

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Separate Management Account Investing



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(ZBX502) TWST: Would you begin with an overview of RNC Genter Capital Management and its investment philosophy?

Mr. Genter: Our focus is providing service to high net worth individuals and medium-sized institutions.

From a corporate philosophy standpoint, the overall focus for us is to try to take an institutional service to the middle market, both for high net worth individuals and institutions. In that, we have a vertically integrated product line that runs everywhere from all common stocks to all bonds. On the bond side, though it's all investment-grade bonds, we have an intermediate-term product and a short-term product for taxable accounts, as well as tax-exempt accounts, in which we do a lot of active municipal bond management. We also provide a whole series of balanced accounts.

Then on the equity side, we provide a growth product, a core product and a value product. We also have a newer, high-dividend product that we're really excited about and that is doing very well. So there are some specialty areas on the bond side that we provide. I already mentioned the more actively managed municipal bond area. There we can do a lot of customization in terms of state residency and specific tax parameters.

We also have a very specific style that we've developed exclusively for clients who are exposed to alternative minimum taxes, where we use a blended strategy of both taxable and tax-exempt bonds. So, from a philosophical standpoint, we are going to be investment-grade on the bond side and very high quality on the equity side — and almost exclusively large cap — in each of the disciplines I described.

TWST: Am I right in saying that you were one of the pioneers of the separate management account investment approach?

Mr. Genter: We've been doing it for a long time — basically since 1968. That was a time when being able to provide this level of institutional management, especially to smaller institutions and the high net worth individual, was certainly in its pioneer phase. Those levels of services at that point in time were really only available to larger pension plans, endowments, foundations, etc. There was very little taking place from the standpoint of separate account management. So early on, when I would talk to financial advisors or people in the brokerage community, quite often, I would get questions like, "What is a registered investment advisor?" and "What is separate account management?" Now it's obvious — there's a

plethora of it in the mainstream of the investment community — but at the point in time that we started doing it, there really was very little access for the middle market in this area.

Even though that's become somewhat commonplace in the equity area, one of the other areas where we feel we've been pioneers is providing that type of management in the fixed-income area. Typically, to have a truly separately managed fixed-income account, most clients are looking for at least \$10 million or \$20 million minimums to be with some of the large institutional firms. We really set out to provide that same caliber of service, whether it is taxable bonds, municipal bonds or, as I mentioned, the new strategy — which we've clearly pioneered — is a blended strategy for people who are exposed to alternative minimum tax to allow them to have that same customization but with a more medium portfolio size.

both a ratcheting up of a desire for a higher level of service on the part of people graduating out of the mutual fund area, and then other people who had been managing the portfolios themselves who realized they needed some professional help. Both of those types of people graduated toward the separate managed account area, which has certainly benefited our part of the industry.

TWST: You've told us that you do growth, core and value in the equity part of a portfolio. Are there any common characteristics that you look for in equities?

Mr. Genter: I think what we're looking for are generally seasoned, established companies that still have growth potential. And even though that's something that a lot of people look for in companies, I think what's different about our approach is that we are looking for large and medium-sized companies that are going to have

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TWST: Customized portfolios seem to have taken on a new lease on life since the market downturn in 2002. Have you been getting a lot more interest from potential clients since then?

Mr. Genter: The answer to that question is yes. I think there are two reasons for that. One was certainly the cessation of what was a spectacular bull market ending in the first quarter of 2000. That was a situation where many people were managing their own assets and feeling that they could do no wrong. Everyone was an investing guru, and a rising tide was raising all ships. When that tide started to ebb and flow the other way, a lot of people who perceived themselves as brilliant realized that they'd better seek some help. Having separate portfolios already, they didn't want to liquidate those portfolios entirely and go into mutual funds. They were really looking for something that was a little more sophisticated, and the offerings that were being presented in the area of separate account management were what were attractive.

In addition, people who had been in the mutual fund area were really looking for something that was an upgrade. They had become a little disenchanted and confused by the smorgasbord selection that was available in the mutual fund area, and they began to look outside for what else was available where they could get some advice and support and could have some customization. So you saw

above average growth. Depending upon whether it's value, core or growth, there are different characteristics as far as the rate of growth that we're looking for. Basically, they're going to be companies that have above average growth. They're going to be just very solid companies with overall balance sheet integrity, and they're going to be in a position where they're trading at very reasonable multiples.

Now, we don't necessarily think they're going to knock the cover off the ball — those characteristics are typically reserved for smaller companies, which is not our core competency — but to put it in a nutshell, we want to see earnings growth that's generally going to be 15%-20% faster than the peer group, whether that is in a growth, core or value portfolio. And again, we're looking to enter a company at a discount of 5% up to 15%, if we're looking at a value portfolio, from the relative value of its peer group. It's our feeling that if we have no multiple expansion, even if we just track earnings plus dividends, that's going to be a very solid growth path for us, as long as the earnings integrity is strong and we're coming in at what we feel is a fair to slightly undervalued position. If we're right and the earnings growth continues to be very stable and we can have some p/e multiple expansion that will at least take it back to the mean for the peer group, since we're coming in below that mean, that will be a situation where we're going to have an above average return on that particular security.

Also, if there were to be some pullback in the overall marketplace or some short-term disappointment and we're coming in at a slightly below-peer multiple, since we're already coming in at a slightly lower p/e, we would actually have some insurance that there's some floor underneath that stock if it happened to pull back a little bit. That would be common to those strategies.

The fourth strategy that I mentioned — which, I'll repeat, has been doing very well for us — is our high-dividend strategy, which is somewhat unique in the industry from the standpoint that a lot of mutual funds and some separately managed accounts that are billed as high dividend are, quite often, run in one of two ways. One is invest-

the fundamental stock basis just to make sure that we're getting reasonable value. Hopefully, we're going to have some upside in addition to, on average, getting about a 3.5% dividend.

It's been very interesting using some of that very basic, bottom-up fundamental research of securing the basic integrity of the company as if you were going to lend them money as a bondholder, and then looking at both the cash flow coverage and the dividend payout ratio. Using that analysis, we've actually had a surprising amount of capital appreciation from the stocks, which was really the number two or number three result that we were looking for, but when we're buying companies with that type of integrity, it has worked out very well.

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ing with a rising-dividend theory, which means buying companies based upon the magnitude that they're increasing dividends. The other is buying companies that are paying slightly above average dividends versus an S&P 500 benchmark, which ends up being a backdoor way of creating a value portfolio. What we're doing is different from the perspective that ours is a portfolio for which job number one is really focusing on high dividends. We look for dividends that are almost double what we see the S&P 500 generating — and these are all qualified dividends, so they're all being taxed at 15% rates and receiving that preferential treatment — thereby creating high-income-producing portfolios with dividends as a very significant priority.

The analysis really starts off looking at those companies as almost a bond substitute; we are really doing our initial analysis as though we were interested in buying the bond. So we start off more with a balance-sheet analysis than an income-statement analysis.

We really look to see if the integrity of the dividend is high enough so that that integrity will rival being paid interest payments. In other words, this is a company that is strong, both from a balance sheet and cash flow standpoint, and we would feel very comfortable buying the bonds. Indeed, if we were going to buy that high-dividend stock, the bonds for the same company would all have to be investment grade. It would be a sell trigger for us if those bonds were downgraded.

As a shareholder, we're really looking at whether or not we are going to get our dividend payment the same way we would receive our interest payment as a bondholder. If we feel very comfortable being a bondholder of the company and are comfortable with the integrity of the dividend, then we start to look at the company from

TWST: Have you seen a growing trend among your clients toward yield?

Mr. Genter: Yes, I think there has definitely been a trend toward it, and that's one of the reasons why we've brought out this strategy. It's not a new strategy to us; as a matter of fact, we've been doing it for over 30 years. We have a balanced strategy, which is a maximum income strategy. It's using both bonds and high dividend stocks, so the only thing that's new to us is that we have really never offered that as a separate stock category standalone, and when they changed the tax law three years ago, we spun that off so that people could gain access to that individual stock strategy independently without being in a balanced portfolio.

One of the reasons we did that was not only for the tax benefit, but because, more and more, we're seeing clients that are clamoring for more income, really for two reasons. Number one, with both the equity market and the bond market, total returns have been mediocre and they've come to realize that if you can start off the year getting 3.5% to 4%, especially with that being taxed at 15%, that's a very nice base to be assured of as you come out of the starting gate, so more and more clients are looking for that.

We're also seeing, as the baby boomer population moves closer and closer to retirement, the need for income generation within the portfolio, and people have become much smarter investors in realizing that you can't just rely on growth, as you could in the latter part of the 1990s, to succeed and provide all of your income needs and hedge against inflation. That has happened, and that's great when the years are good. But if you have a portfolio that has very little cash

flow and you get into any kind of a bear market or flat market and you're still drawing 4% or 5% in cash for living purposes, it is very easy for you to get behind the power curve, and the portfolio starts declining because you don't have enough cash flow.

So again, clients are much more educated in saying, "I can lock up intermediate-term bond rates right at the beginning of the year. It's only being taxed at 15%, and I know that I have some good, solid cash flow that's going to provide at least 60% to 70% of my cash flow needs, even if I don't get any growth." We're seeing clients on the equity side with balanced portfolios and even clients with fixed income portfolios that are saying, "I need the cash flow, but this is still a good strategy where I can capture cash flow and I can still get a little bit of upside growth." You're really seeing people from three areas who are saying, "Having this good, solid cash flow from dividends is a very good safety net to get minimum returns, meet cash flow needs and get some upside."

the future and not the past, and that becomes very critical as people are looking at the stock, the bond, cash decisions and the asset class decisions between small cap, mid-cap and international. It's absolutely critical that you can set up some reasonable expectations for the future — not just making decisions based upon the past.

TWST: How do you structure your portfolios?

Mr. Genter: Depending on the strategy, we normally would have somewhere between 35 and 40 different stocks. We feel that you really want to have a minimum of 30 stocks, which allows you to have average position sizes — 2.5% to 3%. They're big enough position sizes that if your stock selection is good, it's going to have some positive impacts on the portfolio, but it's not so big (like 5% or 10% positions), that if something were to go contrary to your belief, it would be particularly onerous for the overall portfolio. So we feel that somewhere in the 30 to 40 issue range is really going to be optimal for get-

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TWST: Is it important for equity or fixed income portfolio construction to have a top-down analysis of the economic trends?

Mr. Genter: I think so. The top-down analysis, in all likelihood, plays a much bigger role in looking at your three- and five-year time horizon. The top-down analysis, with regard to significant asset allocation changes over a very short period of time, can be just as damaging as they are helpful. But clearly, as you start to look at three- and five-year market cycles, you have to do a top-down analysis as to what's going to be the probable relative performance of the different asset classes. If you don't do that or some type of forecasting with regard to top-down, then you're really making all of your asset allocation decisions looking in the rearview mirror, based upon what the historical performance has been the last three to five years. That's where, in many cases, people get into a lot of danger and hurt themselves.

The good and bad thing about our industry is that we do have concrete relative performance to look at. Even though that's very good for judging what the relative performance has been for various asset classes, it's also very bad because it's not predictable in any way, and in many cases, the underlying currents that have been controlling that are seas of change that continue to transform. So I think you have to look at it from the top down, and have to look into

the most traction, but it still allows us enough diversification from the standpoint of both individual securities and allowing us diversification of different economic sectors, which we feel is critical.

Especially in the last three or four years, you've seen some very dramatic sector rotation to the point where it has not been uncommon to have only one or two sectors really driving most of the returns. On the other hand, you may have only had one or two sectors that were causing most of the problems. So having sector diversification, along with individual security diversification, is very key, and I think you're hitting on a very important point.

The difference between professional investment management and portfolio management has a lot to do with the portfolio management side, in addition to just the individual stock selection side. We manage money for a lot of high net worth individuals who are running major corporations, and they're not only running major corporations — they're doing mergers and acquisitions at the billion dollar levels. These people are very accustomed to looking at balance sheets and income statements and projecting the future earnings capacity of companies that they are involved with, so they're sophisticated investors. Their ability to do individual stock analysis and company analysis, in some cases, could even rival our own.

But when you start managing money for those individuals, what you normally see is that it's not necessarily their stock selection in the portfolio that you inherit that's the problem. Typically, it's portfolio construction that's the problem. They may have 30 stocks, but they have three stocks that constitute 40% of the portfolio and they really don't have proper diversification, or they have 50% or 60% of the portfolio that's in one economic sector. So you see that the distribution in the portfolio can be very skewed, and there is not a proper balancing and rebalancing in the portfolios.

Independent of the stock or bond selection, which are certainly the individual pistons that drive the motor, you have to have all the other component parts balanced out for the engine to work properly. That's the real key, and that's where risk management comes into play. Stock selection is certainly the R&D that's going to drive your upside potential, but portfolio management is where you're going to control your risk. Having that diversification, having the proper balancing, and having the rebalancing to keep that risk under control is what's going to make or break total performance in the portfolio as you go through a full market cycle.

of those targets. We may sell a third of the position or half of the position, once again, taking some money off the table and reducing the position in the portfolio and starting to reallocate it. That would be the good side when we're approaching our price target.

The flip side would be that we have a fundamental problem. The basic original thesis for which we bought that stock is no longer intact. At that point in time — whether that's a surprise, a new development or the competitive environment — we have basic premises that we're placing on those stocks when we buy them. Those have to stay intact if we're going to continue to maintain them. So if there's a fundamental deviation, that would be a reason why we would reduce a position. I say that in distinct contrast to the fact that there may or may not be a direct correlation to the fact that the share price has come down.

Quite often, people ask, "Do you have an absolute sell discipline if the stock comes down to a certain level?" And the answer to that is, "No." What we're looking at is why the stock is coming down. Indeed, if there is a change in that thesis and that premise that we bought it on and that is now materializing in a negative share price, that would certainly be something we'd look to sell. On the

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TWST: What is the sell discipline that you employ on the equity side of your portfolio?

Mr. Genter: There are going to be three primary factors that would cause us to sell. Number one (which is the nice thing) is that we set very specific written targets on a per share basis when we buy a particular stock. As we begin to approach that target, it acts as a very formidable sell discipline for us unless we can clearly justify — and the analyst can clearly convince all of his compatriots here — that there has been a significant underlying fundamental change to warrant expanding what the sell target is. Otherwise, that's typically going to act as our sell discipline. Certainly, it would be acting as a point where we would start to take partial profits and at least move some of the money off the table, which is a very common thing for us. It's not that often in the securities business that everything is 20/20 and you can immediately see that it's the perfect time to buy or the perfect time to sell. So quite often, we buy a stock and it's moving up and its p/e is expanding and is starting to approach some

other hand, if there really has been no change and there's just a market dynamic or bad publicity, whatever it happens to be, we indeed might be buying more at that point.

The third reason why we'd sell something would be as a result of top-down emphasis. If we were changing what our sector rotation was, for example, by reducing financials, increasing energy, etc., then we would look to sell the weak link so we could free up some cash to move into a new area. Another example would be if, for whatever reason, we're changing our stock-bond allocation in a balanced account.

TWST: What is the average turnover of the equities in your portfolio? How long do you like to keep a stock if things are going well?

Mr. Genter: Our average holding period is actually about two to three years. There's nothing magical about that. It's not something where we start the stopwatch when we buy it. It's just that it happens to be about that time period. If you look at the typical turnover in the portfolio, it's about 30%.

TWST: Risk management is of paramount importance to you and your investors for the preservation of their capital. Are there any other techniques you might use that you can tell us about?

Mr. Genter: I think risk management is a key one, and from the standpoint of specific techniques, maybe I can expand on that a little because I talked about it primarily from the standpoint of individual stocks. But I think it's also key from the standpoint of keeping the sectors and the stock-bond-cash positions in balance. We may be able to control our risk structure by selling off partial positions in individual stocks and rebalancing. We're also doing the same thing if an individual's economic sector, such as technology or energy (since it's been such a strong relative performer), is outpacing the rest of the portfolio to such a magnitude that it's become too large

internally who are given sector responsibilities. They have the primary responsibility for both new idea generation and for maintaining ideas on existing securities that we're holding. Then we also have Wall Street firms that we're willing to buy research from that will supplement what we're doing internally.

For us, it's a combined effort. We know that we can't be the absolute experts in every particular area, so we're going to take the core competency that we have in those individual analyses and supplement that with additional Wall Street research. But we are doing a lot of the core analysis and research ourselves, so we have a pretty substantial budget for going out to do original research and shoe leather research (physically meeting company managements ourselves), in addition to what we're getting from Wall Street.

“As we’re looking at various bonds that we’re going to buy (because a lot of the money we manage here is fixed income), we’re also directly in contact with research sources and not just taking the word of the various rating agencies with regard to what our opinion should be on those fixed income securities.”

a position. Then we'd take profits and money off the table and redeploy it into other sectors. We would do the same thing if the equity side or the bond side were dramatically outpacing the remainder of the portfolio. We're then reducing that stock position or bond position and rebalancing to whatever our original target is for that client.

I think the important things about that from the standpoint of risk management are obvious. What many people found as we went through the late 1990s and the beginning of 2000 was that they were letting all their stock positions run and clearly, pure mathematics tells you that you're going to be in your highest-weight position in whatever the strongest-performing asset class is right at the top. If you didn't start to take money off the table somewhere in between, then you would have your highest exposure at the most exposed time.

That's probably one of the things I'm proudest of — we really stuck to our guns through that period. Even though clients were clamoring as to why we were selling off equities in late 1999 and early 2000, we were really doing it as a discipline to rebalance portfolios that had started off at 60% equities and had moved up to 70% equities, and we were getting them back to their original targets. I think having those disciplines in place, both from a risk control standpoint and the standpoint of capturing profits and enhancing performance, is critical.

TWST: How do you do your research at the firm? Is it internally generated or is it Wall Street influenced?

Mr. Genter: It's a combination of both. We do have our own in-house research team and we have four research analysts in-

We do that on the stock side and also on the bond side. As we're looking at various bonds that we're going to buy (because a lot of the money we manage here is fixed income), we're also directly in contact with research sources and not just taking the word of the various rating agencies with regard to what our opinion should be on those fixed income securities.

TWST: How do you measure the performance of your different portfolios? Are there benchmarks you can use?

Mr. Genter: It depends on the strategy. For our core strategy, we would use the S&P 500. For the value strategy, we typically use either the S&P 100 or the Barra Value. For our growth strategy, we use the S&P Barra Growth and for our taxable bond strategy, we use the Lehman Brothers Government/Credit Intermediate. We typically benchmark our municipal bond portfolios against the Lehman Brothers Five-Year.

TWST: What differentiates your investment approach to separate management accounts from that at other peer companies?

Mr. Genter: There are a lot of companies out there that have good research departments, but I think the real difference for us is going to be one I mentioned earlier, which is risk control. We're very, very focused on not only security selection, but also on risk control.

The other major point is the ability for clients to customize their portfolios. We have clients here that range from all equities to all bonds and every mix in between, as well as every possible tax

bracket. We also have clients in almost all 50 states. Depending on what that client is trying to achieve, they may have 20%, 30%, 40%, 50% or 60% in equities. The bond part of their portfolio could be all municipal bonds. It could be all taxable bonds. As I mentioned earlier, they could be exposed to alternative minimum tax, where they have 60% in stocks and 40% in bonds that is a blend between taxables and tax exempts that is being specifically managed for their particular state of residency or possibly managed for other tax reasons, where they have a big loss carryforward of some type.

There's a lot of customization that goes into our portfolios, with the primary objective being to give the client the highest rate of return for a given risk level aftertax. There really is a huge difference in trying to manage these portfolios for taxable clients that are being managed on a tax efficient basis, so we're very active at the end of the year in harvesting losses against gains, doing any swaps that are appropriate, and being in contact with the client directly to find out if they have gains or losses in other assets they may have and how we can best help them with that in the portfolio we manage. We estimate that we add about another 1%-1.5% a year in returns just by managing things efficiently for tax purposes. But all that really boils down to being able to customize the portfolio for that client. They're not all created equal and they can't be managed that way.

TWST: Do you also look for alternative investments?

Mr. Genter: We don't really use alternative investments, and that's neither an endorsement nor an indictment of those investments. It's just not really our area of specialty, so we'll look at it from time to time for clients when they ask us about it. The only thing that we try to make sure clients understand is that an alternative investment or a hedge fund is really a concept. Structurally, a hedge fund is really nothing more than a limited partnership, so they just need to make sure that they digest it and dissect it to the point that they really understand what they're going to be doing from an investment technique standpoint within that fund and we just need to make sure it's going to be complementary to what we're doing in the conventional investments.

TWST: With another three quarters to come in 2006, do you foresee any particular challenges in the fixed income or equity markets?

Mr. Genter: Stock selectivity is going to be absolutely critical and is probably our biggest challenge right now. We've had a good first quarter and I think in looking at the overall market, everyone would be very satisfied if they could annualize the first quarter throughout the rest of the year. Most people would be happy to put a padlock on it and go home. But I think as we go toward the latter part

of this year, it's going to be challenging as we begin to see overall earnings momentum probably begin to slow.

We've had three years of exceptional earnings. The market has reacted rather mutedly to those earnings with very little p/e multiple expansion. As a matter of fact, it's been contracting as rates have gone up, and I think even though we're coming toward the end of the interest rate hike cycle (at least from the Federal Reserve perspective) and with likely another 50 basis points to go, you're still going to have a bit of that headwind against the marketplace. Then, you're not going to have well above average earnings growth that has been helping to essentially offset it. With that, stock selection and not having companies that are going to provide you with a disappointment is going to be absolutely critical and I think that is going to be a challenge for the market for the rest of this year.

TWST: Is there anything you would like to add?

Mr. Genter: I think for investors going forward, one of the key things we try to focus on is that a lot of investors' portfolios have become very fragmented. Some of that has been due to a lack of attention and some of it has been due to their getting advice that they need to be diversified, and they've become so diversified into so many areas that some of those areas are working against one another and there's not as much of a coordinated theme.

I think one of the things that we strive for with our investors is to make sure we're looking at the big picture and that you're in a position where all the individual pieces are working for the same common cause. I think investors are going to have to look at that. If you're spreading out seeds in a lot of different fields and that's not being done in an intelligent, coordinated way, it's not going to work in the future. It's going to have to be coordinated, organized and managed.

TWST: Thank you.

Note: Opinions and recommendations are as of 4/5/06.

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