

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

High-Quality Companies with Great Franchises

BRIAN BOYLE, Founder and CEO of Boyle Capital, is the firm's Chief Investment Officer. He graduated summa cum laude from the University of Northern Iowa with a BA degree in Finance. He holds the Chartered Financial Analyst designation and is a member of the CFA Institute and the Iowa Society of Financial Analysts.

SECTOR – GENERAL INVESTING

TWST: Please begin with a history of Boyle Capital.

Mr. Boyle: Boyle Capital is a boutique investment management firm that was founded in 2004. We are registered with the Securities and Exchange Commission and our specialty is on the equity side. We have two main portfolios that we offer to investors. The first is our flagship Boyle Capital Equity Portfolio, which was established back in 2004. The second, which is a newer portfolio, is the Boyle Capital Dividend Portfolio. We established the Dividend Portfolio in March of 2009 as a separate portfolio to capitalize on many of the blue-chip, high-quality opportunities that we were seeing back then and in many cases are still seeing today. We have roughly \$100 million in assets under management.

TWST: Tell us about the dividend portfolio and the criteria you use to select companies for that portfolio?

Mr. Boyle: Sometimes simple is the best. The things that we look for in terms of high quality are the things that most people

would think of: high returns on capital, stable and predictable returns on capital, low debt levels and great franchises. These things all go hand in hand. Typically if you have high returns on capital it is because you have a great franchise. Those businesses with great franchises generally are price setters. If you are able to dictate pricing, you generally see high profit margins. If you have high profit margins, your returns on capital are likely high and thus you don't need a lot of debt. If you don't need a lot of debt to run the business, then your ability to sustain and grow a dividend is greater than those with less stable returns and weaker balance sheets. As I said, it's a simple concept and generally the market has been willing to pay a premium for such quality. But that's the unique thing about the blue-chip, high-quality subset today — in many cases these companies are trading well below the market and their own historical levels.

Highlights

Brian Boyle says that in many cases the blue-chip, high-quality companies are trading well below the market and their own historical levels. He looks for businesses with high returns on capital, stable and predictable returns on capital, low debt levels and great franchises. Great franchise companies can dictate pricing and you generally see high profit margins. He invests for the long term, generally five years and beyond. If investors would focus on the quality of a business and pay an attractive price, the stock will provide appreciation over the long term.

Companies include Johnson & Johnson (JNJ); Kraft (KFT); Coca-Cola (KO).

TWST: Your philosophy is centered around small concentrated portfolios. Why did you select that particular strategy rather than a larger, diversified portfolio?

Mr. Boyle: First off, we believe there are only a handful of truly attractive investment opportunities available in the marketplace at any given time. The investment industry is highly competitive and therefore there are a lot of eyeballs and a lot of brainpower that goes into scouring the globe for investments. Secondly, there are an even smaller number of opportunities we

attractive prices relative to what we think they are worth. The last category, which is only going to be found in the equity portfolio, is what we believe are mispriced probabilistic investments, where the market price of the security underestimates the probability of a favorable outcome of a legal decision or some other development. An example would be a company like **General Growth Properties (GGP)**, which we bought prior to bankruptcy and continue to hold today. It was a very uncertain situation at the time of investment, but the reward relative to what we perceived the risk of it to be

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feel like we understand thoroughly and that fall inside our circle of competence. So for us, number one, we have to find the things that fit our criteria and then ultimately they have to be within our circle of competence. When we can find those things, we want them to be a meaningful position in the portfolio because they don't come around every day.

TWST: What are the primary parameters you look at when choosing a stock for your portfolios, and why do you feel those are the most important?

Mr. Boyle: When you look across the board in our portfolios there are typically three broad categories of things that we invest in. First would be great businesses at fair prices. Great businesses generally are going to have highly predictable and growing levels of free cash flow, low levels of debt and sustainable

made it attractive in our view. We made it a roughly 2% position, knowing that if the courts didn't rule in favor of the company, we could lose our entire investment. The flip side was that a favorable court ruling could make the equity worth many multiples of the price we paid, which is what ended up happening. These mispriced options are never significant weightings at cost but have been significant contributors to performance in the past.

TWST: How do you manage risk in your portfolios?

Mr. Boyle: We don't believe in a formulaic approach to risk management. Our primary risk management tool is the extensive amount of research that we do before we ever make an investment. Buffett's number one rule is never lose money. Number two of course is not to forget number one. It sounds corny, but it is exactly the way we think about investing. We try

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competitive positions. The second category is good businesses or assets at extraordinarily cheap prices, and oftentimes they have a catalyst to realize that value. Those types of opportunities are going to be found more in the equity portfolio for us. They are not the highest-quality businesses that are out there necessarily, but they are good, solid businesses or assets that are trading at unbelievably

really hard to understand where we can lose in an investment. For us, we define “investment risk” as the probability of a permanent loss of capital, rather than the security price volatility. It is our belief that a well-selected portfolio of investments which is well understood and acquired at significant discounts to intrinsic value can mitigate the likelihood of an overall permanent loss of capital.

TWST: How often then do you turn over stocks within a portfolio? What triggers a decision to add or remove a stock?

Mr. Boyle: Our turnover has averaged around 30% a year; however, it's been a little higher in the last 18 months given the volatility of the markets. We have found ourselves in some cases selling cheap to buy cheaper.

Generally our decision to exit a position is triggered by either changing fundamentals or valuations. In the case of changing fundamentals, maybe the franchise is deteriorating or maybe we feel management has misallocated capital, and we no longer have confidence in management. Or it might be that the position has run up near our assessment of fair value and thus

“One other thing I think is critical when assessing a money manager is their commitment to their strategy. We don't allow ourselves to own any other publicly traded securities than what is in our clients' portfolios. It doesn't guarantee anything obviously, but it shouldn't leave any questions about where our interests are aligned. You would be amazed at how many investment firms do not have a similar policy.”

the risk-to-reward dynamics are no longer in our favor. Lastly, it might be a situation, as we saw in 2008, where we were selling things at four and five times free cash flow to buy things for two and three times cash flow.

TWST: What does that mean, when you say you use a value-based approach?

Mr. Boyle: A value-based approach is simply attempting to acquire more for our money than what we believe we are giving up. For us, that means buying things that exhibit significant valuation discrepancies between what the current price is in the market and what our assessment of the true value or net asset value of that business is. It

TWST: Tell us about some of your holdings right now and how they fit in with your philosophy.

Mr. Boyle: If you look at the dividend portfolio today, our largest position is **Johnson & Johnson (JNJ)**. It's not a sexy company, but it's been extremely steady and extremely consistent over the years. In fact very few businesses can boast of a track record like a **Johnson & Johnson**. It was started in 1886 and has been through wars, recessions, the Great Depression, a number of different monetary systems — you name it and odds are JNJ has survived it.

When you look at the sales growth of JNJ from 1886 to present, it is remarkable. Sales have grown from about \$0.1 million in 1886 to somewhere in the order of \$62 billion in 2009,

1-Year Daily Chart of Johnson & Johnson



Chart provided by www.BigCharts.com

“Johnson & Johnson raised the dividend 48 straight years. Then you look at the quality of the business; it's currently represented in 60 different countries. Over 50% of its revenues come from abroad, so it will benefit as the emerging markets, like China, India and Brazil, continue to develop. In addition to geographical diversification, its product mix is extremely diverse as well.”

ultimately comes back to Ben Graham's concept of “margin of safety.” Things don't always work out like you planned, and acquiring something well below fair value gives you protection from those unseen circumstances that seem to pop up all the time.

which is about 11.6% annually. Then you look at the dividends; JNJ's dividends have grown nearly 16% annually since they first started paying a dividend in 1944. They've raised the dividend 48 straight years. Then you look at the quality of the business; it's currently represented in 60 different countries. Over 50% of

its revenues come from abroad, so it will benefit as the emerging markets, like China, India and Brazil, continue to develop. In addition to geographical diversification, its product mix is extremely diverse as well.

Lastly, we think the price is right. At current levels, it trades around 12 times earnings. The average over the past

really like it. The new **Kraft** will have over 25% of its sales coming from emerging markets, which we think is going to be extremely important going forward. We think **Kraft's** dry goods are well suited for Cadbury's distribution platform, and thus there is a big opportunity to plug into that distribution network and provide good growth.

"Kraft has been in the penalty box somewhat over the last year for its aggressive pursuit and ultimate purchase of Cadbury. Cadbury is one of the great businesses in the world, and we believe that over time the integration of Cadbury with Kraft is going to result in a materially higher-quality company and a much faster-growing business than the standalone Kraft."

30 years is north of 20 times earnings, and there have been only a few times in the past 70 years when you have had an opportunity to buy **Johnson & Johnson** for 12 times earnings or less. What's more, we are getting a dividend yield of 3.7%, which has grown over 13% annually over the past decade. Obviously past performance doesn't guarantee anything, and if the market were to suffer another seizure like it did in 2008, **JNJ** would likely go down as well. However, we believe the quality of the franchise and financial stability of **JNJ** warrants a much higher price than current levels. We expect to hold **JNJ** for a long time.

Our second largest position today is **Kraft** (KFT). **Kraft** has been in the penalty box somewhat over the last year for its aggressive pursuit and ultimate purchase of Cadbury. Cadbury is one of the great businesses in the world, and we believe that over time the integration of Cadbury with **Kraft** is going to result in a materially higher-quality company and a much faster-growing business than the standalone **Kraft**. Why do we think that? Well, when you take a look at Cadbury, which

Lastly, much like **Johnson & Johnson**, we think the price is right for the quality we are getting. At current levels, **Kraft** trades at around 12 times our estimate of earnings. In addition, we are getting a 4% dividend while we wait. In the case of both **Kraft** and **Johnson & Johnson**, we are talking about very high-quality businesses with strong balance sheets

1-Year Daily Chart of Kraft



Chart provided by www.BigCharts.com

"In the case of both Kraft and Johnson & Johnson, we are talking about very high-quality businesses with strong balance sheets that are trading at yields materially higher than what the 10-year Treasury trades for today. It's not very often you get this type of quality at a discount to Treasuries."

is in the confectionary industry, confectionery has historically had very strong pricing power, very high gross margins and has been very economically resilient — it's a great example of the high-quality type of business that we look for. And then when you combine it with what **Kraft** already has today, we

that are trading at yields materially higher than what the 10-year Treasury trades for today. It's not very often you get this type of quality at a discount to Treasuries. We happen to find both awfully attractive, which is why they are our two largest positions in the dividend portfolio.

TWST: With all of the changes in the market over the last several years, have you adjusted your investment strategy in any way?

Mr. Boyle: We have not. We established the dividend portfolio in March of 2009 to capitalize on the opportunities in the blue-chip space. I guess that would be the only real change in our investment philosophy over the last 18 months, and it really doesn't represent a change, it represents more of a response on our part to an opportunity. I don't want to say it's a once-in-a-generational-type opportunity, but when we look at some of the high-quality names today, we are seeing prices and yields relative to treasuries that have been available only a handful of times in the past 60 to 70 years.

The last time that we could find where high-quality stocks were this cheap was in 1973/1974. But if you look back to 1973/1974, we had interest rates at 14%. So high-quality stocks trading at eight to 10 times earnings made more sense. Relative to treasuries, you have to go back to the 1950s to find a time where blue chips were this cheap.

I encourage readers of this interview to go back and study the 1970s, and you will see a lot of similarities between then and now in terms of these high-quality companies. Let's take **Coca-Cola** (KO) as an example. Coke was one of the nifty-50 stocks in the 1960s. The thinking back in the 1960s was that all you had to do was put your money in one of the nifty-50 companies and you were set. What people found out in hindsight, which is usually the

time frame while their earnings and the other fundamentals were continuing to build, the p/e went from 42 times earnings to eight times earnings, a decline of about 80%. So here was Coke during an eight-year period where the earnings per share rose 100%, sales per share rose 160% and yet the stock was down nearly 60%.

Now go and look at what happened after that consolidation period. **Coca-Cola's** split-adjusted price between 1972 and 1980 was around \$0.81 a share. That was the average price during that 10-year period after its stock had dropped 60% and while their sales and earnings were rising. If you take a look at what happened over the next two decades, the stock was up about 66 times, using an average price over that 20-year period. That's a heck of a return. Now obviously past performance doesn't

1-Year Daily Chart of Coca-Cola



Chart provided by www.BigCharts.com

“We believe that true investment success comes from investing in high-quality businesses over long periods of time, and that’s becoming more and more rare and uncommon in the investment world today. Everybody is focused on what their performance is this week, what their performance is for the quarter and, as a result, it creates opportunity in the marketplace for the long-term-oriented investor.”

way it works, is that the nifty 50 was nothing more than a mania, just like the tech bubble and countless other manias over the years. Investor enthusiasm had driven prices to unrealistic levels. Ultimately the 1973 bear market came along and a company like **Coca-Cola** went from \$75 a share in 1973 to \$22 a share. I'm looking here at my Value Line and over the next eight years, the stock traded between \$22 and \$30. However, the company did anything but stand still during that eight-year stretch. Just listen to this growth: Sales went from around \$18 a share to \$48 a share. So sales were up 154%-plus during that eight-year period. Earnings per share went from \$1.80 to \$3.60 a share, over a 100% increase. The dividend went from \$0.90 a share to \$2.30 a share, up 160%. Because the price stayed relatively flat during that

guarantee anything in the future and there are a lot of factors that come into play, but I could show you dozens of similar examples from that same time frame that had a similar outcome.

I think the point I am trying to make here, and the reason we established the dividend portfolio, is if you look at history and you look at the rare opportunities investors have had to own the high-quality businesses at the prices that some of them are trading at today, you typically have been well rewarded over time. Now I want to emphasize it will not likely happen over night and that is what makes it so tough for investors today. So many people are focused on the short term and most don't have the patience to be a long-term investor. However, we believe these are rare opportunities today. Just go back and look. These high-quality

companies go through these phases where they do extremely well, investors bid them up to unreasonable levels and then the enthusiasm goes away as concerns maybe over the macro come into the forefront; stocks get pummeled and they go sideways for years. While they are going sideways, their sales and earnings continue to build up and eventually the stock price shoots up to catch up with the growth, and the sales and earnings. That's the type of phenomenon that we think is occurring today in the likes of the high-quality companies such as **Johnson & Johnson** and **Kraft**, which I mentioned earlier. They've spent now about a 10-year period where their stock prices are down considerably, and now they've just traded in a range for the last five to eight years. Yet the fundamentals of these businesses have continued to chug along, and we think they are very attractive relative to the prices being paid today.

TWST: As you said, the approach to investing in the 60s was to buy blue chips and wait. More recently, there has been almost a backlash against the blue chips in favor of smaller, newer companies. Why is that?

Mr. Boyle: We think it's a combination of a couple of things. First, the blue chips are fairly boring companies. Let's face it, there is nothing really sexy about **Kraft**. You are not going to wake up tomorrow and see a company like **Kraft** go up 100%. These are steady, consistent companies that we think over time can produce steady and consistent returns. We think that many investors today have very unrealistic expectations for returns, and so they are so focused on the short term and the companies that can make them 100% overnight. There is a risk side to investing as well, and these same companies that can make 100% overnight can lose it just as quickly. We think boring and simple makes sense today, given the prices that we are trading at.

TWST: You talked a bit about the volatility in the market as well. Does volatility present opportunities as well as risk?

Mr. Boyle: It definitely does. It presents opportunities, and it can present risk. From the opportunity side, as I pointed out, we've been a lot more active in the last 18 months relative to maybe our average over the past because things are so volatile in the marketplace that in some cases, we were selling cheap to buy cheaper. On the flip side, I think the most important thing, when you look at the volatility of the market as it relates to equities, is you have to understand what it is you own; you have to understand what your objectives are, and lastly you have to understand yourself as an investor. Far too many people want to be equity investors until they see volatility on the downside. Nobody complains about upside volatility right? The reality is that if you are a long-term investor, you are going to have periods like we saw in 2008, which are not predictable, where you see downturns

in the market. If you are going to be the type of investor that gets scared out of the market at those particular times, then you need to rethink your investment strategy because people that went to cash in March of 2009 missed out on significant returns and caused significant wealth destruction. So as I said, you have to understand what it is you own, you have to understand what your objectives are, how what you own fits into those objectives, and lastly you have to understand you own temperament. If you are the type of investor that's going to be easily swayed and persuaded by the noise that's out there, then you need to rethink what you are doing.

TWST: What do you see as the main factors impacting the market over the next year to 18 months?

Mr. Boyle: We generally take a long-term focus, i.e., five years and beyond. But it seems that people today are so focused on the macro. As I mentioned earlier, people are looking at are we going to have deflation? Some people are worried about inflation. What's going to happen with unemployment? Are we going to have a double-dip recession? Everybody is trying to predict what's going to happen with the macro economy over the next couple of years and, as a result, they are structuring their portfolios accordingly. We tend to be long-term investors, five years and beyond. We don't think that the general macro economic trends are things that are easily predictable, and so we focus more on the fundamentals of the business. And as I mentioned earlier, you take a look at a business like **Johnson & Johnson** that has been around since the 1800s, it has survived wars, recessions, depressions, inflation and deflation, all the different macro themes that are out there; it's been through those environments, it's a well-diversified business. It doesn't have a lot of debt; it has a product that consumers are going to continue to use, whether we are in a recession or not. They should be able to maintain strong pricing power, whether we have inflation or deflation. So as an investor, if you can focus on the quality of the business and pay an attractive price, provided you have a reasonable time horizon, that's where your focus ought to be. If you can do that, as I said, I think five and 10 years from now you are going to be very pleased. But we don't make any claim about our ability to predict the short term. We are strictly focused on the fundamentals of our businesses in the long term.

TWST: What advice would you give investors right now?

Mr. Boyle: I think it comes back to the last couple of questions, and that is you have to understand what your objectives are as an investor. You have to understand what your time frame is, and you need to understand who you are as an investor. If you are the kind of investor that can't stomach volatility in your portfolio, then the equity market is probably not the appropriate

place for you. However, if you are the kind that can take a five-year approach to investing, then the high-quality businesses today are where we think investors need to be.

TWST: What gives Boyle Capital an advantage over competitors?

Mr. Boyle: I think the biggest thing for us is our long-term focus. We don't believe that you can predict the day-to-day machinations in the market. We believe that true investment success comes from investing in high-quality businesses over long periods of time, and that's becoming more and more rare and uncommon in the investment world today. Everybody is focused on what their performance is this week, what their performance is for the quarter and, as a result, it creates opportunity in the marketplace for the long-term-oriented investor.

One other thing I think is critical when assessing a money manager is their commitment to their strategy. We don't allow ourselves to own any other publicly traded securities than what is in our clients' portfolios. It doesn't guarantee anything obviously,

but it shouldn't leave any questions about where our interests are aligned. You would be amazed at how many investment firms do not have a similar policy. I've never understood why anybody would put their money with somebody that doesn't feel the same way. If it is good enough for my clients to own, it better be good enough for me.

TWST: Thank You. (LMR)

BRIAN BOYLE
Founder, President & CIO
Boyle Capital
13001 University Avenue
Clive, IA 50325
(877) 327-1870
(515) 224-0305 — FAX
www.boylecapital.com
e-mail: info@boylecapital.com