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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Growing Capital Over Time with Less Risk Than the Overall Market

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GEORGE L. SMITH III, CFA, is Senior Vice President and a member of the Investment Policy Committee at Davenport & Company LLC. He is also the Co-Manager of the Equity Opportunities strategy. He has a B.S. in finance from University of Richmond. He has been at Davenport for 17 years, and also serves on the company's board of directors and is the Vice President of Davenport Mutual Funds. He previously served as an analyst in Davenport's Equity Research Department.

SECTOR — GENERAL INVESTING

TWST: I'd like to ask you to begin by giving us an overview of the firm's history and total assets under management?

Mr. Beall: The firm was founded more than 150 years ago. We've been in the asset management business since 1984. Total assets under management are just under $6 billion.

TWST: And what is your client base?

Mr. Beall: It's largely a retail client base. We also have institutional clients, including foundations, profit-sharing plans and endowments.

TWST: We'll focus the discussion on your Value & Income Fund. What is your investment strategy with regard to that fund?

Mr. Beall: We started this strategy as an SMA in 2001, and it was with the idea that the market had just gone through the tech bubble and a lot of investors were very wary of equities. We wanted to have a strategy that was value-oriented, had a little less risk than the overall market and had a meaningful income component. We were seeing an increase in the demographic that wanted to have some dividends as a source of cash flow. Ultimately, our goal is to grow capital and grow an earning stream over time, with a little less risk than the S&P 500.

TWST: What is your process for identifying ideas and then vetting stocks for inclusion in the fund?

Mr. Smith: We have a seven-person Investment Policy Committee that is responsible for making these decisions. First and foremost, we're looking for reasonable valuations. We have a team of seven analysts in house, all of whom have sector responsibility and a deep knowledge of their respective areas. They are responsible for producing ideas for our portfolios, including the Value & Income portfolio. We then sit down and vet those ideas as a group.

I would note that the Investment Policy Committee has an average tenure with the firm of about 30 years. So there is tremendous experience and a myriad of backgrounds as well, including history, business and English. This helps us avoid groupthink and, as I noted, gives us diverse perspectives on any idea that we are looking at.

TWST: What is the current sector weighting? And what do you like about the three sectors that have the highest weightings: consumer staples, financial and industrial?

Mr. Beall: I would say that we think broadly in three buckets. The first and largest bucket would be dividend aristocrat names — companies with a long history of increasing their dividends at a rate that's above inflation. We have a second bucket where we might have somewhat slower growth and a higher current yield, like REITs and utilities. Finally, a third bucket, where we look for depressed valuations. Often, these are situations where we see a good business trading at a depressed price due to headwinds, which we think will fade. These companies may not currently pay a dividend or pay a small dividend but have the capacity to increase the dividend significantly over time.

In terms of sector weightings, consumer staples is obviously an area where you have companies that have a long history of increasing dividends, and they also tend to be a little less cyclical and a little less volatile. Financials fit this description to some extent with the exception of 2008 and 2009, where we had the big dividend decreases. But in the current period they have very reasonable valuations. They also have the potential to grow their dividends at a nice pace. Lastly, they offer somewhat of a hedge against higher interest rates. Most banks would benefit from a rising interest rate environment; however, that's an environment that perhaps would be a little tougher on the higher-dividend-paying stocks in general. The third sector is industrials. We have companies that frequently have global franchises, strong market positions and have a history of raising dividends over time.

Highlights

Michael S. Beall and George L. Smith discuss Davenport & Company LLC and the Value & Income Fund. The fund was started after the tech bubble when investors were wary of equities. The goal of the Value & Income Fund is to grow capital over time with a little less risk than the S&P 500. When identifying ideas for the portfolio, a seven-person committee produces investment ideas and then vets them as a group. This process helps the firm avoid groupthink and provides diverse perspectives. Mr. Beall and Mr. Smith generally look for companies that fit into one of three buckets: dividend aristocrat names, companies with slower growth and high current yields, and stocks with depressed valuations. The firm's profit-sharing plan is invested alongside its clients, which promotes accountability and aligns the firm's interests with those of its clients.

Companies discussed (and % Net Assets at 12/31/15): Johnson & Johnson (3.2% / NYSE:JNJ); Lamar Advertising Co. (2.2% / NASDAQ:LAMR); Sun Communities (2.1% / NYSE:SUI); Equity Lifestyle Properties (2.5% / NYSE:ELS); Citigroup (2.0% / NYSE:C); Anheuser Busch Inbev SA (1.8% / NYSE:BUD) and Wal-Mart Stores (No position / NYSE:WMT).

TWST: Can you discuss two or three of your top holdings, and tell us what attracted you to each stock and why it fits in with your investment strategy?

Mr. Beall: First, let's focus on a name like **Johnson & Johnson** (NYSE:JNJ). This firm has an AAA-rated balance sheet, a long-term history of growing their dividend and is a long-term beneficiary of aging demographics, in addition to better living standards around the world. In the current environment, it yields about 2.9%, which is actually higher than their 10-year bonds. So that would be a poster child for the perfect stock to build the portfolio around. I'll turn it over to George and let him talk about a name that we like, **Lamar** (NASDAQ:LAMR).

Mr. Smith: Lamar is one of a handful of REIT holdings that we own. I'd say it's a nontraditional REIT because it is a billboard company. It's an interesting business that has seen steady growth, and unlike other forms of media, it isn't subject to much in the way of disintermediation by the Internet, mobile or over-the-top media consumption. It's also a business that does not require a lot of capital to run, and billboards themselves don't require much in the way of maintenance. Therefore, the company generates a lot of free cash flow, has a growing dividend, and the founding family still owns a meaningful piece of the company, making it an owner/operator situation, which is something that we like.

Mr. Beall: I would just add in the REIT space two other names that are similar from a nontraditional sense, **Sun Communities** (NYSE:SUI) and **Equity Lifestyle Properties** (NYSE:ELS). While these are both REITs, they are a little different in that they rent air — the space above mobile-home units people own. They have historically been able to increase their rents at the inflation rate and their cash flows have grown at a faster pace. In addition, mobile homes are very affordable at this time in the cycle, and both of these companies are beneficiaries, ultimately, of lower energy prices because they also run RV parks. They are experiencing an uptick in visitation for those. These two firms are not household names and not businesses that people would probably think about investing in, but we found them to be very attractive and fit perfectly in the portfolio.

TWST: I know your approach to investing does include some contrarian ideas. Can you discuss one of those stocks and tell us what you like about it?

Mr. Beall: Citigroup (NYSE:C) would not necessarily fit a contrarian idea, but it would fit in the bucket where we focus on depressed names. This is a bank that is trading at less than tangible book value, has had a meaningful change in its business mix and management over the last few years, has both domestic and global exposure, and currently pays a nominal dividend, but we expect in the years ahead will pay a significant dividend. It is, we think, one of the better values in the marketplace right now.

It reminds us to some extent of **Budweiser** (NYSE:BUD), which we bought when it was out of favor three or four years ago after it had made a major acquisition and had a very nominal dividend. As they completed the acquisition and the cash flows grew, it became a very nice dividend grower. We think **Citigroup** will fall in that category.

TWST: What is your sell discipline? Can you share an example of a stock that you've sold recently and explain why?

Mr. Beall: We monitor the price performance of all the stocks. We set price targets when we buy stock. And when the stock hits that price, we look at the fundamentals and the valuation, and make a decision as to whether it is something we will continue to own. More often than not, things are going well if it's hitting our price target. And if we still feel think the prospects are good, we will raise the target price.

In terms of the sell discipline, on the downside, we monitor each stock whenever it goes both 15% below its most recent high and/or shows significant relative weakness to its group. The key thing at that point is to understand why it's underperforming. We need to know what's wrong. We may like it, but there may be other people that don't, and we need to understand what the issues are, and then, we'll make a decision as to whether to keep it or even to add to it. Therefore, in terms of things we sell, it would be based on having achieved a price target that we think fully reflects the prospects going forward, and where the risk and reward is not favorable. It may be a situation that's been a mistake, where the fundamentals are deteriorating and we don't think the prospects are going to improve.

The one other reason that may prompt us to sell the stocks is if we have a new idea that we want to buy, and we really like it. We go through a process where we have to sell something to find a replacement — to fund that replacement and use the same basic principle we do as described earlier. But making room for a new idea makes us go back and look at the portfolio and maybe sell one that we're less enthusiastic about.

TWST: Is there a specific example that you are able to share of a recent sale?

Mr. Smith: One that we recently sold was **Wal-Mart** (NYSE:WMT). We liked the dividend record; we liked the quality of the balance sheet and the long-term history of the company. However, a combination of reasons caused us to sell it. One, the earnings and sales flattened out despite numerous efforts and strategy changes to try to stimulate those sales, and we felt that, over time, they were just market-share losers that various other retail franchises were picking away at and even increasing costs for **Wal-Mart** on the labor side. All these added up to a period of growth not being there for another couple of years.

And while the stock had come down, it was still not really cheap. We felt like we could find better opportunities elsewhere. That was a hard one to sell because it's a company we had for a while and was certainly the company that met many of our other criteria, but we felt like it was facing too many headwinds and was too big a ship to turn around in the kind of a horizon we were looking for.

TWST: What are some of the most common questions or concerns that you find yourself fielding from investors right now, and how do you respond?

Mr. Beall: The one that is on everybody's mind is higher interest rates. We can't dismiss that question, obviously, because it impacts the valuation of everything. But the way we think about it and manage the portfolio is to hold some equity securities in a balanced way that would benefit from some of the events that would accompany high interest rates. For example, our full position in the bank and financial sector, many of which would benefit from higher interest rates, and our industrial stocks, to the extent that we're in a world of rising interest rates, the presumption is it would lead to higher levels of economic activity, which, in turn, should mean higher earnings. We are building a portfolio that should be able to weather a higher interest rate environment and would obviously have a negative impact from some of the other holdings.

Mr. Smith: Many people, clearly, are worried about risk these days. And while we don't know what the future holds, we hope that our strategy will limit downside risk. As Mike noted, we are pretty active in setting targets and maintaining a strict sell discipline. It's a portfolio where we tend to avoid high degrees of business risk and balance-sheet risk, which helps to mitigate downside.

TWST: Is there anything that we didn't touch on that you think is important to add?

Mr. Smith: I think it's worth elaborating on the history of our firm. Davenport & Company was founded in 1863, and Davenport Asset Management was launched in 1984. It was spawned by our very own profit-sharing plan, and the concept of managing our clients' money the way we were managing our very own employees' money. All of our employees' profit-sharing-plan assets are invested alongside our clients in our proprietary strategies, including the Value and Income portfolio. This is a great way to promote accountability and to align interest with our investors.

TWST: Thank you. (MES)

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