed accounts can be more tax-efficient for a taxable investor, and they allow us to manage an account in conformity with an individual client's specific guidelines or restrictions. You can't do that in a commingled fund.

TWST: Are there overall trends you are seeing in the small-cap space right now that are impacting some of your investment choices?

Mr. Larson: Earlier this year, we saw a lot of speculative companies outperform and we continue to see interest-rate-sensitive companies in sectors like REITs and utilities outperform. Recently we have seen some investors shift their focus toward companies with stronger fundamentals and become more defensive. That is not a surprise given the current volatility in the market.

What we are seeing in terms of trends is valuations are getting a little more attractive, but generally the small-cap space is still fairly expensive. Part of our process is to identify high-quality companies and then wait for the right price to buy them. The current environment should afford us some opportunities to put cash to work.

TWST: Are there specific sectors where you see more opportunities in the small-cap space right now?

Mr. Larson: We don't take a top-down approach. We're bottom-up stock pickers, so we go where the research takes us. As a result, our sector weightings are a by-product of our investment process. That said, our most recent new buys have been in health care, materials and information technology. That is entirely coincidental, but that's where we have found opportunities recently.

TWST: As you said, the U.S. All Cap Value strategy does include larger caps as well. Are there different trends you're seeing in the larger-cap names?

Mr. Derse: Generally speaking, valuations are stretched across the capitalization spectrum. As bottom-up investors, we don't look at large-cap names any differently than small-cap names. We don't weight the portfolio based on any cap-size prognostication. But there are some differences in researching and monitoring large-cap companies. For instance, with large-cap names covered by a slew of analysts, our ability to find value is more limited than it is in the small-cap space.

Also, the large caps we own are generally a bit more stable — most pay healthy dividends, are household names, and like everything else we own, they've been around for a long time. We own some tech, but it's old tech: **Microsoft** (MSFT), **Cisco** (CSCO) and **Intel** (INTC). In the past few years, old tech has been unloved, and we've been able to buy some good companies at attractive multiples. But the price is always important. For example, **Microsoft** was much more attractive at $25 when we bought it than it is now at $45.

TWST: Does the macro or the global situation play a role in your selection?

Mr. Bernzott: Several years ago, we were completely agnostic to macro factors and the global environment, but that's no longer the case. We had a problem with that philosophy seven or eight years ago, and so now we spend a little bit of time thinking about those kinds of things from a risk-mitigation perspective. But we remain bottom-up stock pickers, and macro doesn't influence stock selection, although it may impact our DCF modeling assumptions as we analyze pricing and derive buy targets and fair values.

TWST: In the Small Cap strategy, two of your holdings are International Game Technology and FTI Consulting. Can you talk about why you decided to include those in your portfolio and how they fit with your philosophy and strategy?

Mr. Larson: We initiated a position in **IGT** (IGT) in October 2008 and exited the position last month. **IGT** was a great fit for us for a number of reasons. A primary driver was market leadership in the gaming equipment business. We estimate at least 50% share of the installed slot base, and **IGT** has very high margins, probably the highest in the industry.

In 2008, the stock came under pressure during the financial crisis given concerns about consumer spending and domestic casino growth, and we were able to establish a position at less than 10 times free

Highlights

Kevin Bernzott, Scott T. Larson and Thomas A. Derse discuss their firm's investment philosophy and strategies. According to the managers, their focus is a fundamentally driven philosophy aimed at finding quality and value. They look for companies that perform well regardless of external market conditions. The portfolio managers talk specifically about two of the firm's strategies, which holdings they like and why.

Companies discussed: Microsoft Corporation (MSFT); Cisco Systems (CSCO); Intel Corporation (INTC); International Game Technology (IGT); FTI Consulting (FCN); GTECH S.p.A. (GTK.MI); Thermo Fisher Scientific (TMO); Oracle Corporation (ORCL); Dresser-Rand Group (DRC); Siemens Aktiengesellschaft (SIE.DE); Rayonier Advanced Materials (RYAM); Rayonier (RYN); Masimo Corporation (MASI) and Covidien plc (COV).

cash flow. In March 2009, following a management shakeup, Patti Hart was named CEO. Ms. Hart led a cost-cutting effort and focused on developing fresh game content and de-leveraging the balance sheet. The combination of a lower cost base and a recovery in the North American replacement cycle fueled strong operating results and EPS growth.

We trimmed about 20% of position in September 2013. In June 2014, **Gtech** (GTK.MI), an Italian lottery company, announced it was buying **IGT** at about a 46% premium. The combination should generate some $300 million in synergies, so it's a good deal for shareholders of both companies. We exited our remaining position and are redeploying the profits.

We took an initial position in **FTI Consulting** (FCN) in May 2013. **FTI Consulting** is a diversified consulting firm with business segments including corporate finance and restructuring, forensic and litigation, economic consulting, and technology and strategic communication. Because of this diversification, they do pretty well in a variety of market conditions and do very well in extreme conditions. They have benefited significantly from the recent IPO surge, and if the economy falters, are well-positioned to thrive given their restructuring and bankruptcy expertise.

FTI Consulting has a new CEO and CFO, and they've outlined some bullish long-term projections. The company is a market leader, has good margins and significant margin expansion opportunity, reasonable leverage and low capex intensity. The company should do well in a variety of conditions and is trading at about a 30% discount to our calculated fair value.

quality market leader with predictable recurring revenue make it a nice fit. Because valuations are stretched, we haven't added many new large-cap ideas recently.

We think **Cisco** has a little more room to run. The company has scale, great customers, high switching costs, margins that aren't impacted by competition, and it is well-managed. The stock is trading about 11 times 2014 free cash flow, and net debt is zero. Most every business is increasingly dependent on their network not just for communication but to operate and grow, so we think it's good to be a **Cisco** shareholder.

TWST: Have you made any changes to the portfolio this quarter, the third quarter?

Mr. Larson: In addition to **IGT**, we had two other 3Q successes. First was **MICROS**, a software company we bought in July 2013. It was acquired by **Oracle** (ORCL) for a 22% premium, about 50% above our average cost. Second was **Dresser-Rand** (DRC). We started buying it in December 2010. After a bidding war, **Siemens** (SIE.DE) is slated to acquire **Dresser-Rand** for $83 a share in a deal closing summer 2015. That's a 37% premium to the price before M&A chatter and about 55% above our average cost.

We bought two new small caps in 3Q. We purchased **Rayonier Advanced Materials** (RYAM), a spinoff from **Rayonier** (RYN), the timber REIT. The company is the world's leading producer of high-purity cellulose. We previously owned its chief competitor, Buckeye Technologies, which was acquired by **Georgia-Pacific** at a 30% premium. We saw an opportunity to buy **Rayonier Advanced Materials** operating in an industry that we knew well because of our prior Buckeye ownership.

"We remain bottom-up stock pickers, and macro doesn't influence stock selection, although it may impact our DCF modeling assumptions as we analyze pricing and derive buy targets and fair values."

1-Year Daily Chart of FTI Consulting

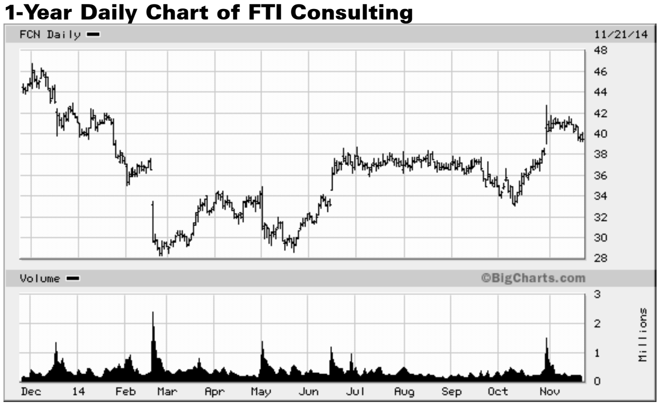

Chart provided by www.BigCharts.com

Rayonier Advanced Materials has about 30% market share, about twice Buckeye's, so the two essentially have an oligopoly. There have been no new competitors in 25 years, so they have a hammerlock on the market. The company has very long-term relationships — the top 10 average customer length is 38 years. We like the strong margins as well. Prior to the spinoff, the parent helped them significantly by spending a lot on growth capex. It trades at about 10 times free cash flow, about a 42% discount to our calculated fair value.

The other 3Q buy was **Masimo** (MASI). They develop and manufacture noninvasive patient monitoring products primarily for the pulse oximetry market. Their SET product, which stands for signal extraction technology, is state-of-the-art, and the follow-on Rainbow product extends the monitoring from pulse oximetry into other areas like hemoglobin and oxygen. **Masimo** has a 40% market share and has an installed base of 1.26 million units.

Masimo's top competitor is **Covidien** (COV), which has 45% to 50% market share, so another oligopoly. **Masimo** has excellent Intellectual Property (IP). In fact, **Covidien** was found to have infringed on **Masimo's** IP and now is paying royalties to **Masimo**. They have high recurring revenue; a razor/razorblade model where they give away the monitoring unit and then sell consumables to the hospitals. These contracts are three to seven years in length providing good revenue visibility. Although the company is

TWST: Can you give us two holdings in the U.S. All Cap Value strategy and why you like the names?

Mr. Derse: The U.S. All Cap Value portfolio consists of the small-cap names with eight or so large and mega caps layered on top. A recent large-cap purchase is **Thermo Fisher Scientific** (TMO). It has 18% market share in a $95 billion market; 75% of the revenue is recurring, 20% operating margin and a clear path to expand that. Valuation is reasonable, about 15 times 2015 free cash flow. The dividend yield is a little smaller than some of our other large-cap names, but the other characteristics such as being a highfacing some regulatory and related issues, we see little downside. **Masimo** trades at a 38% discount to our calculated fair value.

TWST: You have between 20 and 35 names in the portfolio. Why do you like that number?

Mr. Bernzott: There's no magic number for us, and that's actually a bigger range than we're used to having. We want enough names to provide diversification, but few enough so they make a difference. Some might call it concentration; we call it conviction. There's no reason to own a company that makes up 0.5% of the portfolio — that's a sideshow we wouldn't pay attention to. We know what we own, we know why we own it, we have a calculated fair value for every holding, and after doing high-quality research, we're prepared to own a material amount of the stock.

TWST: Is diversification important in the portfolio?

Mr. Bernzott: Yes. There are a number of academic studies demonstrating that you can achieve adequate diversification with as few as a dozen names. So although we are a conviction-oriented investor, it's important to note we don't own any two companies that do the same thing. We are adequately diversified.

TWST: What makes you decide to sell something?

Mr. Larson: We have a calculated fair value for every company in the portfolio which is regularly updated. When a company reaches 90% of fair value, we start to trim the position, and when it reaches 100% we exit the position altogether. We may sell if the position appreciates to the point where it is overweighted, if we discern deteriorating fundamentals, or if we conclude our investment thesis was simply wrong — we made a mistake. We may also sell to raise cash for more compelling opportunities.

TWST: How do you manage risk in your portfolio?

Mr. Larson: While our clients and the consulting community appreciate the low beta and low standard deviation of our portfolio, we don't equate volatility with risk. Volatility can be our friend. It gives long-term investors like us the chance to buy quality companies at a discount. Nor do we equate concentration to risk. We prefer to thoroughly know what we own rather than have exposure to hundreds of names.

Risk management is about protecting against the permanent loss of capital. Our risk management occurs when we underwrite companies, and continues as we closely monitor and research their fundamentals and fair value over the life of the investment.

TWST: What is your general outlook for the rest of 2014 and early 2015, and how do you see it impacting your investment decisions if at all?

Mr. Bernzott: We don't make stock market forecasts. Stock market forecasters are in business to make the astrologers look smart. But there are some macro things that are concerning us that we have in mind as we're doing our research and modeling our stock selections.

First, we're still faced with systemically high unemployment. The headline number dropped to 5.8%, and you read all about that in the mass media. But the U-12 number, a broader gauge of unemployment, is stuck stubbornly high at just under 12%. U-12 is the people that the government says are unemployed, plus over 7 million people stuck in part-time jobs because they can't find a full-time job, plus several million more that the government says are "marginally attached workers" who don't count anymore — the people that are so discouraged they've given up looking, and if you're not looking you're not considered unemployed by the Department of Labor. So unemployment is vastly understated, and given that consumer spending drives two-thirds of GDP, that's a problem that concerns us.

The second issue is unsustainable government spending continuing at every level from federal to state and local, and that can't go on forever.

Finally, there are ongoing national security concerns and issues from Ebola to ISIS where it's impossible to quantify the potential impacts, if any, but the potential is there.

TWST: Thank you. (LMR)

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