
THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Protecting Capital by Managing Risk



MICHAEL GOLUB is the Founder and CEO of the Golub Group. He began his career in the securities industry in 1967. His 36 years of experience in all different investment climates gives him a depth of experience and perspective possessed by few in the industry today. His principal responsibility at the Golub Group is to direct the activities and to serve as its senior portfolio manager. Mr. Golub is a graduate of the University of Colorado at Boulder with a BS in Finance. He and his wife Linda have three children and two grandchildren, all living in the Bay Area. He takes great joy in applying his experience as a portfolio manager and advisor for the benefit of firm's clients and in his management and leadership of his Golub Group team.



COLIN HIGGINS is the President of the Golub Group and directs the investment research and portfolio management activities of the firm. Prior to the formation of the Golub Group, he served as a research analyst and portfolio manager with regional investment firms, Branch Cabell, & Co. and Hoefler and Arnett, Inc. Mr. Higgins graduated from Washington and Lee University where he was an All-American lacrosse player. He lives in San Francisco with his wife, Kate.



KURT HOEFER, CFA, performs portfolio management and business development for the Golub Group. Prior to joining the firm, he founded and built Hoefler Capital Management, LLC, to counsel families and individuals on investment and financial matters. Previously, he was an investment banker with Thomas Weisel Partners and Banc of America Securities and an institutional stock analyst at Salomon Brothers. Mr. Hoefler is a graduate of Stanford University, where he received a BA in Economics, and the Anderson School of Management at UCLA, where he earned an MBA. He lives in San Francisco with his wife, Melanie, and two children.

(XAT502) TWST: Would you begin with a brief overview of the Golub Group and your respective responsibilities there?

Mr. Higgins: The Golub Group is an independent registered investment advisory firm located in San Mateo, California. We specialize in portfolio management for high-net-worth individuals and professional and corporate retirement plans. Our founder, Mike Golub, has been taking care of individuals' financial needs for 37 years, and along with the rest of the team, The Golub Group has over 65 years of combined experience in investment advisory services.

Golub: When you see a world-class business like a McDonald's after it has fallen from a high of roughly \$55 to \$15, when Wall Street's given up on it and the momentum players are out of it, etc., you do your homework. So you know that as a business it's dramatically undervalued and you know that you are not incurring much risk when you come in at that point. That's the way we limit risk.

We have \$250 million in assets under management for 210 clients. Our average account size is \$1.2 million. Our minimum initial account is \$250,000 and our largest account is \$18 million. Our custodian is Charles Schwab, and Schwab has proven itself to be an excellent partner.

I'm the President and co-Portfolio Manager for the firm. Kurt Hoefer is a co-Portfolio Manager. Michael Golub is the Chairman, Founder and CEO of the firm as well as a co-portfolio manager.

TWST: What is the overall investment philosophy at the firm?

Mr. Golub: Our philosophy is that the best way to create wealth over the long run is to manage risk first. It took me my first 25 years in this business to understand and appreciate Benjamin Graham's dictum that you can either predict or you can protect when you're managing your money in the stock market, and that it's better to be a protector. Ben Graham was Warren Buffett's teacher. We take this philosophy to heart. Our approach is based first and foremost on protecting our clients' capital by addressing risk. We don't want to lose the trust of any client who comes to us.

The way we do this is by investing strictly in high-quality businesses, almost exclusively multibillion-dollar, world-class franchise businesses — typically, those that pay above-average dividends. Number two, not only do we stick with very high-quality businesses, but we devote much of our time and effort to valuation. We want to buy a world-class business at a 20% or better discount to what we calculate to be its present intrinsic value. Furthermore, when a holding in our clients' portfolios becomes overvalued, we have a strict discipline that requires that we take capital from those

investments and find a business of equal quality that is currently undervalued by Wall Street. The effect of doing this is to posture our clients over the long run so that their money is always being managed in a way that minimizes risk. What we've found over the years is that when you do a good job of addressing risk the way we do it — by sticking with very high-quality businesses and being highly disciplined on valuation — ironically, you often get returns far better than you would imagine even though you're not going first and foremost for big quick gains.

1-Year Daily Chart of McDonald's



Chart provided by www.BigCharts.com

Mr. Higgins: Our discipline is simple, but it's certainly not easy to do.

TWST: How do you find the intrinsic value of a business that you're interested in?

Mr. Higgins: We project future cash flows, calculate the appropriate discount rate, and then discount those cash flows to determine their present value. We also look at historic price/earnings multiples, price/cash flow and price/book multiples. We're big believers in reversion to the mean. We know that if we can buy a business at a discount to what it has historically traded at, if it's a consistent and predictable business, over time it will likely revert to that mean.

TWST: Can you describe the investment process, how you come to select those companies?

Mr. Higgins: We have weekly investment committee meetings where Kurt, Michael and I sit down and review the portfolio. We do a lot of screening. We screen the universe of common stocks that are available that meet our investment criteria. We're looking for businesses that have a high return on equity, low leverage, strong cash flow, solid balance sheets, successful management teams and, most important, a history of consistent and predictable profitability. Once we've identified companies that meet these criteria, we narrow it down to a manageable universe of securities that we add to our focus list, and once a company is included in our focus list, we establish our estimate of its intrinsic value. We conduct fundamental research, due diligence and analysis, monitor the pricing of the security, and then, when it reaches what we think is an appropriate discount to our valuation estimate, we'll add it to our buy list.

on an absolute basis our portfolios returned a positive number, and then over the five-year period they've also generated a positive absolute return, significantly outperforming the benchmark. That's a function of the design of our investment philosophy to minimize risk.

Mr. Golub: The claim we make to clients is not that our discipline is designed to outperform in up markets, but, rather, that it is designed to be less risky than the market. Overall, it's designed to be less volatile on the downside than the market.

Mr. Higgins: An example of the success of our discipline is our purchase of **McDonald's** (MCD) back in January 2003 when the rest of Wall Street literally turned its back on the company. **McDonald's** had three years of significant underperformance in terms of same-store sales growth, and the majority of Wall Street had given up on it. We recognized that this was a world-class franchise with over 38,000 restaurants worldwide and 46 million customer visits on a daily basis.

Golub: After General Electric had fallen from the \$60s to \$23 we entered the stock, and we knew that we had relatively little risk in buying it at that price — with it yielding 4% plus on the dividend. We had done our calculations and we knew how undervalued the business was.

TWST: How many holdings generally would you have in a portfolio?

Mr. Higgins: We have 30 to 35 holdings in the portfolio. We take roughly 3% positions.

Mr. Golub: When any position gets above 5% in the portfolio, we will take capital out because we don't want any single position to represent too high a portion of the portfolio. We always want to maintain good, solid diversification.

TWST: How have the Golub Group portfolios performed relative to the S&P 500 benchmark?

Mr. Hofer: The short answer to the question is that they have done quite well. Over the 10-year period leading up to the end of last year, our portfolios returned 10.3% compounded after all fees and expenses versus the S&P 500 Index, the benchmark that we typically point to, which returned 9.1% over the same term. Over the five-year, three-year and one-year terms, we've returned 8.2%, 0.6% and 29.6% against our benchmark's returns over the same period of -2.0%, -5.6% and 26.4% respectively.

Mr. Golub: Year to date, through Friday, our portfolios are up 5.9% versus the S&P 500, which was down -.2%.

Mr. Higgins: What we're most proud of is that in the difficult market environment we've had over the last three years,

1-Year Daily Chart of General Electric



Chart provided by www.BigCharts.com

Looking at the business, at its fundamentals, we saw a company that was generating over \$2.5 billion in cash flow and over \$1.3 billion in free cash flow, and we asked ourselves what this company could do with that cash. It could do one of three things: it could redistribute it to shareholders; it could buy back its stock; it could pay

down its debt. We thought that there were going to be some catalysts coming online, and we said, trading at what we consider to be a deep discount to what it's intrinsically worth — 12 times earnings versus its historical 10-year average of 20 times — we knew this was a great opportunity to own a world-class business at a great price. **McDonald's** subsequently increased their dividend 70% last year, and just last week they increased it another 38%. They've been buying back

Mr. Golub: This is what creates opportunity! We're very thankful that most human beings would rather pay more than less for a good business.

TWST: What are some examples of your top holdings?

Mr. Higgins: Examples from our top 10 holdings are **Royal Dutch Petroleum (RD)**, **Canadian Oil Sands (COS_UN:TSX)**, **General Electric (GE)**, **Citigroup (C)** and **J.P. Morgan (JPM)**.

Hoefler: Amgen's business has never been stronger than it is today. It benefits from an immensely productive research culture. Its blockbuster drug portfolio is protected by a very strong patent estate, both in the US and abroad. And it has the business characteristics that we like. It generates huge cash returns on the capital it employs, producing over \$1.5 billion of free cash flow.

stock and they've also been paying down their debt. So we bought this business in the mid-teens, down from a high of \$50 a share, and currently it's trading at \$28 a share, and we still think this is a great value based on its fundamentals.

Mr. Golub: Here's the point. When you see a world-class business like a **McDonald's** after it has fallen from a high of roughly \$55 to \$15, when Wall Street's given up on it and the momentum players are out of it, etc., you do your homework. So you know that as a business it's dramatically undervalued and you know that you are not incurring much risk when you come in at that point. That's the way we limit risk.

We can give you many other examples. We bought **Best Buy (BBY)** after it had fallen from roughly \$60 to \$23. We had done our homework and we knew how undervalued the business was. Most importantly — and ironically — we knew that it was not worth less as a business at \$23 than when it was trading at \$60. We were just entering at a point at which it was far less risky to own the business.

We did the same with **General Electric (GE)**. After **General Electric** had fallen from the \$60s to \$23 we entered the stock, and we knew that we had relatively little risk in buying it at that price — with it yielding 4% plus on the dividend. We had done our calculations and we knew how undervalued the business was. We could give you more examples. But these, I think, show the way we limit risk: we stick with large, strong, world-class businesses; we buy them when Wall Street is disinterested and we can have them at a relatively bargain price; we diversify and we are patient.

Mr. Higgins: We find it curious that the stock market is the only marketplace in the world where, as an asset becomes less expensive, it becomes less desirable to buyers. No other commodity that we can think of has that characteristic.

1-Year Daily Chart of Amgen



Chart provided by www.BigCharts.com

Mr. Hoefler: I'll give you a couple of examples of our most recent purchases. In August we bought a full position of **Amgen (AMGN)** for our accounts. We think **Amgen's** business has never been stronger than it is today. It benefits from an immensely productive research culture. Its blockbuster drug portfolio is protected by a very strong patent estate, both in the US and abroad. And it has the business characteristics that we like. It generates huge cash returns on the capital it employs, producing over \$1.5 billion of free cash flow — this is after investing \$1.5 billion in new productive plant and spending \$1.8 billion on R&D — and it is returning its surplus cash flow to its shareholders in the form of share repurchases. For example, it spent \$1.8 billion in 2003 and another \$1.6 billion during the current year through the second quarter. In our opinion, the in-

vestment that this company is making in its physical plant and in research and development activities is going to drive earnings growth approaching 20%. Moreover, this is a company whose stock has historically traded at multiples in the upper 30s, and is now trading at a multiple of 20 times our estimate for 2005 earnings. We thought this stock was compelling at our \$54 purchase price, and it remains compelling today. Now, we did not buy on the expectation that we will necessarily reach those levels, but we think the odds are very good that the multiple will expand as earnings continue to grow.

Mr. Golub: We are not, in the classic sense, pure value investors. We're interested in growth businesses. But we only want to buy a growth business when we can do so at a superb valuation.

Mr. Hoefler: I'll give you another example. We're buying **Intel** (INTC) for our accounts right now. This is a company that is

spent the majority of his career at DLJ specializing in the oil and gas industry. He is a 25-time *Institutional Investor* All-America research analyst who's been honored with the top spot in domestic oil. He's frequently quoted in many of the leading financial publications — and not only is he a CFA, he is also a member of numerous industry groups, including Petroleum Analysts of Boston, the Oil Analyst Group of New York, etc. Kurt has pointed out that he thinks **Canadian Oil Sands** to be a truly unique opportunity. They have a 37% ownership in the Syncrude oilfield in Northern Alberta. Some estimates have this oil reserve as being larger than that of Saudi Arabia! We think the proven reserve life of these properties is 35 years, and they're anticipating a 50% growth in production after 2006 after they make an investment into capacity expansion. We think the company's current dividend yield of 4.5% has the potential to triple over the next several years.

Hoefler: We're owning Intel in recognition of its really wonderful fundamental business attributes and on the expectation that this current, weak cycle will, over time, improve. Intel has an amazing, pristine balance sheet: \$17 billion of cash and securities to only \$1 billion of debt. And even in this weak cycle, Intel generated roughly \$8 billion of free cash flow.

very much unloved by the Street. Analysts are focused on near-term issues such as inventory levels on **Intel**'s books and in its distribution channels, which, while important, really aren't critical to the long term. We're taking a much longer view. We're owning **Intel** in recognition of its really wonderful fundamental business attributes and on the expectation that this current, weak cycle will, over time, improve. **Intel** has an amazing, pristine balance sheet: \$17 billion of cash and securities to only \$1 billion of debt. And even in this weak cycle, **Intel** generated roughly \$8 billion of free cash flow, and it is returning this cash flow to its shareholders through share repurchases and dividends. With a dominant position in its markets, robust cash flow, \$3 billion of share buybacks in the first two quarters of this year, and dividends paid at the rate of \$1 billion a year, we think the shares of **Intel**, which is one of the world's truly great business franchises, are a bargain. It trades at 16.7 times Wall Street's estimates for 2005, and it yields 1% — which isn't bad in the current interest-rate environment.

TWST: You mentioned Canadian Oil Sands Trust. What attracted you to the royalty trusts? And what is your outlook on energy stocks in general?

Mr. Higgins: We think one of the things that makes our firm unique is that we have access to some of the best minds on Wall Street. We have a consulting relationship with Kurt Wulff of McDep Associates, which is an independent research firm based in Boston. Mr. Wulff

1-Year Daily Chart of Intel

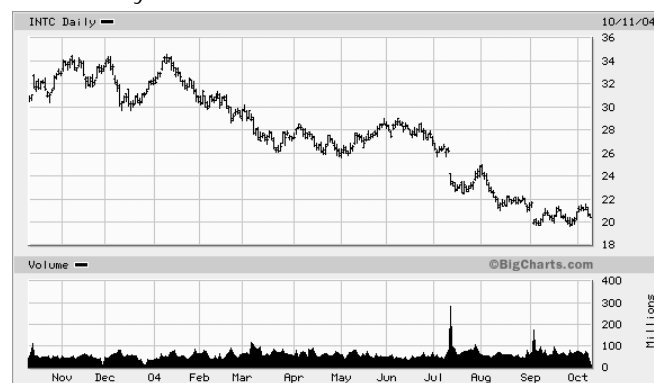


Chart provided by www.BigCharts.com

From a valuation perspective, this is truly compelling, with the shares trading at roughly 40% of what we think this business is worth. Syncrude is a joint venture with some of the most recognized world-class franchises in the oil industry — **ConocoPhillips** (COP) and **Exxon Mobil** (XOM) — which is also a position we hold in our portfolios.

We've taken a large position in the energy space over the last several quarters because of our belief that there's a fundamental supply/demand imbalance, particularly in oil. We think the recent strength in oil is not an anomaly, and with the acceleration of growth in China, with global demand and a finite amount of supply out there, we feel very good about the outlook for many years to come.

Mr. Golub: Our discipline allows us to hold a business for many years, so when we make an initial investment in a business, our hope is that as the price over time appreciates, the fundamentals will appreciate with the price. If that does not occur, if Wall Street — as it often does — simply gets too excited about the business and prices it too highly, we will be sellers.

Higgins: Canadian Oil Sands is a truly unique opportunity. They have a 37% ownership in the Syncrude oilfield in Northern Alberta. Some estimates have this oil reserve as being larger than that of Saudi Arabia! We think the proven reserve life of these properties is 35 years, and they're anticipating a 50% growth in production after 2006 after they make an investment into capacity expansion.

Mr. Golub: To pick up on what Colin pointed out, one of the unique things about our firm, even though we're small, is that we have consulting relationships with some of the best talent on Wall Street who, in effect, are part of our research team, Kurt Wulff being one of them.

We also have Manny Goldman on our research team. Manny consults with the Golub Group on an exclusive basis. As a securities analyst, he has been ranked by the prestigious Institutional Investor All-American research team poll as the nation's top beverage analyst 15 times, and he had been a member of the All-American Research Team for 25 consecutive years. Manny has been quoted extensively by the business press, Time magazine, The Economist and The Wall Street Journal; he has been four times guest of the week on Louis Rukeyser's Wall Street Week; he's been interviewed on 20/20, Nightline, News Hour, by Jim Lehrer, CNN and CNBC. He is, without question, one of the best beverage and tobacco analysts ever on Wall Street. A wonderful guy, just a charming, brilliant man, he is part of our team. We cannot tell you how excited we are to be able to offer this kind of experience and research talent to our clients.

TWST: Can we move on to your sell process? What is the discipline you use?

Mr. Higgins: As we mentioned, we establish a price target at the time of purchase, and we evaluate the fundamentals of the business on a regular basis, monitoring earnings and developments in terms of the various metrics that we're watching. Typically, when a business exceeds our price target by roughly 10%-15%, we will reduce our position. However, if the fundamentals of the business continue to improve and justify the current valuation, we will hold on to the business, as we are long-term investors and we look to let the benefits of compound growth accrue to us as shareholders.

Mr. Higgins: Another thing we do at the time of purchase is establish a re-evaluation price, and if the business were to drop 15% from where we initially purchased it, that would cause us to go in and re-evaluate the basic fundamentals for why we purchased that business in the first place. If then we find something that's fundamentally changed, we're going to take the appropriate action and reduce our position. Conversely, if the fundamentals have not changed and are indeed strong, typically, we will continue to add to the position.

Mr. Hoefler: The net result of this is a portfolio turnover of no more than 25% per year.

TWST: You also do asset allocation in the different portfolios. Could you briefly tell us what your management of fixed-income securities is at this time?

Mr. Higgins: We sit down with our clients and assess their risk tolerance and return expectations and investment objectives, and based on that assessment we're going to determine what type of asset allocation is appropriate in terms of allocation to equities, fixed income, income securities, cash and REITs. I'd note that we're quite experienced investors in real estate investment trusts, and are attracted to the high dividends they provide and consistency and predictability of their businesses. Based on our assessment of our clients' risk and return objectives, we're going to allocate a percentage of their portfolios to those various asset classes.

We invest strictly in high-quality investment-grade securities. We match duration to income needs and requirements, and we're not traders in the fixed-income space. We hold those primarily for cash flow and security of principal.

TWST: What would you say is special or different about the portfolio investment at Golub Group when it's compared with other companies of similar style? What do you bring to the table that you feel others don't?

Mr. Golub: I think that our approach of addressing risk first sets us apart. Most people, when they think about the stock market, including most professionals, think first about opportunities to make a lot of money — particularly opportunities to make a lot of money quickly. This guides their subsequent actions.

We think about where there exists an opportunity to limit risk, and that guides our discipline. What's interesting — and this is what Benjamin Graham was talking about when he said you can either protect or predict — is the fact that last year, for example, calendar 2003, our accounts had a total return of 29.6%, outperforming the S&P, which had a total return of 26.4%. So ironically, if I can be philosophical for a moment, when you go for the right things in life, you often are rewarded far more than you think, and when you go for the wrong things in life, such as the quick buck, you're often punished. My point is that Benjamin Graham had it right. This is the way Warren Buffett has created his wealth. He is attracted first and foremost to high-quality investments that he can take a position in at a time when his risk is limited, because they are bargains, and has later been surprised at how much gain he has made after a short period of time!

I'll give you another example. When we bought **Best Buy** after it had fallen from \$60 to \$23, we really weren't concerned about how soon and how much we would make on the upside. However, 12 months down the road, it was trading at \$59! But we certainly weren't going out there, just looking for something to make a short-term killing.

I think this concept is not well understood by the investing public — and frankly, I don't think it's well understood by most professionals.

TWST: What investment advice would you give at this time for our readers about entering the market?

Mr. Golub: What I would say is to open your eyes, look at the world we're in, see if you don't agree with us that we are in a highly competitive world. We have China producing about 4% of the world's GDP and consuming about a third of the world's steel output. Think about what that means. Think about all the new, productive facilities they're bringing online. Think about what's happening in India, with its large well-educated, talented and low-cost workforce. Think about what's happening in the old Eastern Bloc. Think about a highly competitive world for years to come and the implications that has for low inflation and low interest rates. We think the big surprise for most investors is going to be the fact that we have entered a period

where for the next 10 or 20 years, all you're going to be able to get in a money market fund or a CD is 2.5%. If that's the case, investors should consider the fact that where true value exists today is in big, blue chip, world-class enterprises — companies like **GE, Exxon...**

Mr. Higgins: Pfizer (PFE), Citigroup, etc...

Mr. Golub: ...companies that pay dividends alone that equal or, in many cases, double what money market funds pay. And as fear subsides — and obviously, we're in a very fearful period right now, but fear is cyclical, like everything else — a big portion of the trillions of dollars that are sitting on the sidelines in cash will have to flow back into trustworthy businesses that pay generous dividends. And the sooner that's realized by investors, the better it will be for them.

TWST: What would you like to say by way of summary?

Mr. Golub: There's one other thing I think we'd be remiss if we didn't mention. We mentioned Schwab briefly. I'd like to emphasize that we have a very fine partnership with Charles Schwab & Co. Schwab custodies our clients' assets, but really has gone out of its way to help our firm be more valuable to our clients. We're in the Schwab Advisor Network, a group of about 300 advisors out of a total of 5,300 who custody their accounts with Schwab. In our case, we work with Schwab's eight offices from San Mateo, where we are located, and south to San Jose. We help them serve those clients who need professional money management. They've been an outstanding partner, and we're extremely grateful to them and enthusiastic about our experience working with them.

TWST: Thank you.

Note: Opinions and recommendations are as of 10/8/04.

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