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Two Managers' Takes

Throughout the year, Dan Wiener, our chief executive officer, and Jim Lowell, partner and chief investment strategist, speak to a number of fund managers at Fidelity and Vanguard to get their takes on their funds, the current market environment and what they see for the future. Recently, Jim had the opportunity to speak with Joel Tillinghast, manager of Fidelity's Low-Priced Stock, a long-time component of our clients' portfolios and a proven bear market outperformer in both the 2000-2002 recession and also the 1989-1992 recession. On the Vanguard side, Dan spoke with Wellington Management's Donald J. Kilbride, manager of Dividend Growth, which found a place in our clients' portfolios about a year ago. Read on for a bit of background on each fund and an excerpt of Jim and Dan's conversations with the two managers.

Low-Priced Stock

Tillinghast's mandate on Low-Priced Stock is to buy stocks priced at \$35 a share or less, which increases the likelihood of small and mid capitalization investments in bull markets, but can net him companies of virtually any size in bear market times like these. Foreign investments typically make up one-third of the portfolio. In their conversation, Jim spoke to Tillinghast about his fund's mandate, his investment style and his current assessment of the economy and the markets. We're pleased to share an excerpt of that conversation here.

LOWELL: You have served as a core holding in my newsletter model portfolios, and in the real world money management side of what I do. Your command of the historical landscape, with particular regard to what looks to me like sort of a classic absence of buyers recession that we're heading into, and the fact that it was spurred by the housing crisis and what may or may not have been the collapse of the financial system as we know it based on banking loans related to it, rings a muted bell from back in the day when you actually launched this fund in 1989. But even before we get there, let's talk about your investment style.

TILLINGHAST: When Low-Price Stock Fund was launched, 'low priced' meant under \$15 a share, so they were seriously low priced, unlike today's \$35 limit, which in today's bearish market is not that much of a constraint.

'Low price' is a double entendre. It's both low-priced in the absolute

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dollar sense, but it's also suggesting a value approach. Before I worked at Fidelity, I had worked at Value Line and also at a fixed income futures and derivatives shop. And I guess, to me, value has always seemed more measurable and more real than it does to many portfolio managers. So I look for companies that are selling below my estimate of their present value. Present value usually matches up with price—low price to book, low price to earnings, low price to cash on the balance sheet. But it's also about the future prospects—how well-defined are those future prospects, how stable are those future prospects? So a growing company that is highly profitable and cash generative at 10 times earnings may be a much better bargain than another company at 10 times earnings with no reinvestment opportunities and that's very capital-intensive and generates no free cash.

Low price generally means small cap and mid cap today; at \$15, it pretty much meant small cap. I've always liked small cap stocks, and worked with Morris Smith as the assistant on OTC (FOCPX). Even today, in numbers of holdings, there's a huge *skewness* to small- and mid-cap names, but the dollar weightings mean that there's a big difference between the average market cap and the median market cap. The median market cap actually might be smaller than Russell 2000.

LOWELL: Could you help us put the recent past and today into your historical perspective?

TILLINGHAST: I don't think that there's anybody living who has seen something like this. We've seen aspects of it; recessions. Greenspan took a lot of flak for causing the recession of the early '90s, and I think he made sure that all the other recessions that happened during his time were relatively mild.

In terms of bear markets, you only have to look back six, seven years to see the 2001 tech bubble, but that was more focused. The credit contraction, that's the part that we really have not seen, and don't know how to deal with. Since I'm not very good at economic forecasting, and can't really predict which will be more important; that the Fed has increased the monetary base by 25% in a matter of weeks and its balance sheet is exploding, or the fact that banks are afraid to lend to each other and lend to private customers—what I've got today is looking for protection in terms of the valuation, which is something that I always look for. I think that today the average PE of the holdings in the fund is around 9. I don't think it's ever been in single digits in the history of the fund, even though I have sort of hugged lower levels. But I think that if you look at that valuation, you'd say, this is the best buying opportunity that we've had in the life of fund.

The other way that I try to protect is to look for companies with relatively good balance sheets. And those are tougher to find. And there are companies that you thought were powerful balance sheets, like AIG, that turned out to have a lot of liabilities and risks that weren't comprehended by the balance sheets. But I'm definitely looking for companies with better debt-to-equity ratios or net cash.

The final way that I'm trying to protect is by remembering that present value is the value of future cash flows, and if your starting point is a cyclic high point, the companies that maintain the earnings through the downturn have a greater value to you. And so I'm looking for recurring revenue, habitual purchase, lower-ticket items that do

not have to be funded with credit. I've had some companies, like auto dealerships, that have been total train wrecks because they can't get enough floor plan financing, and their customers are finding it more difficult to get credit, and so traffic has just died. And there's one public company that is selling for one times their 2007 earnings, and in fact, Ben Graham would approve of the fact that it's selling at one times the average of the last five years' earnings. But it has balance sheet risk. [Lowell's note: Benjamin Graham is credited with authoring not just several essential books on value investing, including *Security Analysis*, he's also credited with creating what we call value investing.]

LOWELL: Perfect. Looking for ways to protect shareholder value near-term, but capture the potential that things do in fact turn around—against the grain of the sudden and hyper-politicization of the marketplace—is right on target. It is always good to hear how you are sticking to your discipline and laying out very clearly some of the rules that you're following to increase shareholder protection while pursuing future capital appreciation that's often overlooked in such interesting times.

Dividend Growth

Over at Vanguard's Dividend Growth fund, Donald Kilbride has a mandate to pick companies that are committed to increasing their dividends over time. The fund has gone through a number of changes—it was original a utilities sector fund before being renamed and repurposed as Dividend Growth in late 2002. Kilbride took over in February of 2006 and has since raised the fund's performance and profile, earning a well-deserved spot in a number of our clients' portfolios. Please read on for Kilbride's take on his fund and the current market environment.

WIENER: Don, give me the quick "elevator pitch" on the fund's objective for those who haven't followed its history.

KILBRIDE: The goal is to see a stream of dividend income that grows over time. That's the mandate Vanguard has set. The best way to create that result is to build a portfolio with dividend streams that grow. It's a very simple and powerful premise. It drives you to ask more detailed questions of the companies.

WIENER: So, as you say, your primary objective is to find companies where you believe the dividend will increase over time. Given the state of the economy and the markets, have you had to shift to finding companies that simply won't cut their dividends, or can you still find companies you think will grow them?

KILBRIDE: I think the answer is yes and yes. I think there are companies able and willing to grow the dividend. What I've discovered though is that my best ideas are already in the portfolio. So I'm taking advantage of the current price dislocation to add to my positions. Hopefully the best candidates for my strategy are already in the portfolio.

I may have to redefine victory a bit. Victory may well be companies whose dividend growth rates are lower but still positive. I am trying to minimize those that might be going the other way. But I think your point is a good one and the bar has been lowered just a tad.

WIENER: Where is your search for dividend growth taking you?

KILBRIDE: Lately it has been a function of the price opportunity. I've been buying more energy stocks, taking advantage to add to those positions. For me the integrated oil companies are the most reliable dividend payers and dividend growers. Their balance sheets have only gotten better. Exxon has roughly \$40 billion of net cash. Their spending plans have gotten softer and you have a strong and long history of paying dividends and growing dividends. I have an opportunity in the portfolio to really enhance the positions at great prices. That's the biggest incremental change in the portfolio.

The other places I'm finding myself finding things are in the staples area, a fairly big part of the portfolio and a great source of dividend growth. Health care is also a place where I have added incrementally.

WIENER: We are going through tumultuous times. Do you have a sense of how deep and how bad this thing gets? Or is it fear that's driving us at this point?

KILBRIDE: I think the answer to the first question is, no, I don't have a sense for how bad this can get, because there's no precedent that I can think of. It's really hard to predict things like a bottom or a trough when you don't have any relevant data historically to frame the argument. We are seeing things today that I have never seen nor have I ever contemplated...

WIENER: Like what?

KILBRIDE: Like the degree to which the government has intervened. There may be examples outside the U.S. in different time periods that I'm not aware of, but the degree to which the government has stepped in to help alleviate this credit situation. The other thing that's happening, clearly, is that we have a fairly severe financial panic meltdown, which is overlapped by what appears to be a recession, so there are two more powerful forces acting at once and I don't think there is a precedent for it. I don't know where the bottom is, Dan—I would love to hear your or someone else's analysis and how they're thinking about it. But I will say that I am trying not to manage the portfolio with some view to where things bottom; I'm trying to do what I do, which is to try to identify dividend growth and hope that the prices I am paying with a very long-term time horizon will look very attractive in five years. Is it fear? I think there's a lot of it. I know among my colleagues and among my peers in the investment business and among other people there's tremendous fear, and, of course, fear is an accelerator. It's an environment that lacks precedent and is being accelerated by fear, and I think our job, as professional money managers and fiduciaries to other peoples' money—and, of course, I have practically all of my investment dollars in this fund—is to do what I have told people I'm going to do, and if they believe in that, then I'm doing the right thing.

What do you think? You have a very broad-based view of this.

WIENER: Number one, capitalism is not dead—we still need to put clothes on our backs, turn on the lights, eat and drive around. Several weeks ago, the yield on the Dow was 20 basis points higher than the yield on the 10-year Treasury. If I put a million bucks into a 10-year Treasury, in 10 years I get that million bucks and I earn my income yield. If I put a million bucks into the Dow stocks, I have a hard time believing that million bucks is only going to be worth a million bucks in 10 years.

KILBRIDE: Right, it's a testament to having that kind of horizon. You make an interesting point. We went from a point where risk, however you want to define that, was being priced at absurdly low levels, and now we're at a point where risk, defined the same way, is being priced at the exact opposite—extremely high levels. It's this very dramatic swing from one extreme to the other. I think we've had enough time to think through it. But the way you thought through that is as logical as anyone I've heard—it's hard in the midst of this to be that clear about it, but I think what you say is precisely right. And if you are right, then I really like what we're doing in this portfolio.

Vanguard Merging Funds

Last week, Vanguard announced that it would be merging two bond funds into one—Insured Long-Term Tax-Exempt's assets will be added to those of Long-Term Tax-Exempt's on December 12th. In anticipation, Vanguard has closed Insured Long-Term Tax-Exempt to new investors.

The reason for the merger is the same as the reasoning behind Vanguard dropping the "Insured" part out of its state tax-exempt funds' names several years ago—insured bonds are becoming more and more scarce (only three U.S. bond insurers rated AAA remain) while offering little or no additional protection over uninsured bonds of otherwise similarly high quality.

With the change, Reid O. Smith will continue on as manager of Long-Term Tax-Exempt while John Carbone, Insured Long-Term Tax-Exempt's manager, will lose his charge, but will retain management responsibilities on three of Vanguard's muni funds.

Investors will likely notice no significant difference with the change—both funds have similar performance histories, generally separated by just a few basis points over most periods and their yields and quality are also quite comparable. Through October, each fund showed 2.2% annualized gains over the previous five years, 12-month yields of 4.9% and the average credit rating of the funds' underlying securities was AA (the second-highest credit rating).

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