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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Building Portfolios Based on Dividends, Quality and Valuation

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JOHN FATTIBENE is Director of Financial Planning at Harvest Financial Partners. He began his career as a Commercial Lending Officer in Baltimore. When he left lending, he joined Vanguard, where he worked as a Financial Planner. After leaving Vanguard, Mr. Fattibene worked for two financial planning firms and an investment management firm. He is also an Attorney. Mr. Fattibene attended Vassar College as an economics major. He received his J.D. from the University of Maryland Francis King Carey School of Law. He is a Certified Financial Planner. Mr. Wright and Mr. Fattibene started Harvest Financial Partners in 2008.

SECTOR — GENERAL INVESTING

TWST: You talked about your philosophy on prior interviews. You discuss dividends, quality and valuation. Can you give us some details around that?

Mr. Wright: Yes, dividends, quality and valuation are really the three components of our stock-picking strategy. All are really important, and we need all three in order to purchase a stock for our clients' portfolios. First, every company we own must pay a dividend. The income from dividend stocks has always generated a large portion of stocks' total returns. We also like the steady cash infusion into our client portfolios where it can be used for spending or reinvestment.

Quality is really a protective element, and hopefully it will keep us out of trouble. Discerning this attribute is a little more art than science, but we do spend a lot of time evaluating the quality element of our companies. By quality, we are focusing on strong balance sheets, good cash-generating ability, strong market positions and good management teams.

Finally, we pay a lot of attention to valuation. We often say there are a lot of good companies out there that pay a dividend, but if you pay too much for them, they make really lousy investments. We try to buy stocks at low valuations, and we spend a lot of time looking for them. Today it's been tougher than it was a few years ago, but if we are patient we always find some interesting opportunities out there.

TWST: Is the market pretty fairly valued right now in your opinion?

Mr. Wright: We do not spend a lot of time focused on the overall market's valuation, but we do look at our underlying companies' valuations. Lately we've been finding more opportunities to sell than buy, so that's caused us to raise cash. We are comfortable with that, and we think it does indicate a market that, while maybe not excessively overvalued, is still a little pricey at the moment.

TWST: You talked a little bit about dividend-paying companies, the fact it's nice to have the cash coming in. What are some of the other advantages you see with dividend-paying stocks?

Mr. Wright: The key advantage is the steady stream of income, money that can be used by some of our clients to meet their spending needs, so that's important. But if we have clients that don't need the cash immediately, we can just use those dividends to reinvest. Beyond that, there have been numerous academic studies showing that stocks that pay dividends outperform the broader market. It just simply makes sense to us; starting off in today's environment with a 2% to 3% dividend yield gives an investment a good "head start." Factoring in growth of the dividend over time adds to the advantage. This combination becomes a significant part of the total return for stocks. Our current stock portfolios have a yield of 2.9%, which is about a 50% premium to the S&P 500.

TWST: That's impressive. In terms of your overall portfolio composition, when do you use asset classes besides equity, and you mentioned cash for example, but when do you use them and why?

Mr. Fattibene: The answer to that is very client-centered. We're looking at portfolios on a client-by-client basis to see what the client needs to accomplish with their investments. So a portfolio that needs to fund a child's college education will use different asset classes than one that's for a 50-something year old investing for retirement. Given that, we look within equities and break them into subasset classes: larger U.S. companies, mid/small-sized U.S. companies, developed international stocks, emerging markets and real estate.

If appropriate we also will use investment-grade bonds. The bonds provide predictable cash flow both in dollar amount and timing of when the cash is needed.

Mr. Wright: And the bonds also help to lower the volatility of the portfolio.

Mr. Fattibene: The objective with all of these asset classes is to put them in a portfolio to manage both the return and volatility aspects of the portfolio.

TWST: Since you mentioned bonds, you led right into my next question. What is bond laddering, which is something that I know you use, and when is that useful?

Mr. Fattibene: We think it's useful a lot of times. First, I should say we are big fans of individual bonds, because we basically know our return the day we buy the bond, assuming we hold it to maturity. The way we would describe it is if you think of a ladder, it is composed of rungs. Every year represents a rung on the bond ladder. We buy bonds that mature every year. That means we have cash coming into the portfolio every year.

We can use that cash for one of two purposes. We can use it if the client has spending needs from the portfolio, so those can be funded from the maturing bonds. It means we don't have to sell any stocks to meet a client's spending needs, which is especially helpful if we have a down stock market. It allows us to insulate the risk portion of the portfolio from both short-term cash needs and volatility.

If the client doesn't need to spend from the portfolio, we just reinvest the funds from the maturing bonds further out on the ladder. Using individual bonds changes the nature of interest rate risk in client portfolios. Instead of us facing potential principal loss, all we face is a theoretical opportunity cost of not investing at a higher interest rate at some later date.

Highlights

Jim Wright and John Fattibene share their firm's investment philosophy and strategy. Dividends, quality and valuation are the three components of their strategy. They discuss the advantages of holding dividend-paying stocks and how they construct each portfolio on a client-centered basis. Mr. Wright and Mr. Fattibene talk about specific holdings and how they exemplify the firm's philosophy. Companies discussed: The Coca-Cola Company (KO); Rayonier (RYN); National Oilwell Varco (NOV); Rayonier Advanced Materials (RYAM); Apple (AAPL); Unilever plc (UL); The Procter & Gamble Company (PG); Pepsico (PEP); McDonald's Corp. (MCD)

TWST: What about global investment, do you guys invest outside of the U.S.?

Mr. Fattibene: We do. Some of the companies that we own and that we'll talk about later are global in nature. **Coca-Cola** (KO) for example gets a majority of revenues and profits from outside the United States. They're a quintessentially global company. But we still think that companies that are domiciled in the United States have some different attributes and return characteristics than companies that are domiciled in London or Berlin, or for that matter Rio or Tokyo. And that's why we diversify around the world. I should also say that outside of a few individual stocks, most of our international investing is all done through mutual funds or exchange-traded funds.

At this point in time we find slightly better opportunities in emerging markets and international developed markets than in U.S. markets. Another place we've gone global is that we have recently started adding a global real estate fund to our portfolio. The managers can look worldwide to find real estate opportunities. Real estate is an immense market, and we are more comfortable owning a fund that has a very broad mandate.

TWST: What about sectors, are there certain sectors where you see opportunities right now?

Mr. Wright: I might broaden your idea of sectors and say there are three areas that we've seen opportunities. First, we have found opportunities in companies that are doing some corporate restructuring. Second, the technology space has presented a number of names for us over the last few years. And then finally, we have focused quite a bit on global consumer products companies. John mentioned **Coke** earlier as one example, but there are a number of others that we will mention in this conversation. If you want, I can start to talk about one of the restructuring ideas that we like.

TWST: Yes, absolutely.

Mr. Wright: Over the last few months, we've actually bought two restructuring stories. One is **Rayonier** (RYN), and the other is **National-Oilwell Varco** (NOV). We're going to talk about **Rayonier** today. **Rayonier** was a timberland and a specialty pulp company, but about two months ago, it divided into two separate companies. One of them, which kept the **Rayonier** name and stock symbol, is the timberland company. It owns timberlands in the Southeast United States, the Pacific Northwest and New Zealand. It has a very attractive dividend yield of nearly 4%.

It is a stock that we like in our portfolio for several reasons. One, it's a way to participate in the improvement in housing; as the economy improves and we build more houses, we need more lumber

and timberland companies benefit. Pricing should also improve because of a supply shortage developing in British Columbia due to a pine beetle infestation in Western Canada. The impact of this could be sizable and last for many years.

We also see **Rayonier** as a nice way to continue to play growth in the Far East. As I mentioned, **Rayonier** has timberland in New Zealand, which can be exported to China and other parts of the Far East. They also have timberland in the Pacific Northwest, another place that exports to Asia. So as Asia continues to grow and develop and demand for buildings and houses grow, there is going to be a need for timber from those locations, again improving the pricing picture.

Finally, timber is not a bad inflation hedge. With all that the Fed has been doing recently, inflation could rear its head, and if it does, owning some hard assets like timber will not be a bad thing. So we are happy to hold on to this piece of the restructured **Rayonier**. It has modest price appreciation potential and as I said, an attractive, almost 4% dividend yield. Ultimately, now that it's separated from the pulp business, a larger player could purchase **Rayonier** and probably pay somewhere in the low to mid-$40s for the underlying company.

1-Year Daily Chart of Rayonier

Chart provided by www.BigCharts.com

they have initiated a very modest dividend, which we think they can increase over time. The stock right now is in the low $30s, and we certainly think that in a better environment, in 12 to 24 months, the stock could be well into the $40s, so we're going to continue to hold the stock, and we find it very attractive right now.

TWST: What about another idea from the tech sector?

Mr. Fattibene: We'll talk about **Apple** (AAPL). One of the things I think that's really interesting about **Apple** is it really is like a microcosm of what's going on in the tech sector, and why tech is our largest overweight by far.

The tech sector was all about growth — grow revenues, grow users. A lot of times they weren't even really concerned about profits; they looked at paying a dividend as a negative indicator for their growth prospects. What we've seen over time is more and more of these companies have recognized that it's both too expensive and too dangerous to try and grow larger businesses at double-digit rates and that they can generate very attractive returns for shareholders by focusing a little bit more on capital allocation. So we've seen more of them pay dividends and more of them buy back shares.

Apple is a very good example. **Apple** recently had a 7-for-1 split. It's trading at a little over $96 a share post-split. For a long time we got more questions about **Apple** than any other stock, and it was, "Why don't you own it?" Our answer was it doesn't pay a dividend, and it has already had a strong run. So **Apple** did this parabolic run up to over $100 a share on a split-adjusted basis. It was everybody's favorite stock, and then it started declining and got down into the $50s. **Apple** initiated a dividend in 2012, and we bought it for our clients in a couple of bigger tranches, and it grew to become our largest position at the firm.

What we were getting, even at a price of $96 right now, is a stock that has over a 2% yield; it's under 14 times forward earnings, and it has a ton of cash on its balance sheet. As of the latest quarter, they had net cash, cash minus debt, of over $130 billion or roughly $22 per share. If we adjust the p/e for that cash, we're closer to 10 to 10.5 times forward earnings, an extraordinarily cheap multiple for stock that is still growing pretty well.

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The second piece of this restructuring story is the specialty pulp business, named **Rayonier Advanced Materials** (RYAM). This is a niche business where **Rayonier Advanced Materials** is the largest manufacturer in the world. Specialty pulp is used in a whole range of products including cigarette filters, tires, paints, LCD screens, pharmaceuticals; it's even used as a food additive. It is a much less cyclical piece of the pulp market, and that's a reason we find it attractive.

The biggest end market for Rayonier right now is cigarette filters, but they're growing their business in the other segments of the specialty pulp business. Pricing has been weak in this area for a while, because **Rayonier Advanced Materials** and a couple of other competitors have brought some new capacity on. But **Rayonier**, and I think its competitors, will work that capacity in over time; they're not going to flood the market anytime soon.

So what we like is that if **Rayonier Advanced Materials** slowly brings the new capacity online, keeping pricing generally stable or maybe up, the company's earnings will grow nicely. In the meantime,

The other thing about **Apple** that is interesting, it's not just a hardware company. I mean they have great hardware, but they've created this wonderful ecosystem. The fastest growing segment they have right now is software and services through their iTunes and App Stores. They generated over $13 billion in sales for the nine months that ended with their June quarter. At $13 billion, you have one of the largest software companies in the world, but that's just part of **Apple**, and we think it created a very positive feedback loop for people to continue buying their hardware, whether it's iPhones, iPads or Macs.

On the capital-allocation front, beside the 2% dividend yield, they bought back over $28 billion of stock in the first nine months of their fiscal year, that's about 5% of their market cap. **Apple** may be an extreme case of why we bought a number of tech names and the sector has become such a big part of ours and our clients' portfolios, but the holdings share a common theme. Since they have gotten serious about returning capital to shareholders, we have these companies that have great balance sheets that generate lots of free cash flow. They are sharing

some of that cash in the form of dividends, which they are increasing at a well-above-inflation pace; a lot of them are increasing their dividends at high-single, low-double-digit annual percentages. They are also buying back a lot of stock, and we still see them having long runways of useful life for their products and their services.

TWST: What about in your third category of global consumer products?

Mr. Wright: Actually, if you think about global consumer products companies, **Apple** certainly can fit into that category as well. Some of the other names that we own and like are **Coke**, **Unilever** (UL), **Procter & Gamble** (PG), **Pepsi** (PEP) and **McDonald's** (MCD).

I'm just going to take a moment to talk about **McDonald's**. That stock right now has a 3.5% yield, which they've grown at a midteens rate over the last five years. That dividend growth has been even faster than that over the last 10 years. We expect the company to probably grow its dividend in the high single digits over the next five years.

1-Year Daily Chart of McDonald's Corp.

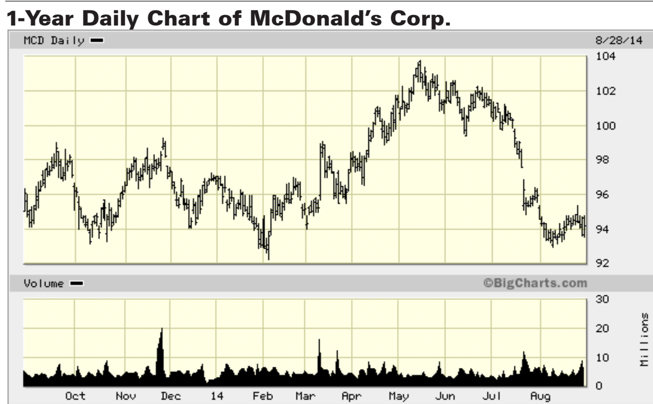

Chart provided by www.BigCharts.com

The stock is selling just below a market multiple, but it has some very compelling characteristics. **McDonald's** has a strong balance sheet, it generates a lot of free cash flow and they continue to grow the earnings. There has been a slowdown in same store sales in the United States. Business has certainly been more competitive as these fast-casual chains like the Chipotle (CMG) and Panera (PNRA) have continued to grow. **McDonald's** is continuing to work on introducing new menu items to improve sales. Still, what we really like about **McDonald's** is its tremendous global presence. There it has a huge opportunity to expand its store base and build out their franchisee base overseas. So we think that's where the opportunity is.

The company remains committed to returning money to shareholders. They just recently talked about how, over the next three years, they intend to return $18 billion to $20 billion to shareholders. That's up from $15 billion over the last three years. Although those dollars aren't quite as significant as **Apple's**, that is a lot of money that **McDonald's** will be returning to shareholders. I think what it represents is a management that's committed to its shareholders and is comfortable with the growth opportunities out there. So with the stock at about $93, we certainly think it could sell well over a $100 in the next 12 to 18 months.

Mr. Fattibene: Coke is another global growth story like **McDonald's**, a great global franchise with what we consider to be temporary headwinds. **Coke's** a little bit under $40, it's got a 2.9% dividend yield. It's obviously a mature company, facing a number of issues as carbonated beverage sales volumes are slowing. **Coke**'s faced a number of issues in the past, and it's dealt with them all successfully over time. It is probably the most unique and dominant global brand out there; if it's not it's in the conversation.

Coke pays an above-market dividend, it has very high returns on equity, which is one way you can measure quality. It's very reasonably financed, another way we measure quality. It commits a lot of the free cash flow it generates, and they generate a lot of it, to go back to shareholders whether it's through the dividend or share repurchases.

In addition, even though **Coke** has been this mature company forever, if you look at it over the last 10 years, it's basically doubled its net profit. So we don't undersell the short-term issues that a **Coke** or a **McDonald's** has, but we still like having positions in these kinds of companies. We like management's ability to figure out the issues that they're facing. We think if we're lucky enough to be holding these stocks in 10 years, we will be very pleased with both the financial performance of the firm and the financial performance of the stock.

TWST: How often do you reevaluate your portfolio and decide about making a change, or even if you decide not to make a change?

Mr. Wright: Just to touch on what we mentioned earlier, we don't have just one portfolio. We treat all our client portfolios individually, and we customize them for each client's specific needs. With that said, we are looking at our stocks all the time. We have a list that we use to monitor our existing holdings as well as what we would call our farm team — those are the stocks that we are doing the work on, and they may make into portfolios or they may not. So we're looking at that list all the time.

Most days, we do no trading. We get excited on the days when we can find something to buy or even something to sell, but many days go by and we're not trading. This year with the stock market rising, we've definitely been doing a little more selling than buying. In most cases, we've reduced existing stock positions; we have not eliminated many names from portfolios recently. **Apple** is an example of a stock that we sold down given the strength we've seen in the stock price. We're really always watching, looking and evaluating our stocks in the portfolio and on our farm team.

Mr. Fattibene: When we started the firm in 2008, we wrote a series of principles. One of our principles is that we will never confuse activity with progress. That remains especially appropriate today.

TWST: How do you manage risk inside the portfolios?

Mr. Wright: We do it a few different ways. One is that we recognize there's always risk when investing in stocks. We know that whenever we buy a stock there's always going to be some potential downside. We hope they all will go up, but we know there's always risk. We like to think that our patience and discipline in making the initial buy decisions eliminates some of that downside risk. But we also think that

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focusing on quality and valuation give us some protection as well. We typically buy only a small initial position and then look to add to it over time, opportunistically.

We sell a stock when it reaches our target price or reduce the position size if it becomes too large. We don't fall in love with any stock in our portfolio, and recognize there is a good price to buy and there's a good price to sell them.

TWST: Tell us about each of your background.

Mr. Fattibene: I worked as a banker in Baltimore for about 12 years, got to take apart and put together businesses' financial statements. I'm an Attorney and a Certified Financial Planner. I've worked for the Vanguard Group and some small investment management or financial advisory firms before Jim and I started Harvest.

Mr. Wright: I've been a Portfolio Manager or Analyst my entire career, which has spanned nearly 30 years. I have my CFA, and I've done an extensive amount of work as an Analyst in the consumer products industry when I worked at Delaware Investments and Davidson Trust Company. But I have also managed portfolios for both individuals and institutions throughout my entire career.

I should just also add that John and I have known each other since college, where we were roommates. We formed Harvest at the beginning of 2008. We just saw an opportunity to provide personalized and customized investment advice and financial planning to individuals and smaller institutions. We think there is a great need for that in the market today.

TWST: In terms of general outlook for, just say the next year to 18 months, what are you all watching, what are you concerned about?

Mr. Fattibene: I will mention that we work with our clients on a number of other financial planning issues outside of investment management, so we do pay attention to things like proposed or actual tax changes. And, given still historically low interest rates, we also talk with them about locking in fixed-rate financing on mortgages.

Mr. Wright: On the stock side, again as we talked about, we're a little less concerned about the market and more focused on the individual stocks that we own. As I mentioned earlier, cash has been building in our portfolios. We continue to watch individual names and their valuations, and wait for opportunities to buy high-quality companies at attractive prices. So that is the main thing that we're focused on.

Of course, like everyone else, we're going to continue to monitor the improvement of the economy, direction of interest rates. But our main focus remains on the underlying companies and looking for ways to continue to build out attractive portfolios for our clients.

TWST: Thank you. (LMR)

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