

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Managing Equity Portfolios



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TWST: Let us start with an overview of Pillar Pacific Capital Management.

Mr. French: Pillar Pacific is the combination of two firms, Pillar Point Equity Management and the California Branch of PacWest Financial, which was owned by Mindy Ying. Mindy and I have known each other since 1990 and we have talked about working together for some time. Mindy had developed a business that was predominantly private wealth, whereas Pillar Point was about half private wealth and half institutional. After the combination late last year, we became about three-quarters private wealth and one-quarter institutional, with about \$450 million under management.

TWST: How would you describe your overall investment philosophy?

Mr. French: Our investment philosophy has two components. The first would be a notion of price to space; price is self explanatory, space would be determined by style, growth versus value and large versus small. To give you an example of how that might work, the space for large cap value would be defined by a short duration cash flow whereas

large cap growth would focus on the discounted stream of future cash flows tied to products, and small cap growth would be concerned with the perception of what those future cash flows might be, the potential.

The second tenet of our philosophy is that investment management is really information management. We build models in order to manage the information relevant to making informed investment decisions in each asset class.

TWST: Do you set models for your different investors to choose from according to their needs?

Mr. French: No. For the most part, we build the portfolios for our clients. The clients' goals and objectives determine which of those models we may employ. In the case of private wealth clients, we're looking predominantly at all-cap portfolios, with a focus on the large cap growth model at this point in the cycle. On the institutional side, in addition to large cap growth, we manage mid-cap growth, small growth and large cap value portfolios.

But these valuation models only serve a securities analysis function. In constructing portfolios we use proprietary optimizers.

TWST: What are the criteria that you look for in potential equity holdings?

Mr. French: The securities analysis part of the process combines quantitative analysis with judgment. The models analyze the financial data of each company in the category into which they fall — large cap growth, large cap value, mid-cap, and small cap growth. The output of the valuation models is balanced by judgment.

Collectively, we have a lot of experience, so we review the model output in the context of qualitative issues such as global macro factors like the strength of the dollar, geopolitical issues, the housing market and energy prices. We're also looking at the company's product lines, the expectations for those product lines and barriers to entry for those products. In a way, what we're doing is using judgment or qualitative considerations to attach subjective probabilities to the accuracy of the data. The valuation model assumptions become the starting point of a dialogue among the various members of the portfolio management team here.

TWST: What about the valuation metrics? What are you looking for?

Mr. French: Going back to my opening description of the process, if you look at large cap growth, we think of that sector of the marketplace as fairly efficient in processing front-end data. We're balancing what are essentially valuation metrics against growth metrics fairly evenly. If you're looking at small cap growth, we skew the weighting toward growth metrics and especially focus on factors such as changes in analyst estimates, earnings surprises and things of that nature.

TWST: Has this turbulent year in the market caused you to make any changes in your portfolio management?

Mr. French: No, not yet. We went into this very well positioned. The sectors that we have overweighted tend to benefit from a weaker dollar; we were underweight in the sectors that have been particularly damaged by the financial sector implosion. We came into this market downturn underweight in financials, underweight in retail, underweight anything related to the consumer, and we tended to be overweight in export-driven producer manufacturing sectors, as well as electronic technology and health technology. We're actually in very good shape and have been in very good shape all during this current year. What we are looking at is when to start leaning against the wind and increasing exposure in those sectors that have been hardest hit.

For example, we don't think the dollar is going to decline very much farther from here. We don't necessarily see it appreciating significantly against the Asian currencies, but we certainly see it stable and possibly strengthening against the euro. That might cause us to challenge the growth assumptions of some of the export companies whose sales have benefited from a weak dollar.

TWST: How did you decide to lighten up in financials and consumer areas?

Mr. French: The financials tend to be quite cyclical. When I first started building the valuation models in the early 1990s, financial stocks tended to be priced cheaply versus the broader market.

In the last decade or so, financial stocks have appreciated significantly against the rest of the market and they reached a level of sustained overvaluation a few years ago. As banks were acquired, we didn't replace them; as they changed their business model or as they become overvalued, we would trade out of them and not replace them. It was a simple matter of reducing our exposure over a multi-year period through attrition. For a brief period in mid-2006, this underweight hurt our portfolio. We didn't see that as being sustainable and didn't change our position on the sectors.

We've enjoyed being underweight in financials. The reduced exposure to the consumer is recognition that consumers have been spending cash flow associated with the rising values of their real estate holdings, their homes, and that wasn't likely to continue. We've slowly reduced our exposure there.

TWST: What about energy and materials? Have they contributed to your growth portfolios?

Mr. French: Yes. On the energy side, we reduced our exposure to oil as the commodity continued to rise and shifted exposure to oil service stocks. We stayed overweight in rails, so we participate in coal through transportation. In the metals part of the cycle, we've stayed equal to market weight, focused on aluminum and copper.

TWST: What are the some of the stocks that you feel are representative of your investment approach and the reasons you found them attractive?

Mr. French: That's a lot harder to talk about than it is with most managers. We see companies and stocks as bricks in a wall that are pretty much interchangeable. The nature of our practice is to equal weight, not to capitalization weight, the holdings in the portfolio. If I read the top five or so holdings that we have in the portfolio, these are positions that represent 1.5% of the portfolio each. We have a large number of holdings in the portfolio and the names that would rise to the top are pretty much dominated by low cost basis holdings in our private wealth portfolios. A few very large individual investors with low cost basis stocks would skew that quite a bit. I can't really tell you that one stock has more weight in the portfolio than another because of its attraction as an individual company. We start with individual companies, but we tend to overweight sectors rather than individual stocks. And the advantage we offer our investors is our focus on building diversified and high quality portfolios.

TWST: What are your views on the healthcare sector? Are you finding opportunities in segments of health care?

Mr. French: Yes, absolutely. Years ago we decided to emphasize those companies that were going to be able to develop new products. At the time they were called biotechs. Biotech companies were more volatile than the large cap pharma stocks, so we underweighted the health tech group, but overweighted the biotech part of the group. With the passage of time, that's worked out very well. We now have a slight overweight in health technology versus the broader market, but we own the rapidly growing companies that are developing new products.

TWST: What about the technology area, IT and so on? Are there opportunities there that you have found attractive?

Mr. French: The opportunities in technology are pretty interesting. In what we call electronic technology, there are two components. There are traditional electronics companies and there is aerospace. The electronic technology companies include semiconductor capital equipment, semiconductor companies and the assemblers, the hardware companies.

Aerospace would be dominated by airframe manufacturers and defense contractors. We're very positive on both aspects of electronic technology at this point in the cycle, primarily because the product replacement cycle will sustain growth through a slowing economy.

The other part that we've been involved with is tech services. In tech services, we're slightly overweight to market and think that there is a little more economic sensitivity to that sector than there is in the hardware part of electronic technology.

If the valuation score or the fundamentals turn particularly negative, the company will be sold. If a stock in a sector is overvalued versus buy candidates, we'll trim or sell the stock.

TWST: What is the average turnover?

Mr. French: Very low. The highest would be in our small caps and in the last few years that's ranged from 20% to 30%, and in large caps it tops out closer to 20%. We've used some cash flow opportunities to make shifts in sectors, which keeps turnover low, and we define turnover as lesser of purchases or sales.

TWST: What about risk control? How do you attempt to control risk at the portfolio level and at the individual security level?

Mr. French: In our investment process, it is important to minimize stock specific risk. We accomplish that by building portfolios with about 100 companies, initiating positions at 1% and trimming overweight holdings, even if the company remains attractive. It goes back to the notion of stocks being bricks in a wall. We are concerned with the wall.

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TWST: Are there any industry sectors where you see things differently from most other investment managers?

Mr. French: Possibly in the transportation sector. The transportation sector in terms of market capitalization is fairly small. I think in the S&P 500, it amounts to about 2% and our portfolios hold 6% to 7% in transportation stocks. I regard our rail system as a national resource. Our country has a real advantage in its ability to move goods efficiently across large distances.

The rails allow the transportation of grains from the Midwest to a global marketplace, allow the transportation of ores and allow the transportation of energy. The need to move these basic goods cheaply and the ability to gain market share in a high cost fuel environment is the reason for overweighting this sector in the portfolios.

TWST: What triggers an exit from your portfolio? Do you set sell targets for your holdings?

Mr. French: No, we're not smart enough to set a price target for exiting a particular stock at time of purchase. If a company's fundamentals change significantly, we'll sell the stock but for the most part it's driven by the valuation models. On the institutional side, we're generally fully invested so if a stock or sector becomes overly concentrated, we'll trim stocks or sectors even if they remain attractive.

To address the management of portfolio risk, we use optimizers constrained by the structural composition of the benchmark, against which we are measured. We define portfolio risk as being at variance to structural characteristics whether it be economic sector weights or benchmark characteristics. As we add stocks to an economic sector, the more overweight it becomes, the riskier the portfolio becomes to the point that even though that sector may be the most attractive part of the market, it tends to start finding other sectors that are going to diversify the portfolio rather than adding to a significantly overweight sector.

TWST: How much does international play a part in your portfolio management? Do you look for companies with overseas operations?

Mr. French: Yes. Years ago when I started looking at international securities, the argument was that they provided a means for diversifying the portfolio. It was believed that international securities provided a non-correlated or a low-correlated returns distribution. That's no longer true. At the time when you need diversification the most, all the markets tend to go in the same direction, so diversification of risk is no longer a valid argument for holding international securities, in my opinion. What is interesting is that with the globalization of accounting standards, our way of looking at information and measuring and evaluating financial information from one com-

pany to another, from one country to another is becoming a lot easier. What we do is look at international companies as a way of buying a growth stream from different places in the world and if a country is growing faster than the overall global economy, then that provides an additional advantage and additional return to investors.

The other way we look at international companies is their ability to provide us an ability to participate in rapid regional growth. For example, in China, we wanted to participate in the growth of the country and the rise of an educated middle class. We didn't necessarily want to participate in companies that were managed for public policy goals rather than shareholder interest. So we invested in Internet companies in order to participate in this rapid growth. It's actually been a lot less volatile strategy for participating in a rapidly growing market and a rapidly growing region than owning the large cap companies that dominate the capitalization-weighted country funds.

TWST: What aspects of management do you look for?

Mr. French: I think management should concentrate on managing the business and not promoting their stock. We rarely meet with managements; we'd rather look at the results that managements produce than to try to make a determination on the quality of a management team on the basis of a short public or private presentation.

TWST: What do you think gives Pillar Pacific its edge? What differentiates your investment approach and wealth management services from that at other companies?

Mr. French: I think there are two aspects. One is the people in the firm are very experienced and we've worked together for a long time, predating the firm itself. For example, in the case of the principals, I've known Craig MacLeod, our Chief Operating Officer and Chief Compliance Officer, for 34 years. We met in graduate school and we've known each other for a long time in a professional and in a friendship capacity. The same with Mindy Ying, who is our CEO. Mindy and I have known each other for 18 years now. Mark Keeling, one of our portfolio managers, worked with Mindy and me at First Interstate Bank. I've known him for about 15 years. Another portfolio manager, Sonny Lin, has worked with Mindy for five years. The other aspect is our valuation models. The models and the information they compile become the starting point for interaction among this group of people, whose views may be somewhat different, as we look at these companies.

TWST: How do you measure the performance of your different portfolios? Do you have some sort of composite?

Mr. French: We have GIPS compliant composites going back to 1993.

TWST: Would you give us a rough idea of how your portfolio of stocks is performing looking back three to five years?

Mr. French: We have different strategies and I can tell you that in the case of large cap value at the end of June, at the end of the

second quarter, for three years our annualized return is 10.6% against the value benchmark at 3.5%. Five years, we're at 14.1% versus 8.9% for the benchmark. Large cap growth, our three-year annualized number is 8.3% versus the benchmark S&P 500 at 4.4%, and five years is 11.5% versus 7.6%. Small cap growth, our three-year annualized return is 11.2% versus 6.1% for the Russell 2000 Growth benchmark, and five years 13.6% versus 10.4%. One-year, 10-year and inception to date, our performance record is just as compelling.

TWST: Do you see any potential problem areas ahead that investors should be wary of at this time?

Mr. French: I would say, at this time the most significant risk to the US financial markets is the unwinding of the excesses in the financial system and how the Fed decides to regulate the financial markets going forward. This is the problem area we read about in newspapers and it is generally discounted in the marketplace. The areas that pose the greatest risk are always those that have yet to be observed. Globally, I think we're heading toward a new world order; Russia is a resurging super power and certainly a force to be reckoned with.

TWST: What advice would you leave with investors about investing in the market now?

Mr. French: Diversify. The only way that you can deal with the uncertainty of the future is to create a diversified portfolio and that's what we do in our practice — we diversify our holdings.

TWST: Is there anything that you would like to add?

Mr. French: As a final comment, I think we are more optimistic about the future than most people. The headlines tend to focus on the near-term negatives, but the human species is very flexible and very creative in its approach toward solving difficult problems. There is a lot of really amazing technology that will be applied to improving the lot of the human condition and each of these solutions will provide new investment opportunities.

TWST: Thank you.

Note: Opinions and recommendations are as of 9/10/08.

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