

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

A Long-Only Strategy that Outperforms Down Markets



DONALD YACKTMAN is the President and Co-Chief Investment Officer of Yacktman Asset Management Co. He is also a Co-Manager for the Yacktman Funds. Prior to founding the firm in April 1992, Mr. Yacktman worked for 10 years as the Senior Portfolio Manager of Selected Financial Services, Inc. During that time, he also served for nine years as the Portfolio Manager of the Selected American Shares mutual fund and was named "Portfolio Manager of the Year" by Morningstar in 1991. Before joining Selected Financial Services in 1982, Mr. Yacktman was a Portfolio Manager at Stein Roe & Farnham for 14 years. Mr. Yacktman holds a B.S. magna cum laude in economics from The University of Utah and an MBA with distinction from Harvard University.



STEPHEN YACKTMAN is the Senior Vice President, Portfolio Manager and Co-Chief Investment Officer of Yacktman Asset Management Co. He is also Co-Manager of the Yacktman Funds. He joined Yacktman Asset Management in April 1993 from Brigham Young University, where he earned his MBA and a B.S. degree in economics, with a minor in math.

JASON SUBOTKY is a Vice President and Portfolio Manager of Yacktman Asset Management Co., and Co-Manager of the Yacktman Funds. He joined the firm in August 2001, having previously worked as a General Partner at Peterschmidt Ventures and as a Vice President at Goldman Sachs. Mr. Subotky received a B.A. in music from the University of Southern California and an MBA from Brigham Young University.

SECTOR — INVESTING STRATEGIES

TWST: Introduce us to the Yacktman Focused Fund and the Yacktman Fund.

Mr. Donald Yacktman: The Yacktman Fund was started in 1992 and is a diversified mutual fund. The top 10 holdings plus cash often equal approximately 50% of the portfolio. The Yacktman Focused Fund, which was started five years later, is a non-diversified mutual fund, so we are able to put more capital behind our best ideas. This fund can invest in a more unconstrained fashion, and typically about 75% of the capital will be in the top 10 securities and cash.

TWST: Who are your primary clients?

Mr. Donald Yacktman: The Yacktman Fund has just passed \$3 billion and the Yacktman Focused Fund \$1.6 billion. Our clients are retail and institutional investors.

TWST: Tell me about your investment philosophy. I've heard it described as a triangle in the past.

Mr. Donald Yacktman: Ultimately, we think this business boils down to what you buy and what you pay for it. Think of it as trying to be a good shopper. What we do is we'll calculate a forward rate of return on prospective investments. This is the rate we would expect if we hold the security indefinitely and the multiple we pay for the business does not change much. We look at the cash being generated and the growth rates of the business, and by adding those components together, you get a forward rate of return.

We have a very long time horizon, and we think in terms of buying something and holding it until better opportunities become available or we think we made a mistake. We look at equities like a bond buyer would look at bonds, so a higher-quality company, like **Coca-Cola** (KO)

or **Pepsi** (PEP), would not need as high a potential rate of return as a lower-grade security. We adjust according to what is available in the market and build a portfolio to have diversification. We try to own good businesses managed by good managers. I think, on average, high-quality companies attract better managers. Again, it really boils down to what you buy and what you pay for.

TWST: How does your management philosophy give you an edge over other funds?

Mr. Stephen Yacktman: We are not investing with a goal of mimicking a benchmark. I think that style evolved because managers could protect their personal business risk. We are bargain hunters and like it when securities go on sale. I don't think you'll find many long-only investors who are more excited than we are when the market declines. A lot of people talk a good game but when it really comes down to it, they flinch.

There was a lot of change between 2007 and 2010 in the marketplace. But if you look at a lot of other managers' portfolios, they didn't really adjust what they owned. We, on the other hand, went from having a sizable cash position to having no cash, and changed the makeup of the portfolio by adding to media, financials, retailers and durables in the market decline. More recently we have reverted to mostly higher-quality issues and some cash. We actually did what we said we were going to do: buying things when they were cheap and selling things when they were more expensive.

TWST: Donald, in 2001 Kiplinger's published a story in which you described some of the struggles you went through in 1998 and 1999. What lessons did you learn then that have helped you more recently?

Mr. Donald Yacktman: I think the difference between being determined and being stubborn is if at the end of the day you are correct, you were determined.

We really try to be objective. A strong dose of objectivity is critically important to the investment process and drives us to what Steve

TWST: You mentioned that you like it when the markets go down. Do your funds tend to outperform even more during down markets?

Mr. Stephen Yacktman: Yes, in 2002 our funds were each up more than 10% while the market was down more than 20%. From 2008 to 2009, the Yacktman Focused Fund was up nearly 25% and the Yacktman Fund increased nearly 18% while the S&P 500 declined more than 20%. We are always very concerned about potential disaster, and one of our primary rules is, "Don't lose the money."

Mr. Subotky: Protecting from severe declines in 2008 and having some fresh cash to deploy in beat-up securities during the height of the panic helped set us up for really strong performance over the 2008-2009 period. In 2009, when the market rallied, the Yacktman Focused Fund increased 62% and the Yacktman Fund was up 59%. Our repeated outperformance in declining markets is largely a function of understanding risk and being very confident in bargain hunting, especially when others are panicking.

TWST: Over the long haul, both funds have strongly outperformed. Both the S&P 500 and Morningstar compare you to the large-blend category. What are some keys to that out-performance?

Mr. Subotky: Our team is focused on objectively analyzing and appraising securities that we think will manage risk and reward over the long term. We operate as partners, while at many other organizations, people are constantly jockeying for power or bonuses or promotions. Flexibility is also key. Although we have a strong preference for large, high-quality, multinational firms, we are willing to go to

where the opportunities to manage risk/reward are best.

Mr. Stephen Yacktman: In the last few years, it helped to avoid losing money in financial stocks. I've generally hated financials because you usually don't know what you have, and when you find out what you have, it is too late to do anything

Highlights

Donald and Stephen Yacktman, along with Jason Subotky, offer an in-depth look at the value-driven, long-only strategy employed at Yacktman Asset Management Co. They explain the motives behind the outperformance of both funds, the Yacktman Focused Fund and Yacktman Fund, during the recession, highlighting their objective yet flexible investment philosophy. In addition to explaining some current holdings, they also discuss their risk management techniques.

Companies include: The Coca-Cola Company (KO); Pepsico (PEP); Wilmington Trust Corporation (WL); Qwest Communications International (Q); Interpublic Group of Companies (IPG); News Corp. (NWS); Johnson & Johnson (JNJ); CR Bard (BCR); Becton, Dickinson and Company (BDX); Medtronic (MDT); Viacom (VIA); Walt Disney Co. (DIS) and Stryker Corp. (SYK).

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referred to: making changes. What I've learned over the years is to be more and more flexible because opportunities come from a lot of different areas, and while we have preferences for dominant global businesses with recurring revenues, we seek to be receptive to other opportunities when they present themselves. There is no substitute for knowledge. To really research and understand a situation is very important. The ability to buy into discomfiting news is a function of having a really good understanding of what the business is and what its value is.

about it. That scene played out in 2008 and 2009, and now there are more people on the "I hate financials" train, but it's not really as relevant anymore.

Mr. Subotky: A perfect example is **Wilmington Trust** (WL). Today it was reported it's getting acquired for a substantial takeover. It's down 40% on the acquisition news. You don't seem to wake up to that kind of surprise with a high-quality, consumer-oriented business.

Mr. Stephen Yacktmann: Despite our inherent distrust of financials, we built a substantial position in **AmeriCredit** in late 2007. **AmeriCredit** is a subprime auto finance firm. We originally established a position in the stock in 2003 but bought it heavily from 2007-2009. You wouldn't have thought those purchases in the mid-teens in 2007 would have done very well, but in fact, if you fast forward to today, you'll see that the company got bought out recently for \$24.50 a share by **General Motors**.

1-Year Daily Chart of Pepsico



Chart provided by www.BigCharts.com

One of the reasons **AmeriCredit** did well relative to other stocks is their business is superior to other financial institutions. They have shorter-term loans, and they have higher margins on those loans, so there is a greater degree of protection. Unlike most financials, disclosure was substantial, so we could evaluate their books. In many complex financial companies or banks, even the CEO doesn't really know what they've got on the books. We also made money in **AmeriCredit** convertible bonds in the Yacktmann Focused Fund.

Mr. Subotky: We focus on what we think the absolute rate of return is going to be for any investment when we make it, and if we do not find securities offering appropriate rates of return for the level of risk, we will let cash build. In the last decade, where you've seen a lot of fairly overvalued environments, that objectivity helped us protect capital until we saw better individual opportunities. It gets back to what you buy and what you pay for it, and constantly being patient and objective.

Mr. Stephen Yacktmann: I think we also do realistic forecasting and do our best to understand historical data. A lot of people like to look at short-term data that is easily available from Bloomberg or outside vendors. In recent years that hurt them because the economy had not had a prolonged or deep recession for so long; these sources did not have relevant data from the early 1980s.

Mr. Subotky: We also are concentrated investors because we tend to have a lot more conviction in our best ideas. I would say we combine patience and opportunism. When valuations warrant it, particularly during dislocations, we've taken sizable positions very quickly.

TWST: You say you're always trying to reduce risk and yet both funds are pretty concentrated. How do you mitigate the risk of those concentration levels?

Mr. Stephen Yacktmann: One way to manage risk is to move up the capital structure. Back in 2002, we bought a large position in **Qwest Communications** (Q) debt rather than the stock. We felt the debt was extremely secure and had a higher forward rate of return than the common stock. The debt ended up getting to a yield to maturity of more than 30%, and we didn't think the common was anywhere close to that.

In that example, you were basically buying phone lines for

\$400 to \$500 each by buying the debt, and these phone lines generated \$125 a year in cash. So unless people pulled out their phones rapidly, we felt the risk was fairly low. In 2008 to 2009, we did the same thing, purchasing **Interpublic** (IPG) debt instead of the equity.

Mr. Subotky: There are a few other ways to manage the risk. The main one is at the individual security level. As we mentioned, a good way to do that may be to be more senior in the capital structure at a given point in time. Another is to look for businesses that are very high quality with strong balance sheets. A third way is through portfolio management. Even though we are concentrated, we seek a degree of sector and security diversification.

Mr. Stephen Yacktmann: Being a diversified holder of Internet or technology companies did not help anybody in 2000. Bottom line is you need to make sure what you pay is actually worth the risk. Risk is not a function of volatility. In the end, risk is about what you paid and what you got.

Mr. Subotky: In the last couple of years, owning **AmeriCredit** rather than a diversified basket of financials worked out completely differently. We think you really can manage risk by knowing what you own versus trying to achieve so much diversification that you don't know your holdings very well.

Mr. Donald Yacktmann: The more confidence we have in a particular idea and the lower the valuation, the larger the position will be.

TWST: I want to ask about two sectors in which you have a heavy focus. The first one is the beverage sector, where you have fixed stakes with Coke and Pepsi.

Mr. Stephen Yacktmann: While **Pepsi** is partially a beverage company, you've also got **Frito-Lay** and **Quaker** foods. Additionally, you have **Gatorade**, which is extraordinarily dominant in the sports drink category.

On the **Frito-Lay** business, all I could say is if you walk down the chip aisle of a grocery store, it is hard to find a bag that's not a **Pepsi** brand. There are niche players, but **Frito-Lay** has some of the highest market share of any major product in the grocery store. It's a fabulous business. We like to say that if you can buy it from a vending machine, we want to own it. Chewing gum, chips, candy, beverages, sodas — those categories have the wind at their backs compared to other packaged food categories.

Coca-Cola is a diversified company, and prior to the bottling acquisition, 80% of its earnings came from outside the United States. **Coke** has high market share in many of the top emerging markets, which we think will allow the company to grow volume at an attractive rate for decades to come.

Mr. Subotky: I think it's less about owning beverage companies and more about investing in dominant packaged food companies with great global footprints. We took these positions because we think the predictability of these businesses is really strong and the valuations are very attractive. When you look at **Coke**, the stock is in the low \$60s, and it sold for more than \$80 a share in 1998. In the next 12 months, we think **Coca-Cola** will earn a bit less than three times as much per share as it did in 1998, so you've had huge valuation compression.

TWST: The other sector I wanted to ask you about is media, where you have a heavy dose of News Corp. in each fund and several other big holdings from this sector.

Mr. Stephen Yacktmann: When you look at something like **News Corp.** (NWS), half of its earnings come from pay-television content, like **Fox News**, **Fox Sports**, **FX** and a variety of international channels. The other content company we hold is **Viacom** (VIA) — and they've got **Nickelodeon**, **MTV** — and if you look at the number of hours viewed per household, they deliver about 20% of total cable/satellite viewership. **Viacom's** channels only cost about \$2 a month for each

subscriber, which compares favorably to **ESPN (DIS)**, which is more than \$5 per month for all of its channels, which produce lower total viewership.

In general, corporate profit margins are back at all-time-high levels. In **News Corp.**'s case, we think you have got margins that are still going permanently higher. For a typical company in the S&P 500, margins have nowhere to go but down. In **News Corp.**, you've got margins that are going up, so the wind's at their back and it's cheap.

Mr. Subotky: We also like the monthly recurring revenues **News Corp.** and **Viacom** receive from cable and satellite companies. It makes their businesses predictable. **News Corp.** is one of the old media newspaper/network television companies that successfully transitioned its business model. The cable content sector, which Steve mentioned, is now more than half of pre-tax profits and has grown pre-tax earnings more than 30-fold in the last decade-plus. In the last three years — in the face of a recession — the cable content business has doubled its operating income, and in the last five years, it tripled, which is far higher growth than we normally find in value-priced securities.

Mr. Donald Yacktman: A lot of the businesses we've talked about generate high returns on assets, and they have the ability to continue to have a high return on assets for a long period of time. A third group, which we haven't spent much time on, is the medical device area, which we've put a fair bit of money into in the last year or two. The common theme there from **Johnson & Johnson (JNJ)** to **CR Bard (BCR)**, to **Becton, Dickinson (BDX)** to **Medtronic (MDT)** to **Stryker (SYK)** is you have high-quality businesses that have suffered significant multiple compression and now sell at attractive prices.

TWST: Why should a long-term investor or an adviser look closely at Yacktman Funds?

Mr. Donald Yacktman: We have a strong team that has successfully worked together for a long time. The exact same people who put together the performance record are still in place today. We have a disciplined investment process strongly focused on protecting capital and producing positive rates of return over time. Finally, we have a significant amount of our personal net worth invested in the top 10 positions and in our funds. By way of full disclosure, the three of us have all of our capital that is invested in the funds in the Yacktman Focused Fund. We prefer the flexibility of the Yacktman Focused Fund to the Yacktman Fund.

TWST: Thank you. (MJW)

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