

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Wedgewood Partners, Inc.



DAVID A. ROLFE, CFA, is the Chief Investment Officer at Wedgewood Partners, Inc. Founded in 1988 by Anthony L. Guerrerio, Wedgewood Partners, headquartered in St. Louis, Missouri, manages \$175 million, primarily for wealthy individuals. As of September 30, 2002, Wedgewood Partners Equity Composite has outperformed the S&P 500 over the past one, three, five, seven and 10 years. Prior to joining his present firm, Mr. Rolfe served for four years as Portfolio Manager at Boatman's Trust Company. Mr. Rolfe holds degrees in Finance and Economics from the University of Missouri-St. Louis. He is a member of AIMR and of the St. Louis Society of Financial Analysts, where he has served as an officer and Director. He lives in the St. Louis suburb of Wildwood with his wife Stacy and their three children.

(SAA501) TWST: Would you begin with a brief overview of Wedgewood Partners and your responsibilities there?

Mr. Rolfe: My partner, Anthony Guerrerio, founded Wedgewood Partners in 1988. I joined the firm in the spring of 1992 as Chief Investment Officer. Our team of investment professionals, which oversees investment research, investment strategy, portfolio management and client contact, includes Mr. Guerrerio, Ms. Dana Webb and myself.

TWST: What is the general investment philosophy at Wedgewood?

Mr. Rolfe: The core of our philosophy is that we believe that financial wealth is enhanced, or at a minimum maintained, by investing in superior businesses for the true long term.

TWST: And your investment style is growth at a reasonable price?

Mr. Rolfe: We hate to be philosophically pigeonholed, so to speak, but yes, the companies that we own are easily identified as growth companies. In addition, we try to be very patient and particular in terms of the valuation we will pay for growth, so yes, we are buying such growth at a reasonable, if not a cheap price. This is a fair way to describe us.

TWST: What do you use as a benchmark for your performance?

Mr. Rolfe: We use two benchmarks. The first, which we utilize when reporting to clients, is the S&P 500 Index. The second benchmark, which we use to compare ourselves to managers of like investment style, is large cap growth indices. In terms of our performance, and this is through September 30, 2002, our one-, three-, five-, seven- and 10-year numbers are all in excess of the S&P 500, as well as all in excess of large cap growth indices.

TWST: What are the characteristics you look for in potential investments?

Mr. Rolfe: We are looking for businesses that possess a superior product or superior service. But more important than that, as it translates into financial numbers, we want to own businesses that have a history of not only good profitability, but outstanding and consistent profitability levels over the course of full economic cycles.

TWST: What is the actual process? Is it purely bottom-up, or do you do macro analysis as well?

Mr. Rolfe: It's interesting. We certainly have macro themes that are present in our portfolio that one could easily find a few predominant themes by just looking at the short list of the companies that we own, but our first step is always a bottom-up, company-level approach. Once we identify a business to be superior, we then must determine if, in our view, historical growth rates, high levels of profitability and high levels of generated cash flow can be sustained.

Then we have to take the “macro view” and ask ourselves, “Why do we think these businesses can continue to excel?” So the macro view, if you want to call it such, certainly is a key component within our investment process, but it is not our starting point.

A rudimentary example, for instance, would be a determination and probability that the profitability and historical growth rates of our owned pharmaceutical companies are sustainable. The macro questions at the forefront of this industry are, “With an aging population, will the cost effectiveness of pharmaceuticals, as it relates to other healthcare alternatives, as well as political and legislative considerations on pricing, increase or decrease in the future?”

TWST: What are the sector weightings of your portfolio? Where are you overweighted?

Mr. Rolfe: Our portfolios are what you would consider to be focused or concentrated. We typically own between 18 and as many as 22 stocks in our equity portfolios, so we certainly are more concentrated than the S&P 500, yet we strive to be diversified enough to mitigate enough individual stock risk without diluting the effects of a focused portfolio. On this point, we agree with academic research that makes the point that active money managers oftentimes diversify too much — too much so that outperforming an index (after fees and management expenses) becomes nearly impossible. In our current portfolio we are overweighted quite a bit in information technology, health care (represented by pharmaceuticals) and financial services, which includes **Alliance Capital (AC)**, **Concord EFS (CE)**, **Legg Mason (LM)**, and **MBNA (KRB)**.

TWST: Are you avoiding any areas in the economy at this time?

Mr. Rolfe: Yes, we are. We have avoided for a number of years now some of the older Rust Belt, deep cyclical companies like farm equipment and the automobile manufacturers for the singular reason that many of these companies carry a significant burden to future earnings power in the form of underfunded pension plans. After a brutal three-year bear market in common stocks and current generation lows in interest rates, investment returns have declined dramatically for defined-benefit pension plans. Investors are now seeing first hand the ramifications of lower assumed pension plan investment returns and lower assumed future return expectations. This in turn raises, and significantly in more than a few cases, the present value of pension plan liabilities. To square such growing liabilities, accounting rules call for a corresponding hit to shareholders’ equity, which will eventually reduce earnings on that lessor equity base as well. Many of these older, cyclical companies never cleared our very high hurdles for sustainable profitability in the past. So we’ve avoided this group entirely.

TWST: When last spoke to you, you said that you were trying to manage “away” from Wall Street? Do you still have that independent view? Also, where do you get your research?

Mr. Rolfe: To the first part of your question, we sure do, and that really is a core of our investment strategy that I mentioned,

which is we invest for the true, multi-year, long term. And if I could even make a finer point, we view ourselves on the research front not in terms of Wall Street-typical security analysts, but rather we like to consider ourselves first and foremost as business analysts and business owners. The way we manage away from the prototypical investment management firm is that we manage very concentrated portfolios and our turnover is extremely low. Our individual stock holding period might be five, six, and in some cases as high as seven years, so our portfolio turnover will be as low as 15% per year. This compares to the typical investment management firm that turns over its portfolio in excess of 100% in a given year and may own up to 40, 50, even 100-plus stocks. Actively managing portfolios in this industry-typical manner, it becomes very easy, if not certain, for a portfolio to look like an unmanaged index. So, again, we manage away from our competitors with concentrated portfolios and low turnover portfolio turnover.

When it comes to our research sources, we may not be too different from a typical money management firm. We get our research from numerous sources, including Street sources, industry publications, talking to competitors, visiting companies. Many firms do this sort of thing. We think where we’re different is how we apply such information. An example of this is while many investment management firms may be obsessed with current earnings expectations, we by contrast are obsessed with making sure that the companies we own in this difficult economic environment are taking the oftentimes difficult, but necessary steps, via R&D, capital expenditures, etc., to improve their competitive position versus their competitors. In other words, we as owners applaud short-term corporate pain for longer-term corporate gain.

Regarding one of the key areas when it comes to research, a lot of investment management firms are very focused, if not obsessed, on what we consider to be very minor changes in earnings estimates. This leads to high portfolio turnover, and we think it’s very difficult to outperform or to add value to your clients when you’re really a trader rather than an investor. So again, it gets back to the key tenets of our philosophy — being business owners, i.e., viewing individual stocks not as pieces of paper that we can flip and trade, but as owners of actual businesses.

TWST: Is this a way also that has protected you from the volatility of the market in the past year or so?

Mr. Rolfe: Yes and no. It’s critical, we believe, how one would describe or view volatility. We try to avoid the most important description or view of volatility that we consider, and that is the underlying volatility of the businesses in which we invest. Typically the companies that we invest in have business models that are superior to the average company, and these business models tend to be less cyclical than your typical business — particularly when it comes to the all-important generation of cash flow. However, it’s important to point out that most investors view volatility in terms of the fluctuation in the value of a portfolio or an individual stock. And since we

run concentrated portfolios, we have philosophically accepted a higher level of market price volatility, but not at the expense of business model volatility.

When the market is quite volatile, as it has been of late, the swings in our portfolios are greater than the market. This has given our clients some sleepless nights, but “Mr. Market’s” temper tantrum has given us opportunities to buy terrific businesses at very cheap prices. The important point that we constantly try to make to our clients is that we believe the most significant risk is not share price fluctuation, but actually the risk of the underlying business, and that’s where we try to focus on minimizing risk and volatility. It’s in the business, not necessarily the share price. We can’t control Wall Street, but we can certainly control what we own in our portfolios, and that’s an important way to reduce risk, as a business owner.

handful of the very best semiconductor companies is that we live in a pervasive, digital world, and the digital content of almost every imaginable electronic device continues to increase.

On the equipment side you have almost a near monopoly in terms of market share, global reach and service, and in-balance resources in the case of **Applied Materials**. They are the industry’s largest gatekeeper for advances in semiconductor fabrication. **Intel** has been in a heated battle with **Advanced Micro Devices (AMD)** for a number of years, but even though the desktop PC market growth rate is shrinking, **Intel**’s enormous resources allow them to expand into other areas. They have the sheer power of their multi-billion resources to expand their technological gap versus almost any competitor that they want to go up against. Investors, or should I say the “bears” on **Intel** seem to have discounted the significant

“When it comes to the analog companies, quite frankly, we are hard pressed to find a better business model in any industry than that of Linear Technology. Linear Technology is a leading, high-performance analog semiconductor company. Analog semiconductor companies’ products are the all-important bridges between our human analog world in terms of sight, touch, sound, heat pressure, etc., and the digital content in electronic devices.”

TWST: Let’s focus now on some of those core businesses that you have selected for your portfolios. Have you bought anything in the last 12 months that you can tell us about?

Mr. Rolfe: Yes. One of the industry groups that we’ve owned for a number of years now is semiconductor stocks. We currently own four semiconductor companies. On the equipment side we own **Applied Materials (AMAT)**, and on the microprocessor side we own **Intel (INTC)**, and perhaps our favorite business models are the analog semiconductor companies. In that space we own **Analog Devices (ADI)** and **Linear Technology (LLTC)**, and as we speak, **Linear Technology** is our largest semiconductor holding, as well as one of our largest firm-wide holdings.

TWST: What attracts you to the semiconductor sector at this time?

Mr. Rolfe: There’s no question that the semiconductor industry is quite cyclical. Such cycles are driven by economic and technological cycles. It takes as long as a year or more to build a billion-dollar semiconductor fabrication plant, and then there’s the inherent cyclicity due to the ever-diminishing size and increasing performance of semiconductors (or the oft quoted Moore’s Law). So we know that going into these stocks. But what attracts us to just a

accomplishment that at the depths of the worst semiconductor down cycle in the industry’s history, **Intel** still managed to generate 10% net margins. We believe that **Intel**’s operating leverage in the next succeeding semiconductor up cycle will be meaningfully higher than many suspect.

When it comes to the analog companies, quite frankly, we are hard pressed to find a better business model in any industry than that of **Linear Technology**. **Linear Technology** is a leading, high-performance analog semiconductor company. Analog semiconductor companies’ products are the all-important bridges between our human analog world in terms of sight, touch, sound, heat pressure, etc., and the digital content in electronic devices. In fact, advances in high-performance analog semiconductor designs often precede advances in digital systems and products. Many people don’t realize that they come in contact with a mass of analog semiconductors throughout their day, whether they’re pushing a button on their microwave oven or setting their coffee maker or when they hop in their car, make an Internet connection, place a wireless phone call, power-up their laptop computer, watch a DVD, get an ultrasound or MRI, or unfortunately, be on the receiving end of any of our military’s most advanced “smart” weaponry.

What is specifically terrific about **Linear Technology** is that, unlike a massively sized digital company like **Intel**, analog products are product-specific, custom designed and therefore they have a very long average life span relative to their digital cousins, and this is the key; these attributes lead to astounding profitability. Consider the recent financial performance of **Linear Technology**. During the most severe down cycle in the semiconductor industry's history, which was just over the past 18 months, this company's margins, in a down market where its revenues were cut in half — cut in half, mind you — were still 70%, their net margins exceeded 40%, and the company generated net-of-cash returns on capital of over 100%. **Linear Technology** is literally a moneymaking machine, and is the prototypical type of company we like to own. Economic, business, and product cycles will never be nullified, but the select few companies that can generate buckets of cash in up cycles and down cycles, that tend also to be very shareholder-friendly, are the companies that we want to own.

TWST: Are there any other business areas that you are attracted to?

pharmaceutical companies to do, in many cases, early stage basic research. They can do such research efficiently and more quickly in many instances than their contracted pharmaceutical company. So as the demands of these R&D budgets are stressed, and without a doubt such pressures only increase in the years ahead, we think there is going to be a large, sustainable demand for the outsourcing services such as **PPD**'s.

PPD, relative to the very small universe of contract research organizations, has industry-leading market share, but even more important than that, they have a much better growth profile and higher levels of consistent profitability relative to their peers. It's a company that generates a lot of cash, and is quite frankly one of the very few companies in any industry that has been willing to forecast publicly that they believe they can grow their business over the next year or two in excess of 20%. So it's a name that we've been buying aggressively over the past year or so, and it is slowly becoming one of our larger holdings.

TWST: Are there any other stocks in your portfolios that you'd like to mention?

“PPD is the leading pharmaceutical contract research firm. They contract with biotechnology companies and leading pharmaceutical companies to do, in many cases, early stage basic research. They can do such research efficiently and more quickly in many instances than their contracted pharmaceutical company.”

Mr. Rolfe: Yes, we like the pharmaceuticals as well, and admittedly it's been a group that has been a poor performer for quite a while. But we are currently invested in four pharmaceutical-related companies, and those are **Amgen** (AMGN), **Merck** (MRK), **Pfizer** (PFE), and **Pharmaceutical Product Development** (PPDI) — **PPD** for short.

TWST: That's an interesting choice. What attracts you to PPD?

Mr. Rolfe: There are a couple of industry-related events that continue to unfold that affect all pharmaceutical companies. The R&D cost of bringing successful drugs to market is ever increasing, and the time it takes to get through the regulatory approval processes continues to increase as well. Pharmaceutical companies, particularly the ones we own, like **Amgen**, **Pfizer** and **Merck**, have enormous, multibillion-dollar research R&D budgets, yet even within these massive budgets, there is still a need to outsource a number of elements of the research and development process, and **PPD** is the leading pharmaceutical contract research firm. They contract with biotechnology companies and leading

1-Year Daily Chart of Pharmaceutical Product Development



Chart provided by www.BigCharts.com

Mr. Rolfe: We have talked about some industry groups where we have an overweighted representation, but a name that perhaps doesn't fall into some grand macro investment theme is one that we've owned for a number of years, and that is the auto supplier **Gentex** (GNTX). **Gentex** is a very unique company. It's classified as your standard or typical auto parts supplier, and their claim to fame is that they invented automatic dimming rearview mirrors. But when you peel back the layers of this company, you quickly realize

car of **Gentex**'s products. So it's a terrific, near-monopoly company — hard to find better one.

If we could have a whole portfolio of companies like **Gentex** it would be ideal. Here's a company we bought when it was considered a smaller cap company. Now it's a mid-cap company and we'd like to own it for many years into the future while it becomes a large cap company. So it's been one of our better investments over the past few years.

"Gentex is a very unique company. It's classified as your standard or typical auto parts supplier, and their claim to fame is that they invented automatic dimming rearview mirrors. But when you peel back the layers of this company, you quickly realize that Gentex is certainly not your run of the mill auto parts supplier. Even though Gentex is an auto supplier, they really are a high technology company wrapped in an auto parts moniker, if you will."

that **Gentex** is certainly not your run of the mill auto parts supplier. In the company's early years, the company's auto-dimming mirrors were available only in luxury cars. However, due to the demonstrated safety attributes of these mirrors and due to the consistent lowering of the cost to manufacture, **Gentex** mirrors continue to be added as standard equipment, as well as options on a growing number of cars around the globe. Even though **Gentex** is an auto supplier, they really are a high technology company wrapped in an auto parts moniker, if you will.

Again, similar to many of our companies, it's a company that possesses proprietary technology, which is usually a prerequisite to outstanding profitability. On almost any measure in terms of gross margins, operating margins, net margins, and particularly, and most importantly, return on capital (+50%), **Gentex** is 4, 5 or maybe 6 times as profitable as the typical auto parts supplier, and that is because of the high proprietary content within their mirrors. The mirror side looks like a standard mirror, but the inside looks like the inside of your personal computer.

Gentex bucks the trend relative to other auto parts suppliers in that they are not solely dependent on raw production numbers out of the big automobile companies since more and more cars use their mirrors. So they have an extra level of unit growth that the industry does not have. In addition to that, they are adding more electronic content to their mirrors so that the average price goes up, and this just does wonders for margins and generating cash flow. In addition, new proprietary and revolutionary products such as their auto-dimming headlights will only serve to increase the dollar content per

1-Year Daily Chart of Gentex



Chart provided by www.BigCharts.com

TWST: And Gentex fits your profile of being dominant and formidable in its industry.

Mr. Rolfe: Yes. In fact, given their market share in auto-dimming mirrors, which is in excess of 80%, you would almost have to say they have a monopoly in that market. So if we can own near-monopolies, or government-blessed monopolies like **Microsoft** (MSFT), which we also own, more power to us.

TWST: Is that an investment theme of yours, to search out a profitable niche and go after the market leader?

Mr. Rolfe: Yes, without a doubt. I had mentioned **Amgen** before as a leading biotechnology company, again, in terms of their four multibillion products, plus being extremely profitable. They generate a ton of cash and they are buying back their stock. But the trick to this business is not so much in recognizing these companies, because with computers these days, people can screen for companies that possess high levels of profitability, growth and so forth. But it's what price you buy them at that counts, and obviously what price you sell these stocks at if they run. But maybe even more important is how long you hold onto to your stocks. If you can get the initial purchase valuation right — never a given — then your holding period becomes paramount. In the case of **Amgen**, we have owned these shares since 1993. Given the industry with ever-increasing pressures on money managers for short-term performance, we find it to be a more difficult challenge to truly hold terrific companies over many years.

“Home Depot: We’ve owned it now for quite a few years, and the new management under Nardelli has tackled not only changing the company’s strategic growth mission but the underlying employment culture. And it’s probably been a bigger task than what they thought at first, but we still like the stock for a number of reasons. We think at current prices the stock is a terrific bargain.”

Microsoft is a good example of these difficulties. It was our best performer in 2001 when it gained about 50%, and last year it fell 25%. So from a stock perspective, maybe we shouldn't have held it. Yet throughout this past year **Microsoft** has introduced more products than they have in their history, and they continue to expand in more markets; the business is getting better, they have a ton of cash, and we expect terrific things for them going forward. Yet in hindsight we probably should have sold, waited, and bought back, but I have to admit that we're not that clever and we don't try to be that clever. Our biggest mistakes over the years have been our selling our entire positions of terrific businesses when excessive valuation or company fundamentals appeared to become a short-term stumbling block. Speculative trading is a slippery slope to mediocrity and underperforming in the world of money management. So it's tough for money managers, I think, to stick to their guns and to their philosophy when you have such enormous pressures to perform daily, weekly, monthly, quarterly. More than half of the battle to outperform in this business is to be blessed with clients who understand the oftentimes difficult difference and distinction between investment and speculation.

TWST: You try to capture value at the initial investment stage. What would you consider your best markets at current prices today?

Mr. Rolfe: The current valuations that we like the best would include **Berkshire Hathaway** (BRK), **Concord EFS**, **Merck** and **Pfizer**, **Juniper Networks** (JNPR), **MBNA** and **Home Depot** (HD).

TWST: Home Depot has not been doing well of late.

Mr. Rolfe: Yes, I must admit that we've been on the wrong side on this stock of late. We've owned it now for quite a few years, and the new management under Nardelli has tackled not only changing the company's strategic growth mission but the underlying employment culture. And it's probably been a bigger task than what they thought at first, but we still like the stock for a number of reasons. We think at current prices the stock is a terrific bargain. When you compare **Home Depot's** business model to that of their main competitor, which is **Lowe's** (LOW), **Home Depot** comes out on top in every key profitability metric. But let's give **Lowe's** credit where

credit is due — they have beaten **Home Depot** in terms of raw growth, building more stores, more square footage, which was **Home Depot's** domain during the 1990s, when they grew their square footage by an astonishing 25% per year. Yet, as we see now, a lot of that raw hyper-growth really stretched the organization, and the current management is trying to change that.

We really like what Nardelli and his management crew has done so far. When you compare **Home Depot**, when you look at the profitability metrics, gross margin, operating margin, and net margin, they exceed **Lowe's** in every metric. And when you look at free cash flow, **Home Depot** is generating a ton of free cash flow, and currently the stock is priced at only about 13 or 14 times free cash flow. When you look at **Lowe's**, I think they're priced at over 100 times free cash flow.

In addition to that, **Home Depot's** balance sheet is quite a bit less leveraged than **Lowe's**. They both claim to earn about 17% or 18% return on equity, but if you squared **Home Depot's** capital structure to be similar to that of **Lowe's**, **Home Depot's** return on equity would be in excess of 30%. So Wall Street is still not convinced that Nardelli and his new management crew have their hands around the problems within the store structure of **Home Depot**. But in the short time that Nardelli

has been there, what they've done just in generating cash from their 1,500-store base we think is terrific, and we think the stores can only improve. And at current valuations we think it's the cheapest stock on our list right now. So while we think that **Home Depot** is never again going to be a 20% revenue grower, we think there's no question that they can be a mid-teens revenue grower and a high teens earnings grower for a number of years. And if all they do is take this flood of cash that they're generating each and every quarter and buy back stock, we think the stock could be a surprisingly terrific performer.

So we're not only going against the grain and holding onto it, but we are buying more. We'll see what 2003 brings for **Home Depot**.

TWST: There's been a lot of talk this week about ending the double taxation on dividends. Are you interested in looking at stocks with dividends as part of your investment?

Mr. Rolfe: In looking at stocks with high current dividend yields, the answer would be no. However, if Wall Street and Corporate America can get away from their quarterly earnings gamesmanship nonsense that's been going on for the past few years and investors start to value companies not only at current dividend levels, but more importantly for the ability to pay a rising stream of future dividends, we'd be very much interested. By definition such companies are going to be growth companies and companies that generate increasing amounts of cash, and we think we own a bunch of them that can do just that. Our only caution for investors would be to not get too carried away and not be too dogmatic and demanding that all companies dramatically alter their respective dividend payout policies. Remember that a company's dividend payout ratio usually signals management's view of future growth prospects. Again, let's go back to high growth companies such as **Linear Technology** and **Gentex**, that possess tremendous growth opportunities in which they can take large amounts of retained earnings and invest back into their businesses. As long-term business owners, we would applaud these actions. For those companies whose growth rates are not what they once were, or that sit on tens of billions of cash, an **Intel** or a **Microsoft**, for example, we would certainly welcome a dividend and, most importantly a growing dividend stream.

Lastly, there is the case of some of our pharmaceutical companies; their payout ratios are already about 40% of their earnings base. So we don't think that there's going to be a dramatic change in the dividend payout ratios of such companies. They are about as high as they probably need to be right now. So this whole dividend question must be viewed industry-to-industry, company-to-company.

TWST: You have said that your turnover is very low, but what does trigger an exit from your portfolio? Do you have sell criteria that you stick with?

Mr. Rolfe: Certainly we're patient investors, but once we admit that we're just plain wrong, we sell and move on. In addition, within our fully invested portfolios, if we come upon a company that we understand, a company that we want to own and it's a terrific price, we will then force ourselves to go back to our portfolio, and re-

evaluate our holding. We then ask ourselves what company within our current portfolio do we have the least amount of confidence in, do we think maybe has the weakest business model. In this case we simply refresh the portfolio. Then in the third case it's more of a portfolio management move. We certainly overweight industries and we'll overweight individual stocks, but if we are correct and stock prices subsequently rise, we will trim back on the holding when it becomes too large a part of a portfolio.

1-Year Daily Chart of Home Depot

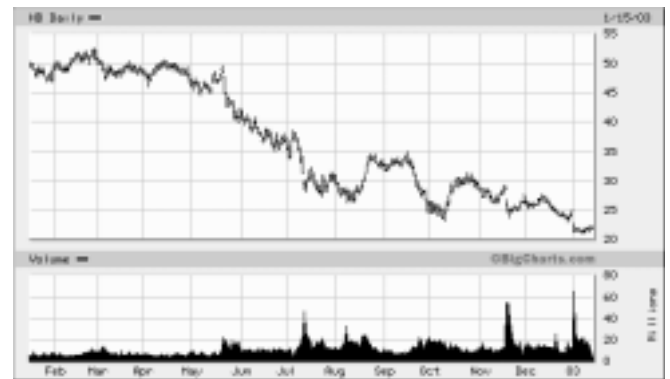


Chart provided by www.BigCharts.com

TWST: What distinguishes Wedgewood from your peers? What are the competitive differences?

Mr. Rolfe: We are proud to consider ourselves "old-fashioned" money managers. My partner, Tony Guerrero, and I cut our teeth in our business, working directly with individuals across kitchen tables, so we like to get in front of clients and deal face to face. As a private company we are under no outside shareholder influence or pressure to generate short-term earnings. In other words, we are not conflicted when it comes to rendering independent opinions to our clients. The only relationship that matters is our personal relationships with our clients and no one else. We run our business as we hope the companies we invest in do, i.e., for the creation of long-term wealth. When it comes to our investment philosophy, we have found success in discussing on our investment philosophy with many of our clients. Many of our clients are individual business owners themselves and business executives, so our philosophy easily resonates with them. These clients understand the view of a business owner rather than trying to decipher the hieroglyphics of the daily programming on CNBC. So we're different in that sense from a philosophical point of view.

When it comes down to investment strategy or portfolio strategy or how we build our portfolios, again, we are much more concentrated than the typical investment advisor, and, again, we try to manage

away from the S&P 500 Index. With the record of the money management industry underperforming the S&P 500 Index so daunting, it would seem to me to behoove money management firms to try to be as unlike the S&P 500 Index as they possibly can. When an investor can get exposure to the stock market with very low-cost index funds, the hurdle rate for active money managers to add value is very high. We think we've done that in up cycles as well as down cycles. But as long as our competitors don't want to follow at least our philosophical model, terrific.

TWST: What would you say are the biggest challenges you are grappling with at this time? What worries you going forward?

Mr. Rolfe: Quite frankly, we've been in an historically brutal three-year bear market, and even though our one- and three-year numbers are better than the S&P 500, we're down as well, and down markets are tough. Clients cannot spend or eat negative returns, so outperforming in a down market is of little consolation to clients. The current generation of investors, with very few exceptions, has never seen or experienced declining markets like this. So one of the tough things about this business right now is convincing people to stay in the stock market. A lot of people track their portfolios on a daily basis on the Internet. They're getting bombarded with financial information from a variety of financial magazines and other media, and after three down years for some it's just too much. Money managers in this environment are really earning their pay and it's been a challenge, and there have been difficulties in trying to have clients see eye to eye and keep a long-term view when so many market forecasts, including ours, over the past couple of years have been dead wrong.

TWST: What are your views on the importance of management credibility, particularly in view of the corporate scandals and accounting scandals in the past year. Is that an important criterion in your investment selection?

Mr. Rolfe: Yes. We developed a culture of the celebrity CEO during the 1990s in which managements awarded themselves gargantuan amounts of compensation in terms of salary and stock options. That led to all sorts of what we now know was impractical behavior at best and illegal behavior at worst, to keep earnings ever growing. Corporate America must regain the trust of investors.

Consider a difficult business, such as the airline industry. When honest managers tell their shareholders the difficulties that they face, and they're up front, even though the stock may not be performing well and the industries are in turmoil, they are certainly serving their shareholders better than they would be if they were constantly trying to sugar-coat things. So there's nothing that we like better than a brutally honest management group.

TWST: Your portfolios are primarily for wealthy individuals. How important is tax efficiency, and what approach do you employ to minimize the effect of taxes?

Mr. Rolfe: Our primary objective is to maximize the after-tax wealth of our clients. We begin individually reviewing accounts as early as August of each calendar year — we begin the process of minimizing capital gains, without, if we can, compromising the integrity of the overall portfolio. Certainly having lower turnover we can be as tax-efficient as we possibly can. But then again, we certainly don't want to go to the extremes, and we try not to go to the extremes where the "tax tail wags the investment portfolio dog." Yet for better or worse, for taxable portfolios, the government is a partner in any realized capital gains. So we try to minimize the impact. We utilize tax-loss selling where we can where it makes investment sense. But then again, capital gains are a component of successful long-term investing, there's no way around it, so in up markets we're going to have gains, and hopefully in down markets we're still going to have successful investments and generate gains as well. It's part of the overall total return picture. But certainly a little tax efficiency can go a long way, and we try to be as efficient as we can.

TWST: Is there any advice that you would leave with investors today?

Mr. Rolfe: Stay the course. It's been a very difficult three-year period, but markets have a unique property in that they typically revert back to the mean. And when markets get out of whack, often those reversions can be quite strong. We saw it in the late 1990s when the market was very overvalued, and we saw a lot of stocks fall hard for a number of years. Yet, here we are after three years of a bear market and a lot of excesses of the prior bubble economy have been wrung out. Good businesses have proven themselves in up markets and down markets. So my final message would be if you are invested in the stock market, try to think more like a business owner than a stock trader and keep a long-term view. Furthermore, investors must try to ignore much of Wall Street's advice, which is to generate transactions. If an investor can minimize one's portfolio transactions and maximize their investment time horizon, they are on their way to better returns.

TWST: Thank you. (PS)

Note: Opinions and recommendations are as of 1/14/02.

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