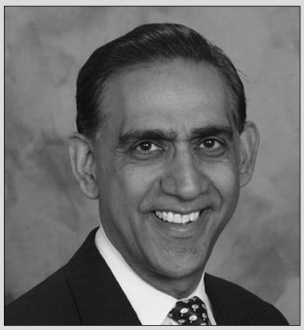
REPRINTED FROM JULY 8, 2013

THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

A Focus on Franchise Quality in Equity Selection



GAUTAM DHINGRA, CFA, is the Founder and CEO of High Pointe Capital Management, LLC. From 2008 to 2010, he was also a Lecturer of Finance at Northwestern University's Kellogg School of Management. Prior to starting High Pointe, Mr. Dhingra was the Partner in charge of investment consulting at Hewitt Associates responsible for the Midwest, Southwest and Western United States. He joined Hewitt in 1986 as Director of Investment Research and became a Partner in the firm in 1993. He developed the firm's asset allocation model and led the team that developed its 401(k) plan investment consulting practice. At Hewitt, he advised 12 Fortune 100 companies, among others, as to how to structure their investment programs. Mr. Dhingra is the Chairman of the Board of Directors for CFA Chicago. Previously, he served on the Board of Regents of the Financial Analysts Seminar presented by the CFA Institute. Mr. Dhingra holds a Ph.D. in finance, with a specialization in investments, from the University of Florida, where he also taught courses in securities analysis and derivatives. He is a CFA Charterholder, having earned his charter in 1987. He has written and published several articles, most recently an article titled "Intangibles: The Next Frontier in Stock Valuation."

SECTOR — GENERAL INVESTING

TWST: Please start with a background of High Pointe, including its history and an overview of the firm today.

Mr. Dhingra: High Pointe is a unique firm, based in Chicago. When we started our journey we identified an inefficiency in the marketplace in how the market values intangible assets, such as patents and brands. Based on that insight, we built a process to add 3% to 4% alpha per year to any benchmark that a client would designate. Our main products are large-cap growth, large-cap value, small-cap and international equity. In all of these products we have been able to achieve our goal of adding 3% to 4% alpha using the initial insight and refining it along the way as we learned more.

TWST: Who are your typical clients and what are your assets under management?

Mr. Dhingra: About three-fourths of our assets are from institutional investors, typically multibillion-dollar public pension plans. About 25% of our assets are from high net worth individuals. We manage approximately $300 million for these clients.

TWST: How would you describe your overall philosophy that serves as a base for your various products?

Mr. Dhingra: Our investment philosophy is to buy stocks that are inexpensive relative to their franchise quality and growth prospects. Our thesis behind this philosophy is that, one, franchise quality is determined by intangible assets, such as brands and patents, that are not visible on a company's financial statements; two, an increasing proportion of a company's value is associated with franchise quality, even though few people seem to focus on franchise quality as a primary factor; and three, franchise quality is often mispriced because it does not get the attention it deserves from investors. The net result of these three factors, we believe, is that by incorporating franchise quality into a rigorous stock selection framework, High Pointe can generate alpha relative to market benchmarks.

TWST: Since that is different than the traditional stock valuation approach, how do you assess that franchise quality?

Mr. Dhingra: We use a three-step process for stock selection. The first step is evaluation and scoring of intangible assets that drive franchise quality. To do this scoring, we have designed a proprietary metric called "Competitiveness Score," and that score is derived by scoring all industries and companies on seven important characteristics. Those seven characteristics are: barriers to entry, barriers to exit, degree of competition, pricing power, sustainability of competitive advantage, proprietary value added and competitive position of the company within the industry.

Our view is that these seven factors explain stock valuations to a significant extent. However, because others don't score these factors and explicitly take them into account while valuing stocks, there are times when these factors get mispriced, and that is where the opportunities arise for us to add value. The factors that I mentioned have some similarity to a well-known industry model that was designed by Michael Porter called the Five Forces Model. Michael Porter is a Professor at Harvard University who has written extensively about competitiveness of companies and industries, and his Five Forces Model was, to some extent, an inspiration for us to design our own model custom designed to work on the broad stock market. Our factors have some resemblance to Michael Porter's, but at the same time, they represent an expanded and enhanced approach designed for a specific task, i.e., superior stock selection.

Highlights

Gautam Dhingra of High Pointe Capital Management describes his investing philosophy as one that finds stocks that are inexpensive relative to their franchise quality and growth prospects. He outlines the firm's three-step stock selection process and how it evaluates a franchise's intangible assets. Mr. Dhingra also explains how his firm avoids emotional reaction to news headlines with its "risk aversion coefficient," and he highlights a couple of his favorite names.

Companies include: Valeant Pharmaceuticals International (VRX); Philip Morris International (PM); Schlumberger Limited (SLB); Halliburton Company (HAL) and Baker Hughes (BHI).

TWST: In addition to evaluating these intangible assets, what other factors do you focus on when you are looking at potential investments?

Mr. Dhingra: The scoring of the intangibles is the first step in our three-step process. This step allows us to distinguish good businesses from mediocre businesses. However, in order to buy a stock it is not sufficient just to know which is a good business and which is not. We also need to know whether the price that we are being asked to pay for a business is the right price or not. So the second step of our investment process is to incorporate our intangible scoring from step one and put it in our stock valuation model to see if the price that we are being asked to pay is reasonable compared to the characteristics of the company. This step gets us closer to prospective "buy" candidates, because it identifies companies whose intangible assets are good but are mispriced.

Then we apply a third and final step by doing an analysis of risks facing these potential buy ideas to make sure that our quantitative modeling did not miss a risk that might explain the apparent undervaluation. In this third and final step, we take a look at balance sheet risks, regulatory or legal risks facing a company, and potential changes to the business model that might have an impact on the business of the company, because these are the types of risk that cannot easily be taken into account by a quantitative model. If we find that a company that came through as quantitatively undervalued indeed faces one of these risks to a significant extent, we would pass on the idea and move on to the next idea. So this last step is a fundamental overlay to what is otherwise a primarily quantitative process.

TWST: Would you give us an example of what you consider an attractive stock pick today?

Mr. Dhingra: One of the companies that we have held in our portfolios for some time, and we continue to hold, is a company based in Canada, **Valeant Pharmaceuticals** (VRX). **Valeant Pharmaceuticals** is a company that's unlike any other pharmaceutical company. It is, to some extent, a financial engineering and private equity-type of company masquerading as a pharmaceutical company.

Traditionally, people have thought of pharmaceutical companies as those that invest billions of dollars in R&D with the hope of coming up with blockbuster drugs that they can then sell at a high price to mint money. Mike Pearson, the CEO of **Valeant**, came up with a completely different insight. He realized that the productivity of R&D dollars in the pharmaceutical industry had declined consistently for quite a long period of time. So he set about designing a company that spends very little on R&D, but instead focuses on buying existing products that were developed by other pharmaceuticals. He then cuts costs and takes advantage of tax laws to minimize the tax burden, and in this process generates extraordinary income from the same assets that a traditional pharmaceutical company could not.

Valeant is headquartered in Canada, which means that it does not face the same income repatriation restrictions that U.S. companies face. It has domiciled its intellectual property in locations that allow it to keep its tax burden minimal. So when you compare this company to other pharmaceuticals, you see that instead of spending 15% of the revenue on R&D the way a traditional pharmaceutical does, **Valeant** spends hardly 3% on R&D, so that saving goes directly to the bottom line. On top of that, the company's tax rate is 3%, compared to the normal 25% that other companies pay. And lastly, **Valeant** benefits from cost cuts as it generates economies of scale.

I believe this is the first company to realize that there is more than one way to make money in the pharmaceutical space. Other companies all try to do the same thing, which is spend money on R&D and hope to come up with a blockbuster product. Mike Pearson realized that you can make money in the pharmaceutical space not just by employing Ph.Ds and M.Ds the way other companies do, but by employing a lot of good tax accountants and MBAs, and he has delivered on this unique business model.

TWST: Is there another example you would share?

Mr. Dhingra: I'll give you a very different example of a company that has been in our portfolios for quite some time, and that is **Philip Morris** (PM). **Philip Morris** is well known because its products have a strong brand equity. The Marlboro Man is one of the most recognized figures all around the world, and the company enjoys exceptional brand loyalty. When it split off from its U.S. operations, which were renamed **Altria**, it gave us an opportunity to own a growing business that has strong intangible assets because of its brands, which give it pricing power. On top of that, there is repeat purchasing by the consumer because of the addiction element to the products, which means that the buyers keep coming back. Not only are the buyers addicted, but also the regulators too. As much as some people think that government is an adversary for tobacco companies, the reality is that the governments need the revenues that tobacco companies provide through the high taxes that are levied on their product. The cost of producing the product is minimal as tobacco farmers have no pricing power. Lastly, this industry is an oligopoly, and that brings with it additional intangible benefits, because oligopolies usually ensure that pricing competition will be benign.

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1-Year Daily Chart of Philip Morris International

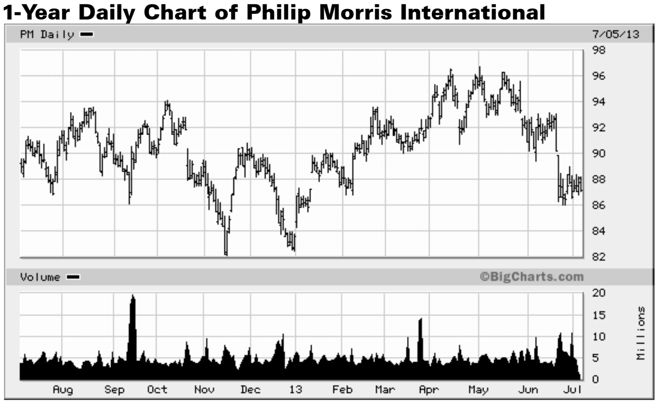

Chart provided by www.BigCharts.com

All of these characteristics are intangible in nature and do not show up on the balance sheet of **Philip Morris**, but they make **Philip Morris** one of the exceptional businesses in the world. From time to time, when this company becomes available at a reasonable price, it offers a buying opportunity like few others. We have owned this for quite a number of years, and we continue to hold it today, because unlike in the U.S., where cigarette consumption is declining, opportunities to grow in Asia and Eastern Europe are significant for **Philip Morris**.

TWST: How diversified are your portfolios? Do you intentionally overweight or underweight particular industries, or find that themes emerge based on your individual stock selection?

Mr. Dhingra: Even though our process is primarily bottom-up, we do pay attention to sector and industry diversification in order to achieve a desired level of risk control. Typically we have limits on how far away we would stray from our benchmarks. Although we are typically underweight in sectors such as energy, raw materials and utilities, because they do not typically have the intangible characteristics we seek, we make a special effort to see if within these sectors we can identify some companies that have some intangible characteristics. For example, at first glance it appears that in the energy space, companies are simply commodity-price driven and do not offer any intangible benefits.

Nevertheless, by looking carefully one can see that the services sector within the energy sector is actually an oligopolistic industry. **Schlumberger** (SLB), **Halliburton** (HAL) and **Baker Hughes** (BHI) control about three-fourths of the market for energy services. So even though energy, generally speaking, is a commodity-oriented sector that does not provide significant intangible assets, within that we are able to find some subindustries that do meet our criteria, which allow us to gain some exposure to companies in a sector that has minimal intangible assets.

Overall, however, it is true that our portfolios are somewhat underweighted to regulated sectors, like utilities, as well as to commodity sectors, such as energy and natural resources. Conversely, we are overweighted to technology and health care, and sometimes industrials and consumers as well.

TWST: From a macro, top-down standpoint, are there any particular trends or issues that you are paying most attention to today?

Mr. Dhingra: One thing we have noticed over the last few years is that the trends are shorter in duration than they used to be. For example, we go through a three-month, four-month period when the markets seem to become risk averse, perhaps because of the headlines about Europe falling apart or China slowing down, or any other of a myriad of reasons, but then everything turns around because Ben Bernanke or Mario Draghi utters soothing words. So we seem to have had a yoyo market at a macro level, where risk aversion and risk-seeking behavior seem to be taking turns every three to four months.

In order to make sure that we are not reacting emotionally to these headlines, we designed a metric we call the risk aversion coefficient. The phrase "risk aversion coefficient" is not a common industry term; it is a term that we coined. We believe it is a critical risk-control tool that's needed to help managers navigate this unique macro environment that we are in. We have calculated the risk aversion coefficient for every stock in our universe, so we are well aware of how each company is likely to behave when risk aversion increases and when it decreases. Now, we are able to change our exposure to this risk aversion factor if we have strong conviction that the markets have gone too far in one direction or another.

For example, back in October 2011, after a significant decline in the marketplace, we had strong conviction that the market was too risk averse and that there were opportunities for somebody who was willing to take a contrarian view. We intentionally positioned our portfolios so that their risk aversion coefficient was significantly lower than that of the benchmark. That benefited us when the market did indeed turn around and, over the subsequent nine months, stocks with a low degree of risk aversion coefficients performed well. That phenomenon lasted until about March 2012, at which point we cut our overexposure to this particular factor. So to answer your question, we think the new phenomenon in the macro environment is the volatility in the degree of risk aversion, and we think a process is needed to control it and benefit from it.

TWST: Is there anything else you'd like to discuss?

Mr. Dhingra: We have high conviction that we have designed a process that's different from others and that we are exploiting an area of the market that's inefficient. Ultimately, in order for it to be a worthy competitor in the marketplace, it has to show that it works better than other processes out there. That is why we are happy to report that our process has ranked better than that of most other managers since inception. The process has indeed worked the way we had hoped when we designed it. It's a process that has a long life to it.

TWST: Thank you. (MN)

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