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Questioning Market Leaders For Long Term Investors

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MONEY MANAGER INTERVIEW

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Investing in High Quality Stocks

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ERIC S. BARLOW is a co-Founder of Alta Capital Management, LLC, and has been assisting clients in accomplishing their long-term financial goals for more than 12 years. After working as a fee-based financial consultant for several years, he became a partner in the largest fee-based financial planning firm in the Intermountain West. His extensive financial background includes experience in investment management, tax, estate, and retirement planning. He received his Bachelor's degree in Finance from the University of Utah and then obtained the Chartered Financial Consultant designation.

MATTHEW A. STEPHENSON is a Senior Research Analyst with Alta Capital Management, LLC. He has several years of experience in business valuation and corporate finance. Prior to joining Alta Capital, he worked as a Business Valuation Associate for Neilson Elggren and Arthur Andersen, performing private equity valuation services for mergers, acquisitions, estate tax purposes and litigation support. He graduated from the University of Utah with a Bachelor of Arts degree in Accounting and is a CFA charterholder.

SECTOR – GENERAL INVESTING (ZAK501) TWST: Would you begin with a brief overview of Alta Capital Management and what you both do there?

Mr. Barlow: I am one of two managing principals and a Portfolio Manager. Alta Capital Management is a high quality growth investment firm located in Salt Lake City, Utah. Alta has three different products — an All-Cap, a Mid-Cap and a Large Cap product — investing purely in high quality stocks.

Highlights

Eric S. Barlow and Matthew A. Stephenson invest in multi-cap high quality stock portfolios. They believe that, over time, high quality stocks are going to outperform more aggressive stocks and with less risk. They say that a company's stock movement is going to be driven by earnings production, but earnings quality is definitely tied to free cash flow. Markets do not consistently recognize the intrinsic value of companies; therefore they can find these great companies and buy them at a discount. They have a concentrated portfolio of about 30-40 stocks and they get to know every company very well after running them through Alta's earnings analysis models and the Alta Intrinsic Model (AIV). Risk management happens at every step of the investment process, which is why their numbers look so strong and even more when the risk characteristics are taken into consideration. Companies include: Walgreen (WAG); Home Depot (HD); AutoZone (AZO); Intuit (INTU); Polaris Industries (PII).

Mr. Stephenson: I am a Senior Research Analyst with Alta Capital, and have been with the company for about three years. I received an Accounting degree from the University of Utah and am a CFA charterholder. Prior to joining Alta, I worked with Arthur Andersen in their Business Valuation practice, performing valuation services for mergers, acquisitions and litigation support.

TWST: What is Alta's investment philosophy?

Mr. Stephenson: The tenet of our firm is the basic belief that, over time, high quality stocks are going to outperform more aggressive stocks and with less risk. We firmly believe in the fact that a company's stock movement is going to be driven by earnings production, but earnings quality is def-initely tied to free cash flow. We believe that the markets do not consistently recognize intrinsic val-ues of companies; therefore, we can find great companies and buy them at a discount.

1-Year Daily Chart of Home Depot

Chart provided by www.BigCharts.com

Mr. Stephenson: Alta is a bottom-up shop, so we focus our research efforts on analyzing the fundamentals of a company, primarily its earnings and what will drive those earnings going forward. But as Eric mentioned, the quality of a company's earnings is directly correlated to its free cash flow. Therefore, at the end of the day we want to be able to answer the question, "How much free cash flow will this company place in the pockets of its owners?" This number is the company's intrinsic value, or what the company should be selling for, in our opinion.

TWST: Would you talk about your portfolio construction process and the key measurements that you use to identify the companies you invest in?

Mr. Barlow: Once a stock has made it through Alta's very thorough evaluation process, the stock is put on a watch list. This is where we further evaluate a company and wait for a price where we like it. Once the decision has been made to buy the company in the portfolio, we add the security at a 2% weighting. Since Alta is close to 100% invested at all times, we typically have to sell something to make room for a new stock. Alta has very low turnover (about 20%). All positions as they come into the portfolio are put in at a 2% weighting, but over time we can own a stock up to a maximum of 6% in the portfolio.

TWST: How many stocks generally would you have in the portfolio? And do you fluctuate with the number?

Mr. Stephenson: We usually have about 30-40 stocks in the portfolio, so it is a concentrated portfolio; we get to know these companies very well. And I would say that, on average, the number is right in the middle, 35. We have 36 right now, and it just fluctuates between 30 and 40. I would say that at any given point, you're safe to assume that we own 35-36 names.

Stephenson: One of our largest holdings is Walgreen. This company has been amazing over the last several years. Sales and earnings growth has been very impressive; there have been very strong financial statements; it's expanding at a rapid pace, gobbling up competition; and it's also doing all of this with cash flows from operations, without taking on any debt. Walgreen's free cash flow as a percent of sales is very impressive.

TWST: What are some of the core holdings in the portfolio and the reasons you were attracted to them?

Mr. Stephenson: One of our largest holdings is **Walgreen Company** (WAG), and one of the things we love about this company (and all of our portfolio holdings) is its track record. This company has been amazing over the last several years. Sales and earnings growth has been very impressive; there have been very strong financial statements; it's expanding at a rapid pace, gobbling up competition; and it's also doing all of this with cash flows from operations, without taking on any debt. **Walgreen**'s free cash flow as a percent of sales is very impressive. Based on its track record, its competitive position within the industry and its financial strength, we consider **WAG** to be a great holding. Its intrinsic value in our model is continuing to rise as its stock price rises, so we feel comfortable continuing to own the company.

1-Year Daily Chart of Intuit

Chart provided by www.BigCharts.com

Stephenson: AutoZone is using its strong cash flow to buy back its stock at a rapid clip. Incidentally, AZO has repurchased about 40% of its stock in the last several years. So as the company generates these impressive cash flow streams year after year, it is returning value back to the shareholders in the form of buybacks.

TWST: Matthew, do you have any companies that you recommend as core holdings?

Mr. Stephenson: Home Depot (HD) we've owned for several years now for many good reasons. It is the dominant player in the home improvement space, more than doubling the number two player's — **Lowe's** (LOW) — sales and profits, both overall and on a per store basis, and we believe the company is doing the right things to defend its market share. As for innovation, its do-it-for-me segment is growing at 3.5 times the company average. At the same time, new technologies such as self-checkout and wireless scanners are speeding the checkout process and reducing operating costs. **Home Depot** has also used much of its impressive cash flow to improve the look and feel of its stores. The results of these investments have been increasing same-store sales comps, traffic numbers and average ticket size, as well as showing improved margins. With an impressive balance sheet, industry position and financial leverage, we continue to view **Home Depot** as a great investment.

TWST: Do you do a sector analysis and take leading companies from those sectors?

Mr. Stephenson: That's a good question. Since we are a fundamental bottom-up firm, we're focusing at the company level first. All our analysis is driven by looking for great com-panies that are priced very well in the market-place. As I mentioned, we like to see a 20% or greater discount in the companies we buy.

Sectors come into consideration as we near the end of the analysis process. For instance, if we have three very strong companies that are on the watch list, we will evaluate which sector needs to be represented and offers the best long-term up-side based on current economic trends. A good example of this is about a year and a half ago, we started whittling down Alta's financial sector exposure and increasing the energy weightings due to world demand and valuations. So even though a financial company might screen well for us right now or look really good, we're going to hesitate until we can see that the Fed is finished tightening and earnings have normalized.

Stephenson: We have three different phases of our research process that all these stocks go through, so by the time a company makes it into our portfolio, we understand it well because we've looked at it through three different models.

Now, with that being said, the highest weighting that we'll ever experience in any one sector is 30%. And if we take a look, say, at the end of 1999, where we had the big run up technology, where the S&P had a 35% weighting in technology, the highest weighting that Alta reached at that time was 27%. An interesting note on technology, Alta ended up selling off about half our technology positions in February 2000. This was driven by the ridiculous valuations. Alta will never abandon any of the major sectors of the economy, but it got to point where technology was so ridiculously valued we had to whittle down the weighting.

So we're paying attention to sector weightings and looking at economic trends, but it all begins with finding great companies in any one of those sectors.

TWST: What are some of the stocks you've invested in over the last 12 months and the reasons why?

Mr. Stephenson: I can think of one right off the top of my head — **AutoZone** (AZO). When we're looking at **AutoZone**, we're looking at things that will drive the top line, obviously store base growth and same-store sales growth. And those are both impressive to us as we go through our discount cash flow model.

First of all, when we model these companies, we're very conservative on our growth assumptions — one, because we realize that sometimes management is a little overzealous when they are giving out their projections; and two, our model can serve as a sensitivity analysis, in that we like to see how conservative we can be with our assumptions and still get a good discount to the current price in the market. So we feel like we've been very conservative. For example, when we're looking at **AutoZone**, I think we've modeled in 3%-5% store base growth and another 0%-5% same-store sales growth to come up with our sales assumptions going forward. Now, those assumptions are under what management has projected, but we think they are reasonable. Also, something specific to **AutoZone**, the company is using its strong cash flow to buy back its stock at a rapid clip. Incidentally, **AZO** has repurchased about 40% of its stock in the last several years. So as the company generates these impressive cash flow streams year after year, it is returning value back to the shareholders in the form of buybacks. So those are some of the reasons we like **AutoZone.**

1-Year Daily Chart of AutoZone

Chart provided by www.BigCharts.com

Mr. Stephenson: As Eric mentioned, we have bumped up our energy exposure in the last year and a half. Now, while it would seem that we were doing that based on a top-down analysis, we are again looking at the earnings and cash flow growth of these companies. And the macro trends are just contributing to the earnings growth of, say, **ConocoPhillips** (COP) and **TOTAL** (TOT), and other companies in the energy space. With the supply and demand situation that we have in the world right now with oil, we think that these companies are just going to continue to generate great cash flow streams going into the near future, as they have been doing for the last year and a half. And we don't think that oil is going to drop down as low as other analysts believe it is. We think it could get down to the mid-$40s in the near term, whereas other analysts think it can get down to the high $30s.

1-Year Daily Chart of Walgreen

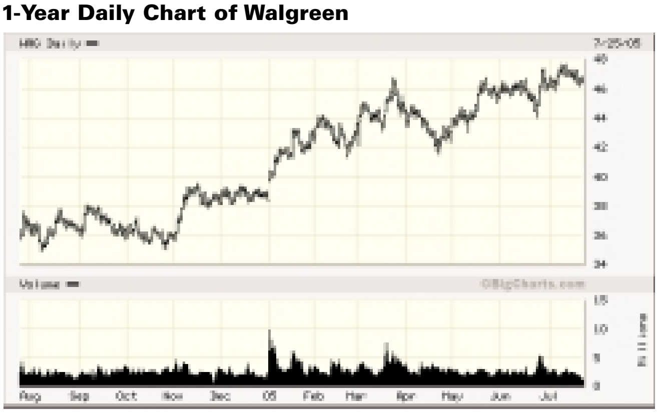

Chart provided by www.BigCharts.com

TWST: What do you like to see companies do with the free cash flow?

Mr. Stephenson: I really think it depends on the company and industry. For a company that is relatively small, we like to see it reinvest the money back into the company because that tells us that the management team believes in the company's prospects, they believe that they can grow. And so if they are reinvesting the money back into the company, and the company continues to post impressive ROIC metrics, then that's a positive indicator for us.

Now, if the company is more mature, sure, we like to see the company returning money to shareholders in the form of dividends and buybacks. Also, if the company is in a roll-up industry, or one in which it needs to make acquisitions to grow, such as the insurance brokerage industry, we like to see it doing that. The focus here is making sure that the company is not overpaying for acquisitions and that it has a good track record of completing and integrating those acquisitions successfully.

TWST: What about some other companies in other sectors that are representative of your portfolio process?

Mr. Barlow: Intuit (INTU) is a company that we've owned for a long time. Of course, it's the creator of QuickBooks, Quicken, QuickPro and TurboTax.

Intuit is a company that's had very strong cash flow, and when we were originally looking for some names in technology (we've owned **Intuit** for about three years), it was the one that we could find that had very, very solid cash flow and wasn't trading at ridiculous multiples. So **Intuit**'s one that we really liked that has been a consistent grower and has had good consistent cash flows over time.

Barlow: The thing we're hearing most often from consultants is how they like our process and patience. We are very, very consistent with our process, and none of the stocks that we hold made it into our portfolios without going through a stringent process.

Just as a side note, **Intuit**'s kind of a strange beast in that when we're looking at software companies, we almost want to get them when they are very small because you have **Microsoft** (MSFT) out there, and it seems like whenever **Microsoft** sees a little software company making money, it wants to enter the space because it has the cash and the human capital to do it. But **Intuit** has maintained its industry-leading position by continuing to come out with the latest and greatest products, and upgrading and cross-selling its clients very well.

Stephenson: Home Depot is doing the right things to defend its market share. As for innovation, its do-it-for-me segment is growing at 3.5 times the company average. At the same time, new technologies such as self-checkout and wireless scanners are speeding the checkout process and reducing operating costs. Home Depot has also used much of its impressive cash flow to improve the look and feel of its stores.

TWST: What about the sell process?

Mr. Barlow: There are going to be a num-ber of different reasons why we sell a company. I mentioned one of them already, and that is be-cause they've reached their full valuation accord-ing to our Alta Intrinsic Model (AIV), which incidentally Matt created and which we rerun on every company we own every quarter as we get the new quarterly numbers. So one of the main reasons we sell companies is the full valua-tion has been achieved.

Another reason we sell a company is be-cause it has become overweight in the portfolio. We wanted it at 2%, it's grown to a 4% or it is at 4% and the valuation is not as attractive as when the company was first introduced to the portfolio. We may need cash for another position coming into the portfolio and so we whittle a company back down to a 2% position.

We would also sell if the fundamental reasons for purchasing the company no longer exist. There may be a number of things that are driving the growth of these companies Alta owns, and we pay very close attention to those key growth drivers.

Another reason we might sell a company is because there's a 25% relative drop to its peer group. Now most of the stocks we own in the Large Cap portfolio are tied to the S&P 500, and each of the three portfolios has its own benchmark which we're tying the companies to. If we see a 25% relative drop in performance versus that peer group or that benchmark, then that stock would be a sell in most all cases.

Now, once again, because we're a fundamental money manager, we're look-ing at fundamentally what's happening with that company that is driving that drop in value. And that's the main reason why we're going to sell it. But the 25% down is the one that has gotten us out of positions that could have hurt us over time. It helps us to sell them at a reasonable price.

Another reason we'd sell a stock is just that there's better options on our watch list. Maybe a stock hasn't performed the way we thought it should perform. We're patient, but we're not going to wait forever. We have a lot of good research on companies coming through, so we'll be ready to replace a stock if it's not performing.

TWST: Do you have any examples of stocks that you have sold or trimmed back on in recent months to illustrate this discipline?

Mr. Stephenson: Yes, I'll give you one just off the top of my head. We owned **Polaris Industries** (PII) and watched it double. We cal-culate our intrinsic values and we update those calculations every quarter, or when the stock price gets within 10% of our intrinsic value cal-culation, whichever is most often. And so as we held **Polaris,** every quarter the company would beat the consensus estimates, the stock would run up, we would review our intrinsic value calcula-tion model and it would also creep up. But we found that the stock price was running faster than the intrinsic value was. And so once it reached full valuation, we exited the position, placed the stock back on the watch list, and hopefully, we will come across another attractive entry point. We like the company, we just don't want to buy it at the wrong price. Buying a good company at a bad price is just like buying a bad company in our eyes.

Barlow: Intuit is a company that's had very strong cash flow, and when we were originally looking for some names in technology, it was the one that we could find that had very, very solid cash flow and wasn't trading at ridiculous multiples. So Intuit's one that we really liked that has been a consistent grower and has had good consistent cash flows over time.

TWST: What about your risk management? How do you attempt to control investment risk?

Mr. Barlow: I think we just covered one of the ways, and that's our sell discipline. But if you look at our process of valuing stocks, there is risk management starting from the first screens that we run on companies: three- to five-year historical EPS growth of greater than 12%, two-year future EPS growth of 12% plus, year-over-year sales growth of more than 15%, historical return on equity above 15%, stable or increasing margins, p/e under 25 times forward, PEG ratio less than 1.5, price/sales 3.5 times, and debt to equity of 50% or less. Only about 150 companies exhibit the referenced qualities and are typically solid, proven companies. This is only the first stage of our analysis.

By the time we complete the analysis of these companies and run them through Alta's earnings analysis models and AIV we are getting to know them very well. The companies are then presented to the investment committee to be scrutinized by Alta's team. So really risk management for us happens at every step of the investment process, and that's why our numbers look so strong and even more so when the risk characteristics are taken into consideration. Alta's current standard deviation is 20% lower than the S&P 500 and 40% lower than the Russell 1000 Growth.

TWST: Who are your typical investors? Is it a mixture of institutional and high net worth individuals?

Mr. Barlow: It's a mixture of both, that's correct. We started out a number of years ago as mostly just a high net worth shop, but over the last five years we've had a lot more institutions that have hired Alta. In fact, we find ourselves, right now, in more and more finals all the time on the institutional side. So it's a very good mix at this point but it's moving more and more institutional.

TWST: What would you say are the differentiating factors that distinguish the investment strategy at Alta Capital Management from that at other companies? What are you bringing to the table that other companies might not?

Mr. Barlow: I think the thing we're hearing most often from consultants is how they like our process and patience. We are very, very consistent with our process, and none of the stocks that we hold made it into our portfolios without going through a stringent process.

Mr. Stephenson: We have three different phases of our research process that all these stocks go through, so by the time a company makes it into our portfolio, we understand it well because we've looked at it through three different models.

Mr. Barlow: One comment that we hear often from consultants who visit our shop is that we have a process that can be duplicated into the future and therefore results that can be duplicated.

Being located in Salt Lake City helps Alta attract some very talented people. Utah is known as one of the highest educated states in the country per capita and, as a result, a lot of people leave here to go to some of the top educational institutions in the country, and they love it here and want to get back. And there are not a lot of options in the way of money management firms. There are really two, and then some smaller firms. So we're really able to cherry-pick top talent as we're growing. We have a very, strong core of people that are here at the firm helping run this whole process we've been talking about.

TWST: Is tax efficiency a concern to your investors?

Mr. Barlow: I think tax efficiency is a concern for most any aftertax investor. It should be if it's not. But I'll tell you, just from the nature of our process, we are extremely tax efficient. Our tax efficiency, as you can imagine with a 20% turnover, means we're holding stocks anywhere from three to four years on average; some we've held much longer than that. Those clients that do have large taxable portfolios, we're able to, of course, tax manage toward year-end for those clients. Rarely will a client have short-term gains with us, especially if they've been with us for more than one year.

TWST: You have an excellent performance record. In the recent Money Manager Review, you're number four in the list of large cap growth managers.

Mr. Barlow: Alta's performance has been very steady for a long time. It is always nice to be ranked amongst the top versus your peers.

The Money Manager Review ranking that you are referencing is a very good study because it takes into consideration risk and return. Alta has been in the top 20 of that Review many times.

One of the great lessons in investing, and a core belief of ours, is that it's much more important to hang on to money through the downside than to hit home runs on the upsides. As most of your readers understand, for every percentage that you go down, you have to earn an exponential return back to get to even. So even through the early 2000s and the worst point of the market, when the S&P was down around 50%, we were down around 16%-17% fully invested. And that's because great stocks typically don't go out as far as the rest of the tide. Therefore, Alta's downside participation as measured by downside market capture is about 56% as compared to the S&P 500. Yet Alta's upside market capture is usually between 85% and 105%, just depending on what types of markets are moving on the upside. So clients who invest with Alta Capital are really getting a terrific mix: they're getting not only top-tier performance, but much lower-than-market risk. And again, that's with the beta at 0.8, and the standard deviation 22% lower than the market. So it's a fun story to tell.

TWST: What advice would you give investors who are looking to invest at this time? Is this a good time to invest, and where would you steer your investors?

Mr. Stephenson: We don't believe that market timing is a winning game. In fact, there is a dearth of statistics that I've read that support the assertion that market timing works. So if someone has money and they're looking to invest, right now is a great time to invest as long as they have a long-term time horizon.

But I think there's a Part 2 to this. The reason retail clients lose money in the market is due to their emotions directing their investment decisions. They're not buying based on logic and statistics:

they are buying and selling because of fear and greed.

But there's another reason why clients don't make money in the market. If retail investors could learn to do the opposite of what everyone else is doing, then they would fare well.

So one thing is, if you're going to get in the market, buy the right kind of companies for the right reasons. Make sure you have a process in place, not only to buy them but also to sell them.

I guess it's three-pronged: Don't let your emotions dictate what you're doing, buy stocks for the right reasons, and sell them for the right reasons. And if you buy high quality stocks like Alta Capital does, you're going to alleviate a lot of your risk — as long as you're patient.

TWST: Thank you. (PS)

Note: Opinions and recommendations are as of 7/22/05.

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