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# THE WALL STREET TRANSCRIPT

**Questioning Market Leaders For Long Term Investors**

THE FOLLOWING REPORT IS EXCERPTED FROM  
**THE WALL STREET TRANSCRIPT**

## **MONEY MANAGER INTERVIEW**

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# Focused Investing in Large Cap Growth

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## SECTOR – GENERAL INVESTING

**(ZBU502) TWST: Would you begin with an overview of Wedgewood Partners and its investment philosophy?**

**Ms. Webb:** Since we currently manage about \$560 million, Wedgewood Partners, Inc., is oftentimes categorized as a boutique investment management firm or, as we prefer, an emerging manager. We manage a large cap growth focused product exclusively. There are two points I would like to emphasize. First, our product has been managed by the same two individuals since its inception in 1992. These

two individuals are Anthony Guerriero, our firm's Founder, and David Rolfe, our firm's Chief Investment Officer. The second point is that our philosophy and process have not changed at all over the years. I have had a long association with Wedgewood Partners beginning in 1998. I joined the investment staff in 2002 as a Research Analyst and Portfolio Manager.

We have outperformed our benchmark, the Russell 1000 Growth Index, for the last eight years in a row and 11 out of the last 12. Our current client base has shifted from primarily high net worth individuals to a

### Highlights

*Dana L. Webb and David A. Rolfe are large cap growth managers who have a focused portfolio of 18 to 22 stocks. They focus on businesses that on a fundamental basis offer qualitative and quantitative characteristics that will enable them to have competitive advantages and produce superior stock returns over a period of years. Turnover is low and they are careful not to overpay for the companies they purchase. Wedgewood differentiates its investment approach from its peers by its three key features: focused portfolios, low turnover and the discipline to invest at attractive valuations.*

*Companies include: Apple Computer (AAPL); QUALCOMM (QCOM); Varian Medical Systems (VAR); SLM (SLM); Commerce Bancorp (CBH); Comcast (CMCSA); Countrywide Financial (CFC).*

more balanced mix of institutional/high net worth clients. Our firm's mission is to build our clients' wealth in up markets and to protect that wealth in down markets, and this is exactly what we have been able to accomplish as evidenced by our up market and down market capture ratios over the last one, three, five, seven and 10 years. We are very proud of the fact that our portfolio of steady, consistent growers has enabled Wedgewood to outperform a vast majority of our peers as well over this same time period.

*Rolfe: We're focused investors and we have very low turnover. So if you just start out with a mental model of investing, where you're going to own relatively few companies and are going to hold them for a very long time, then one must seek out those relatively few outstanding companies that have unique, long-term competitive advantages.*

1-Year Daily Chart of Apple Computer



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

We are first and foremost a large cap growth manager. Our disciplined investment philosophy is based on three powerful tenets that we feel give us a competitive advantage. First, we are focused investors with just 18 to 22 stocks in our client portfolios. We like the term “focused” rather than “concentrated” because focused is a broader term. We do not concentrate on any industries in particular

since we are bottom-up stock pickers. Focused implies taking a harder look at your target investment opportunities, and this is what we do — we focus on businesses that on a fundamental basis, offer qualitative and quantitative characteristics that will enable them to fend off competition and produce superior stock returns over a period of years. A stock portfolio with more names can diminish the potential of putting one's best ideas to work and increases the risk of receiving mediocre returns.

Second, as bottom-up stock pickers with a long-term outlook, you can bet our turnover is very low. It has averaged about 15% over the last five years — a fraction compared to the turnover of the typical investment firm. But the key to making our philosophy work (our third tenet) is the discipline not to overpay for the companies in our portfolios and not to think and act like every other large cap growth manager.

We are very proud that our clients' portfolios are populated with names you may not find in other growth portfolios. These three features have distinguished Wedgewood from our peers: focused portfolios with low turnover and the discipline to invest at attractive valuations.

**TWST: When we spoke to you a year ago, you were pretty confident that large cap growth stocks would regain market leadership. How has that turned out for you? What is the outlook now in 2006 for your style of large cap growth investing?**

**Mr. Rolfe:** I think our prediction of a renaissance of large cap growth versus large cap value was certainly early. What we saw in 2005 was pretty much parity between large growth and large value. Recall that our view of growth outperforming value was predicated on a few thoughts we've had here at Wedgewood Partners for the past

year or so. The first was centered on valuation. From the extreme outperformance of growth over value that essentially ended in March 2000, the Russell 1000 Value Index has outperformed the Russell 1000 Growth Index by an astounding 16 percentage points per annum through the end of 2004. In 2005, the Russell 1000 Value Index outperformed the Russell 1000 Growth Index by roughly 2 percentage points (7% versus 5%).

In our view, the extremes in the spring of 2000 set the stage for the outperformance of value over growth. Coupled with the best post-recession earnings recovery since World War II over the past few years, value investing has enjoyed two tailwinds that could not have possibly been stronger. As is the nature of investing, we believe extremes have been reached in the other direction. So to reiterate, our first reason is valuation. We believe that valuations for indices that measure value investing have reached extremes in overvaluation.

***Webb: Apple is an evolving company and with their innovative design, they are able to obtain premium pricing. We look for Apple to continue their assault on the consumer electronics market in upcoming product releases as acceleration of consumers utilizing digital media content continues.***

Our second reason is that we believe that we are in the early stages in a changing profit environment. In this changing environment, we expect a moderating economy and a much slower rate of corporate earnings growth in 2006 and 2007. We are not economists by any means, but as common stock investors, we simply cannot afford to ignore the ominous signs of a flat to inverting yield curve, the ramifications of a

deflating housing bubble, and corporate profitability at record levels.

***Rolfe: Apple's market share almost has nowhere to go but up, in our view. But when you look at their vertically integrated business model today, paradoxically, in our rapidly evolving digital world, their vertical integration may be one of their best competitive advantages. In this world of converging digital devices, not only do people come to expect it, but they, in fact, demand that their various devices communicate seamlessly with each other. No other technology company better exemplifies this digital paradigm shift than Apple.***

Take the matter of housing first. The housing boom over the past few years has had a monumental impact on job creation and growth in housing related industries. In addition, rising home prices have allowed homeowners to extract record amounts of home equity to fuel non-stop spending. But again, too many elements of the housing boom have now turned negative and one just cannot ignore the potential economic impact.

Consider that over the next 20 months, at current interest rates, more than \$2 trillion of adjustable rate mortgages will reset higher. Household debt as a percent of household assets is at record highs. This ratio is up to 19% from 14% in just the last six years. Household debt as a percent of GDP is at a record level as well. In the past 15 years, it has increased from 63% to over 88%. Mortgage debt, as a percent of GDP, has doubled to 63% over the past 20 years. And finally, despite the remarkable gains in home values, the massive amounts of home equity withdrawals have reduced the ratio of home equity/home market value to historic lows. In fact, home equity withdrawals have financed a minimum of 25% of recent consumer

spending — and perhaps as much as 50%. Absent such record withdrawals, current increases in GDP over the past 24 months could arguably have tipped the economy into a recession.

*Rolfe: From a bigger picture perspective, what differentiates us is the fact that we're focused to begin with. There just aren't that many firms that are. Plus, when you start to consider how low our turnover is and our attempt to be valuation sensitive if we even want to have a chance to outperform the market, with either a benchmark index or with just our competitors, by definition, we must be different, and we believe we are.*

As if the deflating housing boom was not enough for investors to contend with, the currently inverting yield curve is, we believe, equally ominous. Historically, an inverting yield curve (i.e., short interest rates greater than longer-term interest rates) has preceded every recession. Now, there have been a couple of false signals, but more important to us is the fact that every single flat yield curve has a perfect record of preceding a corporate profits recession.

Corporate profitability is one of the most mean-reverting sensitive economic time series that we are aware of. Numerous measures of corporate profitability, whether one looks at profit margins or return on invested capital, are either at multi-year or multi-decade highs. Typically, such change to a slower economic environment and slower profit growth favors growth over value, and we believe that the case can be made that growth is inexpensive relative to value — particularly high-quality growth. So we're still sticking with the prediction that growth offers much better risk/reward than value right now.

**TWST: Would you take us through the steps in your investment decision-making process and discuss the characteristics you're looking for in these high-earning growth stocks?**

**Mr. Rolfe:** As Dana mentioned, we're focused investors and we have very low turnover. So if you just start out with a mental model of investing, where you're going to own relatively few companies and are going to hold them for a very long time, then one must seek out those relatively few outstanding companies that have unique, long-term competitive advantages.

Our process starts off quantitatively. We look for high-return-on-equity, high-return-on-capital business models. We begin by sorting through a universe of the largest 500-600 companies. This simple quantitative screen dramatically reduces the universe of those businesses we'd want to own down to maybe 50 or so companies.

*Webb: QUALCOMM is clearly positioned to take advantage of the adoption of 3G technologies as W-CDMA accelerates. At year-end, there were almost 2.2 billion wireless subscribers worldwide and 77% of those were subscribed to services based on GSM standards. Much of this base will shift to W-CDMA standards, offering a huge opportunity in terms of revenue and profit growth.*

After that, we dive into the all-important qualitative assessment of these businesses. We study, evaluate, and try to understand these 50 or so business models as best we can. We must truly come to understand the drivers of profitability and the competency of their managements. As we go through this process, we put together a mosaic of a company's competitive advantages. We ask ourselves if we truly understand a company's competitive advantages. Furthermore, we must reach a

conclusion — if compelling competitive advantages exist, are such advantages sustainable and durable?

*Rolfe: What we like about Commerce Bancorp is that their mindset is completely and utterly different from traditional banks. They view their branches as stores and not the typical plain-vanilla, commodity-like dull consumer experience most branch banks offer. In their view, a customer who has had a good consumer experience will come back – it's simple. So they build expensive branches in key real estate areas.*

1-Year Daily Chart of QUALCOMM



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

After going through that process, we typically get down to a list of maybe 25 or 30 outstanding companies that we think we understand well. So again, as focused investors, we are concentrating on just a handful of select businesses that generate outstanding profitability and, as such, have reinvestment rates high enough to generate at least mid-teen growth for the foreseeable future.

**TWST: You mentioned that you are valuation sensitive. Would you elaborate?**

**Ms. Webb:** This is a key area where we believe we have distinguished our firm from other growth managers. Growth investing is great in up markets, but there's such a long history of growth investing being poor in down markets because of either too much emphasis on earnings

and/or price momentum. Too many investors fail to understand that “growth” and “value” are two sides of the same investment coin. Price is what you pay for a stock, but value, or value creation, is what you get in the business. We must be valuation sensitive — and we are. If we get the company analysis right and the valuation correct as well, then we have put together a portfolio that should perform well in up markets, and will likely outperform in down markets. That's been our history at Wedgewood since 1992. We're very proud of our risk-adjusted returns, and that speaks to outperforming up markets and outperforming in down markets.

One thing we get asked all the time is how to control risk in a focused portfolio. And a point I don't think Dave mentioned is that, being growth investors, the companies we want to invest in emphasize quality and are consistent growth companies, rather than high-growth or hyper-growth companies.

**TWST: So it's sustained earnings over a period that you're looking for?**

**Mr. Rolfe:** It is, but sustainable earnings over any meaningful time period is rarer than many investors believe — particularly regarding organic growth. So everything we do here is simplified to a very powerful point of investing in a small number of very unique business models.

**Ms. Webb:** it sounds simple, but as Dave and I can both attest, oftentimes it's very difficult because the universe of companies that we're dealing with is very small, and we must be disciplined, so we don't overpay for these outstanding companies. In addition, we also have to be careful not to overstay in an investment. Even the greatest company hits a growth wall at some point, and we have to be ahead of the curve in trying to identify that.

**TWST:** So the companies in your portfolio don't have to produce, say, 20% earnings growth every year.

**Mr. Rolfe:** Absolutely not. We are very pleased with a mid-teen growth rate. Now, we do have some companies that are barely doing 10%, which is the minimum that we look for, and we also have a few in our portfolio that we think, at least over the next three to five years, can click along at maybe 20%-25%. But again, to have a long-term view of a company or an expectation of earnings growth of greater than 20%, is very rare territory. You could probably count on two hands the rare companies that have been able to pull off 20% compounded earnings growth over any 10-year stretch of time.

1-Year Daily Chart of Varian Medical Systems

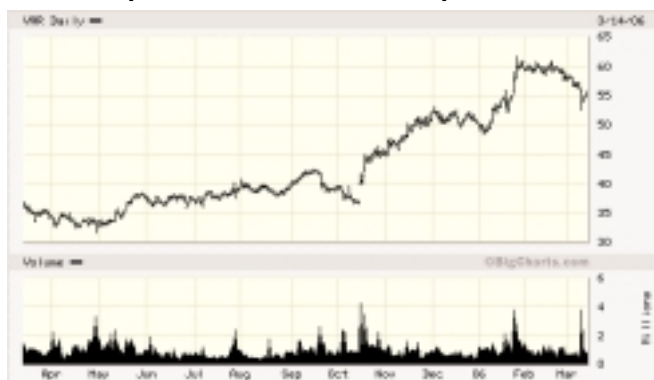


Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

*Webb: Varian has a very long history of operating excellence and cutting-edge product design. They essentially invented the radiotherapy market. With their sophisticated machines for radiation treatment, increasingly, the cure rates are improving and different cancers are being treated as well. Varian competes in a market where they are bringing out new products, and they are well accepted.*

**Ms. Webb:** That leads me to bring up one of our most recent purchases, **Apple Computer** (AAPL). **Apple** is our second-latest purchase. It's

a company that we believe can sustain at least 20% growth over the next three to five years.

**TWST:** What attracted you to **Apple**?

**Ms. Webb:** We purchased **Apple** in the beginning of October when the stock was just under \$50. While the stock was up 123% in 2005, it was **Apple's** increasingly visible strategy to become an end-to-end solutions provider for the networked home and their moving beyond the PC market that attracted us to the stock. With iPod sales of over 32 million last year, we saw the iPod success leading to success in other areas of the company. **Apple** is an evolving company and with their innovative design, they are able to obtain premium pricing. An example is in their latest product announcement, a complementary Hi-Fi stereo system for the iPod that is priced at \$350, which is \$50 above a comparable product from Bose. We look for **Apple** to continue their assault on the consumer electronics market in upcoming product releases as acceleration of consumers utilizing digital media content continues. While their recent media event showcasing the Hi-Fi and new Mac mini disappointed analysts, we believe **Apple** is saving the "good stuff" for their 30th anniversary on April 1. Return on equity has tripled since 2002 from 2.9% to over 23% last year. And as you can imagine, cash flow has skyrocketed.

**Mr. Rolfe:** We've been watching **Apple** for some time. We had owned **Intel** (INTC) for quite a long time and **Microsoft** (MSFT) for quite a long time too, so we just had to follow **Apple**. Years ago, their business model, which is essentially that of a vertically integrated PC company, hurt them, quite frankly. The company's products have always been a combination of both proprietary hardware and software. They are great products, no doubt, but they never licensed their key intellectual property to others. The success of **Dell** (DELL), **Microsoft**,

**Intel** and numerous others on the shared standard classic PC platform is, of course, well known. **Apple** was relegated to outstanding products that underwent boom-bust cycles, but their market share was always stuck in the low single digits.

***Rolfe:** Sallie Mae has a very unique and outstanding business model in that it's one of the least credit-risky financials and least interest rate-risky companies we've ever owned, much less come across. 85%-88% of their student loan book is under the auspices of the government student loan program, where the loans are 99% guaranteed by the federal government. Sallie Mae is very unique in that both their interest rate spread and credit quality is essentially fixed.*

**Ms. Webb:** And it's still in single digits. It's amazing — if they can just add a small percentage of market share take over the next couple of years, you'll be looking at terrific growth in their Mac line. There were 218 million PCs sold last year, and just 4.7 million Macs were sold — yet the unit growth from the previous year was a terrific 35%!

**Mr. Rolfe:** Their market share almost has nowhere to go but up, in our view. But when you look at their vertically integrated business model today, paradoxically, in our rapidly evolving digital world, their vertical integration may be one of their best competitive advantages. In this world of converging digital devices, not only do people come to expect it, but they, in fact, demand that their various devices communicate seamlessly with each other. No other technology company better exemplifies this digital paradigm shift than **Apple**.

Because they develop their hardware and software in tandem across all their product lines, **Apple** is a natural home now for people who want

cutting-edge technology, and also for those who have never used these digital devices before. The company's stores exemplify this emerging and growing digital reality. We all know that the company has fanatically loyal users, but even more significant to us is that the company reports that 40%-45% of people who are buying products in their stores are first-time users of any Mac or **Apple** product. And that, to us, speaks volumes.

Again, they are drawing into the realm of first-time users for a number of these various products. They currently have about 130 stores, and the traffic has grown terrifically over the past few years. They now do about \$30 million of revenue per store. And if you assume management can simply meet their stated expectation of new stores rolling out over the next few years — and what that implies for incremental earnings for the company — you can make the case that just new store growth alone is going to achieve consensus earnings estimates for the next couple of years.

**1-Year Daily Chart of SLM**



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**Ms. Webb:** And that's not, of course, taking into consideration a robust growth environment for their desktops and laptops, the continuing growth in their iPod franchise, as well as the new products we expect the company will roll out.

New products, I might add, are an underappreciated aspect of the **Apple** story. Thus, we would be surprised if some time, probably late this year, **Apple** did not roll out a multi-function cell phone. And again, if you just start backing out some of the numbers in these markets, it's amazing what the incremental growth could be. If you assume that **Apple** is successful with its phone — call it an iPhone — and is able to get just 5% market share of the global handset market, that would come to anywhere between 40 and 50 million units a year. And if you assume an average selling price of about \$150 per iPhone, all of a sudden, that's another \$6 billion in additional revenue!

So again, our core thesis on **Apple** is that today, unlike in its past, it's not just a one- or two-product company with short product cycles and a business model that's subject to boom-bust cycles. We're looking at a multi-product platform with a sustained high level of profitability, and they are just generating buckets of cash right now.

**Mr. Rolfe:** Dana, how much cash did they end up with at the end of the year?

**Ms. Webb:** \$8.7 billion — which is just over \$10 per share.

**Mr. Rolfe:** So the **Apple** story is quite powerful and has more than a few legs to it.

***Webb:** What the selling of Comcast and Countrywide have had in common is that when the long-term growth prospects — or more specifically, the quality of future growth prospects — seem to be permanently reduced, we will step aside. That's what our thinking was in both cases.*

**Ms. Webb:** We failed to mention that the new **Intel** microprocessors are going to be great for their products too, with the heat and the performance attributes that the notebooks will have now.

That's going to mean more sales for them, and the concern for **Apple** investors is whether **Apple** can meet demand. Currently, limited availability of the new MacBook Pro has lengthened the delivery time to the customer to two to three weeks. March estimates of sales may prove to be aggressive.

#### 1-Year Daily Chart of Commerce Bancorp



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST: Your investment in Apple raises a question that often comes up about investing in quality growth companies: knowing when to enter the market. When do you purchase them if they're always doing well and have high stock prices?**

**Ms. Webb:** A case in point was with **Apple** and their third quarter earnings release. We got in in early October. It wasn't that the month of October had anything to do with it, but it was relevant that it was during earnings-reporting season. They reported their third-quarter numbers, and they were outstanding. But in what I like to call a post-Reg-FD (fair disclosure)/Sarbanes-Oxley environment, it's the rare management that's going to overpromise on corporate results, so you get a lot of gamesmanship about expectations — and **Apple** is a serial underpromiser and an overdeliverer in terms of expectations. Now, if you rewind back to October, what they said was that for the fourth quarter, they were going to do about

\$4.7 billion in sales. That was a little bit lower than what the Street expected, and the stock, which had been on fire, got hammered.

If we have a short list of companies that we're following, it's when we think there's a miscue in terms of expectations — maybe there's a one- or two-quarter problem and the stock gets hit — that we jump in. Your point is excellent. The stories of the companies in our portfolio are usually well known, but we have to be patient and try to get into these companies when there's a short-term miscue. And just to put the final touch on what happened with the fourth quarter, we all know now that **Apple's** fourth quarter was just outstanding, and their revenue came in at \$5.7 billion — it was only a \$1 billion miss in terms of expectations. The same thing happened when they reported those fourth quarter results in January: the numbers were outstanding, but when they forecast what they thought they could do for the next couple of quarters, the stock got hit again. And now we're in the process of adding to those positions in the portfolio. It was an underweighted position when we first bought it at 2.5%, but now we're bringing it up to an equal weight at 5%.

Again, we like to be opportunistic buyers. We like to be patient, and it's the rare company that doesn't come in, or at least pull back, on some type of short-term variable. But again, Wall Street is obsessed with short-term results, and as long-term investors, we must take advantage of that. Hopefully, we did it with **Apple**.

I also think it's interesting to think about what **Disney's** (DIS) Pixar is going to do for their video distribution. They have 40 TV shows right now, but just adding some of that **Disney** content is going to be interesting to watch.

**Mr. Rolfe:** Yes, all the talk about content is really interesting. Just since they announced the

video enabled iPod, they've had over 8.5 million video downloads, but when you talk about **Disney** and Pixar and the future possibility of downloadable video content, the numbers could be striking. Consider — a typical top-10 TV show on any given night has an audience of about 10 million, and here we are with a different type of video/digital content device that we think hasn't even reached critical mass yet. When you add dozens upon dozens of potential downloadable TV shows and full-length movies, the potential addressable market opportunity is enormous.

The iTunes music store was the fastest-growing Internet site as ranked by Nielsen last year. Everybody talks about the so-called halo effect, and it's mentioned so much that you have to start to wonder if it's overused, but all the evidence that we can put together says it is not. And we think it's more powerful than people realize.

**TWSTL** What other companies do you want to tell us about that you feel exemplify your investment philosophy?

**Ms. Webb:** Our latest purchase is **QUALCOMM** (QCOM). **Apple** and **QUALCOMM** are most exciting companies. Each respective company's technology is not only proprietary, but it's second to none. It's funny — we've been talking about steady, consistent growers, and now we're throwing out high-tech names.

But **QUALCOMM** is truly a great one. **QUALCOMM** is clearly positioned to take advantage of the adoption of 3G technologies as W-CDMA accelerates. At year-end, there were almost 2.2 billion wireless subscribers worldwide and 77% of those were subscribed to services based on GSM standards. Much of this base will shift to W-CDMA standards, offering a huge opportunity in terms of revenue and profit growth. In studying these companies, certainly you have to peel back

layers of the onion and delve into a lot of different variables, but when you take an overview and simplify the story — call it the 10,000-foot overview — I think what **QUALCOMM** has in common with **Apple** is an underappreciation for how robust their business model is.

When it comes to the mobile handset market, again, we are seeing a convergence of broadband speeds, content, and video — every day there are new announcements. In regard to **QUALCOMM**, consider the paramount need for these major, national wireless service providers to keep subscribers on their respective networks as long as possible to enhance the value of that network. When you're looking at video and Internet surfing and any type of digital content over a handset, typically, your monthly bill is going to go up, and that's great for the wireless service providers.

Wireless service providers also have a huge incentive to have subscribers upgrade to the latest phones to do all these wonderful things that are available. Right now, the global turnover of handsets is about 18 months. So the average user gets a new cellular phone every 18 months, and we expect the global handset market in 2006 to approach almost 1 billion or maybe about 900 million units. And increasingly, when we're going to 3G (third generation), the next-generation high-speed broadband wireless networks, you're hard-pressed to find a better company that has more irons in the fire in terms of their intellectual property, handsets, chipsets, and selling baystation-related software than **QUALCOMM**.

With the company's CDMA technology, they have 14% of the global subscriber base, and that translates into 20% of global handset sales — but it's estimated that with the W-CDMA and the third generation, they should account for more than

30% of total subscribers and possibly 60% of total handset sales that they will have exposure to.

**Mr. Rolfe:** Yes, **QUALCOMM** already has a long history of being successful, but the future market share take is tremendous — and that's the simplified story. Relating it back to **Apple**, these are new markets that are opening up. The market share is very low right now, and the market share take could be considerable.

**Ms. Webb:** Also, if you talk about the chipsets, with W-CDMA they had 10% of the market in 2004. It moved up to 20% in 2005, and they expect it to move up to 50% within the next couple of years.

**Mr. Rolfe:** Again, it's our experience as investors that there's nothing more powerful in terms of operating leverage than a company that takes market share. That is simply one of the key things we look for in any company that we're considering for our portfolio — market share take. It's also great when you have economic tailwinds or some new product introductions and so forth, but raw market share take is just a terrific driver of shareholder value.

**Ms. Webb:** And the reason they're able to license their technology and receive those royalty payments is because they control two-thirds of all the patents involved with CDMA technology. And with 3G and W-CDMA having become a standard in 2000, one-third of those patents are controlled by **QUALCOMM**.

**Mr. Rolfe:** Thinking about technology, even biotechnology, I'm hard-pressed to think of any company that we've ever looked at, much less owned, that has intellectual property as broad-based as **QUALCOMM** does.

**Ms. Webb:** They have over 4,000 patents!

**Mr. Rolfe:** The **QUALCOMM** story is simple and quite powerful. **QUALCOMM** is the

toll bridge for the next-generation cellular market. There are 800 million second-generation handsets in the world (2G and 2.5G). We expect next-generation 3G (W-CDMA) handset sales of 100 million in 2006, and perhaps doubled to 200 million in 2007. **QUALCOMM**'s intellectual property only addressed 20% of second-generation handsets. The 3G markets are wide open to the company. And here is the kicker — at least 40% of **QUALCOMM**'s revenues and 60% of their operating profit comes from licenses and royalties, which carry 90%-95% gross margins! And even though the company is very familiar to a lot of growth investors, our take on their story is that we think the legs here are much longer in terms of growth than what a lot of people expect.

**TWST: In what other areas of the economy are you finding these good growth companies? You've mentioned two technology stocks.**

**Ms. Webb:** Out of the 19 positions that we own, three are in health care — **Amgen** (AMGN), **Varian Medical Systems** (VAR) and **Medtronic** (MDT).

I'll start with **Varian**. First, the company is not terribly big — in terms of a traditional large cap growth company. The current market cap is just over \$7 billion, so it's somewhat under the radar screen for a traditional, large cap growth investor, but it is big enough for us. Anytime we look at a small large cap (or a big mid-cap), we insist that such companies be exceedingly successful, obviously, but, typically, we are looking for companies that are the inventors of their market. In addition to **Varian**, a couple of stunningly outstanding "smaller large cap" companies that we've owned over the years that fall into this category are **Linear Technology** (LLTC), which we've owned since 1996, and **Gentex** (GNTX) — the auto-dimming mirror company that essentially in-

vented its own market that we've owned since December 1997.

**Varian** has a very long history of operating excellence and cutting-edge product design. They essentially invented the radiotherapy market. With their sophisticated machines for radiation treatment, increasingly, the cure rates are improving and different cancers are being treated as well. The latest machines allow for very heavy doses of radiation — typically in one or two treatments — yet the cutting-edge technology embedded in their machines is increasingly so precise that they minimize the killing of healthy tissue. So here's a company with operating margins that have gone up five or six years in a row, their latest machines have average selling prices that are higher, and there is terrific operating leverage of their business model. And — unfortunately, there's no other way to say this — the treatment of cancer is a growth business, and 60%-70% of all cancer patients are getting some type of radiation treatment.

**Varian** competes in a market where they are bringing out new products, and they are well accepted. Here in the United States, they have the highest market share. Unfortunately, in international markets, such cutting-edge radiotherapy machines are very underpenetrated, but that means the international side of their business is growing at a very rapid rate. They just reported terrific earnings, but the most telling statistic of their latest quarter is that their backlog grew 25%. So essentially, their backlog now is worth one year's worth of revenue. Again, it's a company that has a lot of visibility. The growth looks to be not hyper-growth, but it's good, solid, consistent 15%-17% top-line revenue growth for at least the next three to five years.

Moreover, **Varian** is in an industry that is quite different from the companies we were previously talking about in the high-tech field; in this

case, it's in the medical field. They have 70% market share in the United States and 60% worldwide. The World Health Organization estimates a 50% rise in cancer patients by 2020 and that there are currently 10 million new cancer patients diagnosed annually. We've talked about their cutting-edge technology. Basically, the treatment is one to eight high-dose treatments, versus daily treatments over a four- to six-week time frame — and with lower side effects.

Their return on equity for 2005 was about 25%. It's a company that we like with steady growth and a huge backlog of over \$1 billion.

**TWST: Financials have been buffeted by the rising interest rate environment for the last couple of years. How are your holdings in financials doing?**

**Mr. Rolfe:** Better than one would suspect in a rising interest rate environment — but there are good reasons for this dichotomy of performance.

We've had a pretty large weighting in financials over the years. We like to look at the broad financial industry in two buckets — financial services and interest-rate financials. Our holdings that are the most interest-rate sensitive are **Commerce Bancorp** (CBH) and, to a lesser extent, **SLM Corporation** (SLM), the old Sallie Mae.

Let's start with **Sallie Mae**. **Sallie Mae** has a very unique and outstanding business model in that it's one of the least credit-risky financials and least interest rate-risky companies we've ever owned, much less come across. 85%-88% of their student loan book is under the auspices of the government student loan program, where the loans are 99% guaranteed by the federal government. Within that program, the government mandates a spread over variable commercial rates. **Sallie Mae** is very unique in that both their interest rate spread and credit quality is essentially fixed. So they are able

to prudently leverage their balance sheet to produce returns on equity routinely in excess of 30%.

The other interest-rate sensitive financial that we've owned has indeed been hurt by the flattening yield curve. It's a traditional bank, **Commerce Bancorp**, headquartered out of Cherry Hill, New Jersey. What we like about this company is that their mindset is completely and utterly different from traditional banks. They view their branches as stores and not the typical plain-vanilla, commodity-like dull consumer experience most branch banks offer. In their view, a customer who has had a good consumer experience will come back — it's simple. So they build expensive branches in key real estate areas. They have consumer friendly hours; they're open on weekends. The core of their model is, if people are given a great experience, they will come through your doors in droves and they're going to give you their deposits. They are unmatched within the industry — small, mid or large in terms of size — in their consistent, growing deposit base, which annually approaches about 30% a year.

But, like any bank, it's a spread business and the flat yield curve has hurt them, and it has hurt **Commerce** more than others because their loan growth has not kept up with their incredible deposit growth. They typically invest in short-term securities, and the yield that they earn on securities is significantly less than with a traditional loan. With the flat yield curve, interest margins have been squeezed, lowering their growth rate over the past year. But we continue to own this unique company because we believe that in a more normal yield-curve environment, Wall Street is dramatically underestimating the earnings power of this business model.

They still generate positive growth, but the compression on their net interest spread was pretty dynamic.

**Ms. Webb:** In 2004, the spread was 4.3%, and it ended the year at 3.5%. But the stock was still up over 8% for the year, so that speaks to the **Commerce** deposit-generating story. Despite that compression, their earnings growth was still driven by just outstanding deposit growth. So if we get into a more traditional yield-curve environment, there's the potential for earnings growth to exceed deposit growth, which would really speak well for the stock's valuation down here in the low \$30s.

**TWST: What triggers an exit from your portfolio?**

**Ms. Webb:** The last position that we sold was **Comcast** (CMCSA) and we replaced it with **QUALCOMM**. One of the key reasons we'll sell a company is if we believe the growth prospects of the company are compromised, and then we'll replace it with a company we believe offers better long-term sustainable growth. We were bullish on **Comcast** and we were looking for the company to penetrate their client base with their advanced services, such as their digital cable, video on demand, high-speed Internet and their VoIP, which has been rolled out slower than we had expected. But we believed they would increase their average revenue per user and reduce defections to satellite services.

That said, we have come to the belief that 2005-2006 will prove to be the beginning of the end of their monopoly on video distribution, so we sold **Comcast**. Furthermore, we believe that the rapid emergence of digital content over IP networks is reducing the value of their distributed content over broadband networks. The prospective growth rate is diminishing and their ability to raise prices is limited, plus, their monopoly on programming is being eroded.

They will soon encounter competition for high-speed Internet offerings from companies such as **Verizon** (VZ), which charges lower

prices for equivalent speeds, or, for a couple of dollars more each month, customers get twice the speed of cable. We believe the competition is here to stay and will certainly intensify pricing pressure on **Comcast's** commodity products. Lastly, content-related assets on their balance sheet — given the rapidly changing nature of Internet content distribution — are at risk to be depreciated at quicker than current schedules, which is not good for earnings growth.

Another recent sell was **Countrywide Financial** (CFC). We were fortunate to have a very successful investment in **Countrywide**. We were originally attracted to **Countrywide** because we felt that the company's diversification away from the traditional mortgage origination business was not only very successful, but it was being ignored by Wall Street. They've grown exclusively organically over many years to ultimately take the number one share on the mortgage servicing side, and the number one share on the mortgage origination side — it has just been an incredible growth story over the years. But the nature of their growth has changed quite a bit of late. It was disconcertingly more sub-prime and adjustable rate mortgage oriented. The net effect of that was that their margins were getting squeezed, so we were concerned about their underlying profitability, and it, in fact, has come down.

It was our largest holding not long ago and we had trimmed it back when it got to that point. We also sold a half position some time ago because we were getting concerned. The final chink in the armor was that we just felt that the quality of their growth was being quite compromised. We sold our final piece of **Countrywide**, and with those funds, we initiated our position in **Apple**.

I think what the selling of **Comcast** and **Countrywide** have had in common is that when

the long-term growth prospects — or more specifically, the quality of future growth prospects — seem to be permanently reduced, we will step aside. That’s what our thinking was in both cases.

**TWST: If you come up with an exciting idea like Apple Computer, do you have to sell one of the stocks that isn’t performing quite as well?**

**Ms. Webb:** Yes. And again, we have a long history of being fully invested. When a new idea comes down the road where we really like the business and the valuation is very compelling, that forces us to go back to our current portfolio and review the investment thesis for each company. For the company that we have the least amount of confidence in, we’ll typically kick it out to make room for an idea that we believe is significantly more compelling.

Again, there’s this whole idea of a focused portfolio. Hopefully, we know these businesses very well. We’re thinking and acting like business owners rather than security analysts (which, I must add, we believe is not only central to our culture at our firm, but is one more differentiating factor we employ in our philosophy and process), with the continuing goal of having the best portfolio possible at all times. We’re patient investors and our turnover is very low, but there’s a fine line between being patient and being stubborn, so this process of adding a new name to a portfolio when it becomes compelling helps to cure our stubborn problem if it ever starts to develop.

**TWST: People with largely diversified portfolios criticize more focused portfolio managers by saying that you get too emotionally attached to companies. That’s not the case with you — you sell a company for business reasons.**

**Mr. Rolfe:** Right, and I think that’s probably a valid concern for any type of investor. We have very low turnover and there are a growing list

of companies that we’ve owned for over 10 years. But what we’ve learned over the years is that there’s a risk of becoming too infatuated with a company where we just can’t pull the sell trigger. I guess the flip side of that debate is that the worst mistakes we’ve made over the years have been with those terrific companies we’ve sold when there was a problem that we thought was developing. In the case of a handful that come to mind, a problem did develop, but the mistake we made was that the problem was overcome in a short period of time and we never got back in. You don’t see those mistakes in our performance record, but Dana and I can assure you that we have cost our clients a bucket full by not getting in these terrific companies that overcame a fixable problem.

**TWST: What are the differentiators that distinguish your investment approach at Wedgewood Partners from that at other firms that have concentrated portfolios?**

**Ms. Webb:** I feel it’s more of our style of investing in steady, consistent growers, plus being valuation sensitive. If you consider a few of our competitors, those firms have what we consider the “must-own” stocks — the **Googles** and the **Yahoo!’s** and the **eBays**, whereas we own steadier, consistent growers. Actually, we did a comparison with one of our more prominent competitors and the p/e on our 2006 earnings was about 23 times on forward earnings, whereas that particular portfolio was at 54 times.

**Mr. Rolfe:** It’s really interesting that in the big scheme of things, when you look at the thousands of money managers that are out there — either value or growth — there really aren’t that many focused investment firms. I think from a bigger picture perspective, what differentiates us is the fact that we’re focused to begin with. There just aren’t that many firms that are. Plus, when you start to consider how

low our turnover is and our attempt to be valuation sensitive, just intellectually speaking, if we even want to have a chance to outperform the market, with either a benchmark index or with just our competitors, by definition, we must be different, and we believe we are.

That's the feedback that we get, particularly from the consulting community because obviously, they're looking at a slew of money managers all the time. Even though some of these firms may not hire us, it's rare that they don't say, "Wedgewood, you are different."

**Ms. Webb:** Another thing on the portfolio management side is that other focused firms may let their positions rise to well over 10%; we start trimming back at around 9%. We're focused, but we don't want to be too focused.

**TWST: Is there anything you'd like to add?**

**Mr. Rolfe:** We've talked a lot about our investment philosophy, but allow us to sum up our business philosophy. We're very careful here at our firm not to mess up what got us here in the first place in terms of our performance and our attitude toward making the decision-makers at our firm exclusively available to our clients. People have trusted us with their hard-earned money, and a lot of our clients have been with us for many, many years, often with the bulk of their investable assets. We take that responsibility very seriously.

**Ms. Webb:** We're interested more in the performance of our clients' portfolio than in the

performance of our firm. We know that growth will come if we exceed our clients' expectations. It's just one of those businesses where, if you have halfway decent numbers, people will find their way to your door. But we try to protect and grow responsibly in that we don't have any marketing people. We know that if we did and we scoured the country with a couple of marketing people, the business would not only grow, but it would mushroom. We don't necessarily think that would make our business better, and our business is terrific when our clients are happy. Again, we have a very simple investment philosophy and we have a very simple client service philosophy and business philosophy here at Wedgewood.

Compared to a lot of firms, it's a very small firm. We are a boutique and we intend to keep it that way. We just want to focus in on what got us here in the first place, and that is competitive investment performance. All of our effort is focused in on that.

**TWST: Thank you. (PS)**

*Note: Opinions and recommendations are as of 3/13/06.*

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