

# THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

## Cardinal Capital Management



**GLENN C. ANDREWS, CFA**, is the President of Cardinal Capital Management, Inc. He has more than 30 years of financial management and investment experience, including 11 years at Burroughs-Wellcome Co. where he served as Treasurer. As Treasurer, Mr. Andrews oversaw over \$1 billion in corporate and employee investments as well as provided investment oversight for the Burroughs Wellcome Fund, a non-profit foundation. He also served as Executive Vice President and Chief Financial Officer at Medco Research, Inc. (MRE:NYSE), where he listed MRE on the New York Stock Exchange and later negotiated the merger of MRE with King Pharmaceuticals. Mr. Andrews holds BS and MBA degrees from the University of Tennessee and completed the London Business School, Wellcome, executive management program. He is a member of the CFA Institute and a past President of the North Carolina Society of Financial Analysts. He currently serves as a Director of the Juvenile Diabetes Research Foundation, a director of the Triangle Educational Advancement Foundation, and is a member of the Duke University Medical Center, Heart Center Board.

**TWST: Would you please begin with an overview of Cardinal Capital Management and your responsibilities there?**

**Mr. Andrews:** Our firm is a small investment management company. We have \$130 million assets under management, most of which are in equities, and we manage only separate accounts for our clients. We use proprietary quantitative tools to identify good companies that are temporarily undervalued due to being out of favor for one reason or another. We have produced superior returns versus the market over the last 10 years, with below-market risk, which is our objective. We have a total of five employees. We have 130 clients, and most of these are high net worth individuals, endowments, pension plans, corporate accounts and not-for-profits. I serve as the President of Cardinal Capital Management.

**TWST: Do you have an investment philosophy?**

**Mr. Andrews:** Yes. Our philosophy is one of relative valuation; we are not a pure value investor. Our process involves a weekly screening of approximately 10,000 companies in the COMPUSTAT tapes. Each week, we run our proprietary valuation screen against the information on those 10,000 companies. We'll get a list of companies that are statistically, significantly and abnormally inexpensive on multiple measures of valuation. Then, we look through those lists for companies that have good balance sheets, good business models, very strong or premier market positions, and that are out of favor for whatever reason. Again, we monitor multiple measures of valuation, and when they all line up as being statistically significantly cheap, that's when they come to our attention.

As a result, we don't own purely value stocks. We occasionally will have some of what the S&P 500 would classify as growth stocks; we currently have some of those in our portfolio. Over time, this very disciplined relative valuation methodology will identify large cap stocks as well as mid-cap and small cap stocks at times they are out of favor. The types and sizes of companies identified by our screen change over time. Our fully discretionary portfolios have produced superior results vis-a-vis the market at below market risk over the long term.

**TWST: What is the investment climate like at this time for your type of relative valuation selection?**

**Mr. Andrews:** As of December 15, our screen continues to identify large cap stocks as being significantly undervalued. As an example, the large financial services companies appear to be undervalued with p/e's of 11 and 12, dividend yields around 4%, 20 years of dividend increases, and historical earnings growth of 12% or 13%. So those are extremely good companies with good quality ratings but for a variety of reasons, they are underappreciated at present.

More generally, many other of the larger cap stocks currently appear to be undervalued. If the economy does slow, which it appears to be doing, these large cap stocks will perform better than smaller cap stocks. If the US market does slow and growth continues or picks up overseas, which it appears to be doing, large caps on average have about 40% to 50% of their revenue sources abroad, and that provides a benefit from overseas growth opportunities, as well as from a weaker dollar. So it gives us some exposure that would be helpful in those circumstances.

And in addition to benefiting from these overseas markets, we know what accounting principles the US-based companies adhere to and what corporate governance standards exist in these domestic large cap companies. So we like the large caps at present.

**TWST: How many stocks generally do you have in your portfolio?**

**Mr. Andrews:** We currently hold 40, and we usually are in a range of 35 to 45. We may vary outside that range, but 35 to 45 is the range we try to operate in.

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**TWST: Do you have a benchmark that you weigh your performance against?**

**Mr. Andrews:** Yes, we’ve been in operation for 15 years, and we have benchmarked ourselves against the S&P 500 Index for those 15 years. As I mentioned, we’ve had superior returns and below market risk as measured against that benchmark over the long term.

**TWST: Have you found any sectors that are showing opportunity for your type of investing at this time?**

**Mr. Andrews:** First of all, we go where relative value takes us, rather than placing top-down bets. But as it so happens, we are currently overweight in consumer staples and in health care. Again, that’s determined bottom-up; our sector allocation is a residual of that process.

**TWST: Would you tell us about some of the stocks that you feel are representative of your investment and the reasons why you found them attractive?**

**Mr. Andrews:** We have very low turnover, maybe 20% per year. So we are not bringing a large number of stocks in every year, but one recent purchase was **Bank of America** (BAC). That was before their recent run-up, before they eclipsed **Citigroup** (C) as the largest market cap bank. We’ve had a 15% return on **Bank of America** over the eight months we have held it. **Bank of America** was very inexpensive at the time we purchased it according to our model, with 10 to 11 times earnings, a 4% plus dividend yield and trailing 13% earnings growth. The purchase played out very quickly in our favor.

Another company new to our portfolios is **Microsoft** (MSFT). When they hit our screen, we were very surprised. We’ve long admired their near-monopoly business model and their ability to perpetuate strong cash flow. When they were looked at unfavorably, in part due to their delays in getting their newest software out and their troubles with the EU, we saw an opportunity to own one of the greatest technology stocks of all time. That’s a very new experience for us, given our methodology. We have a 25% plus return on **Microsoft** in the seven months since we first bought it.

**TWST: What have you found attractive in the consumer staples area?**

**Mr. Andrews:** We’ve had **Alberto-Culver** (ACV) for a number of years; we’ve experienced multiple 100% returns on the stock since we first bought it. **Alberto-Culver** just recently spun off their **Sally Beauty** (SBH) operation and paid a large cash dividend. We’ve experienced multiple 100% returns, plus we’ve received a large one time dividend. We’ll probably be saying goodbye to both of these before long, if not imminently.

In terms of more recent purchases in that area, we bought **Coca-Cola** (KO). **Coca-Cola** probably has the most recognized and most valuable brand in the world. **Coke** hit our screen over a year ago, and we have a modest return on it thus far, but we really feel good about the company and its dominant global market position. It’s a wonderful name. Historically, they wouldn’t have found their way into our screen, so we are very happy to add them.

We’ve made out very well with **Procter & Gamble** (PG) in the past and **Gillette** before that. **Costco** (COST) has been a really great performer for us too in this sector.

**TWST: What about health care?**

**Mr. Andrews:** One of our recent additions is **Eli Lilly** (LLY). It’s a fine pharmaceutical company. It has a great tradition of pharmaceutical research; ethical, quality management; a proven ability to develop products (currently one of the better pipelines in the industry actually); and the strongest franchise in the diabetes arena in the US. And the incidence of diabetes unfortunately is growing dramatically in the US. We feel this is a very good company.

Another company that has worked out very well for us is **Merck** (MRK). I think we’ve had about a 60% gain in **Merck** since we first added it to the portfolio. So it has worked out extremely well and we’ve only been in that for a little over a year. That has probably been one of our better recent healthcare companies. We’ve also done extremely well with **IDEXX Laboratories** (IDXX), which has been a very good performer in the portfolio.

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**TWST: Tell us more about IDEXX. What do they do?**

**Mr. Andrews:** **IDEXX** provides detection and diagnostics products for veterinary applications and provides laboratory testing and consulting services to veterinarians. They also deal in the detection of contaminants in meat, dairy plants, and in soil and water testing. Since we’ve added it to the portfolio, it has been up 275%; we’ve had it for some time. It has been a really great performer. The idea of price controls is not a headline issue in the pet and veterinary area. People are generally going to take good care of their pets and their animals. It has been a great performer for us in the healthcare sector over a longer period.

**TWST: Do you like companies that pay out dividends?**

**Mr. Andrews:** We do. The dividend yield in our portfolio is currently above the S&P 500 dividend yield. We have a 2.4% dividend yield currently. We have 40 stocks in our portfolio; 36 pay dividends, and 33 out of those 36 have increased their dividend in the last year. So we do like dividends and dividends that increase over time. It's actually a great way to get a return and a great way to reduce risk in the portfolio

**TWST: Would you say that you have a contrarian bent since you are looking for companies that are undervalued?**

**Mr. Andrews:** Without a doubt. We are looking for good companies at good prices, which generally means they hit our screen when they are out of favor. So whether it's rotation in the economy and the interest in the various industry sectors, or possibly a management that's overstayed its helpfulness or something else, we are frequently going a little bit against the grain. But we are not making huge, deep value bets.

**TWST: I suppose when you bought Merck, it was a contrarian pick at the time.**

**Mr. Andrews:** It was badly beaten up at the time. I have experience in the pharmaceutical industry. I used to be the CFO of a NYSE-listed pharmaceutical company, and I know the strong tradition of drug research and the ethical environment that existed at Merck. So I had great respect for the company and when we saw it hit our screen, we did our arithmetic relative to the estimates for the amount of the potential liability and put that up against the cash flow they were generating on an annual basis and against the current assets they had on their balance sheet. At that time, they had a 5% plus dividend yield. It seemed very attractive to us and it has proved to be a good investment. It's up about 60% since we put it in the portfolio.

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**TWST: You said you have a low turnover, 20% on average, but what is the sell process?**

**Mr. Andrews:** Our quantitative model works on both sides. It identifies securities that are statistically significantly undervalued, and likewise overvalued. So when a stock has reached or exceeded what we would consider to be fair value, the probability of the stock going up versus going down changes, and when this model identifies the security as having a very low probability of going any further upward, we look to sell it. We examine it closely with our own independent research and various sources of information. Unless we see something new and dramatically different in the company that's going to propel earnings — for example, cash flow beyond the normal historical norm — we would very likely sell it.

On average we have about a 20% per annum turnover, which is very tax efficient with the current tax rate for capital gains and divi-

dends. So it works out very well for the taxable investor. We're very disciplined. We rely on our screen to nominate companies to perform more research on, and we rely on our screen to nominate companies for sale. We perform further research to make sure we are not missing something. It's not infrequent that we are a little early in, and it's not infrequent that we are a little early out.

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**TWST: Do you mostly trim stocks back rather than have outright sales?**

**Mr. Andrews:** We do some of that. I mentioned earlier one company that we'd had a multiple 100% gain on. We do not have more than 5% of the portfolio in one stock at the time of purchase and we usually have just a 2% to 3% position in any stock. But, obviously, when companies have multiple 100% gains they will exceed the targeted proportion you want to own. We will re-examine the fundamentals, re-examine the relative valuation in our model and continue to hold it if appropriate but trim back the position to the targeted proportion. But frequently there are companies that we will sell outright if they reach or exceed our expectation of valuation, and it looks like the probability for further gain is low relative to the probability for potential decline. At that point, we would just liquidate the position.

**TWST: Obviously, the diversification of your equity holdings is a major risk control for the portfolio. Are there other ways that you try to control risk?**

**Mr. Andrews:** We do. We limit the weighting of an individual security at the time we purchase it. We monitor and adjust the weightings of securities over time. We have a disciplined sell process. We also limit the exposure to any one security according to our assessment of the company's specific risk. If it is a single product company and maybe a smaller cap stock, we would likely limit the holding to only 1% of the portfolio, but if it's a large, high-quality, well diversified company, we might allow its weighting to be as much as 4%. As I mentioned, we could go as high as 5%, but that's rare. So we try to differentiate for the risk in the individual companies by the weightings.

For the sector weightings, we don't really exercise a huge amount of management there other than to make sure we don't exceed a 2 times weighting versus the S&P 500. While we don't manipulate top-down sector weightings, we go where the valuations take us, we do limit the maximum sector weightings. We do not let a sector weighting in our portfolio rise above 2 times the S&P 500 weighting of the industry sector. We do pay attention to beta. We have historically had a beta that is bottom quartile versus our peers; that would be other managers that benchmark against the S&P 500 across the nation. We try to manage beta. It's not the primary determinant, but we do pay attention to it.

We buy high quality companies in general, with good balance sheets, good cash flow, good business models, strong and dominant market positions, and good debt ratings where that's appropriate. We limit our exposure to their specific risk. We limit our exposure to industry sectors. We like dividends, and we do keep an eye on the beta, but that's not a prime determinant for a security going into or coming out of the portfolio.

**TWST: Do your portfolios have a cash reserve at all, or are you always fully invested?**

**Mr. Andrews:** In our all-equity accounts, we generally try to keep them between 90% and 100% invested, and a very normal cash balance would be 5%, just to take advantage of new opportunities and, in the case of taxable accounts, we occasionally need to perform some adjustments for tax purposes which may require some cash.

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**TWST: So tax efficiency is an important consideration for you and your clients.**

**Mr. Andrews:** Very much so. I think our portfolio composition is in the neighborhood of 50-50 taxable versus tax deferred or tax exempt. For those that are taxable, it's important to have low turnover and have a major component of their return arise from dividends. And we do take tax losses as stock prices fluctuate over time.

**TWST: What do you think differentiates your investment approach for relative valuation from that at other firms?**

**Mr. Andrews:** First of all, my partner and I are heavily invested alongside our clients. We eat our own cooking, and not in small, token, quantities. So our interest there is very much aligned with the clients. Second, we do provide individual one-on-one contact with our clients whenever possible, which is almost always. Furthermore, our proprietary quantitative screening model has a focus on analysis and independent research. We are not in the stream of research chatter in the money centers. As a result, we see things a little differently and we take a more objective, dispassionate view of the opportunities out there.

Our methodology has produced very good absolute and relative values of alpha, Sharpe Ratio, and excess return over the long term. I wish we could charge hedge fund fees. We have produced superior absolute and relative investment returns over time, and we have produced superior returns at below market risk. Lastly, we are a small firm and if we have either a great idea or we are suddenly alarmed by some news about a company or an industry, one of us walks next door, we have an investment committee meeting, and we make a decision to take action. Not all firms can do that.

**TWST: Being a small firm, does that give you an advantage in knowing your clients personally?**

**Mr. Andrews:** Absolutely. As I mentioned earlier, we have 130 clients. When they come in or we have an annual review, they are talking to the person who's managing their portfolio. They are also talking to somebody who has invested in the very same companies they are invested in. It's very important to some investors to have that access.

**TWST: What advice would you give to investors who are looking to enter the market? What are the advantages of coming to a smaller boutique-type firm like yours rather than the major large firms?**

**Mr. Andrews:** The first thing would be contact with the people who are actually making the investment decisions and doing the research. You are not going to have that in a big firm. We think it's important for our clients to understand the investment process to know what to expect, what's going to happen with their money, how quickly it will be invested, and what methodology and process will be used to invest. They can call us and say, “Why did you buy Merck?” and we can walk them through it. In all honesty, if they say, “I don't want any part of that,” then that's not an issue. We will accommodate their wishes, and I don't think you'll always get that at a bigger firm. But most of our accounts are fully discretionary and the clients trust our judgment.

We are in Raleigh, which is near the Research Triangle Park, and we have a number of technology executives as clients who have taken some money off of the table from their technology endeavors, whether they are biotech or otherwise, and have placed it with us. So we will adhere to their wishes to avoid further investment in a particular technology. We can be very accommodating, and the attention to tax is critical to those with taxable accounts.

**TWST: Did we overlook anything that you wanted to bring out in this interview?**

**Mr. Andrews:** One thing that I didn't mention is that my partner and I are both CFAs, and you don't find that in every organization. My partner has been the President of the Hartford Society of Financial Analysts and the North Carolina Society of Financial Analysts, and I was President of the North Carolina Society of Financial Analysts, and that's how we met about 20 years ago. So that is one other distinction of our firm versus some other firms.

**TWST: Thank you.**

*Note: Opinions and recommendations are as of 12/26/06.*

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