REPRINTED FROM APRIL 30, 2012

THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

# Seeking Hidden Value in Larger-Cap Names

**HOWARD A. TRAUGER** founded Schuylkill Capital Management in 1990 to provide investment advisory services to a select group of private capital and institutional clients whose assets total $50 million. For the past 35 years, he has been involved in a variety of roles with banking and money management firms, including research analysis and portfolio management. Before founding Schuylkill Capital, he was a Trust Investment Officer at Provident National Bank in Philadelphia and held positions of responsibility in local independent advisory firms. In the corporate world, he acted as Merger & Acquisition Adviser to the Rohm & Haas Company's acquisition program. Mr. Trauger holds B.S. and MBA degrees in finance from Pennsylvania State University. Maintaining an active interest in his alma mater, he has served on the MBA Alumni Board and sits on the oversight committee of the Nittany Lion Fund, LLC. In 2002, he received the school's MBA Alumni Distinguished Achievement Award.

**SECTOR — GENERAL INVESTING**

**TWST: Please begin with a brief introduction to Schuylkill Capital, including some highlights from its history, an overview of its client base and its total assets under management.**

**Mr. Trauger:** Having spent many years in trust investments in the major banks of Philadelphia and Chicago, I founded Schuylkill Capital as an RIA in 1990 to provide conservative trust investment advisory services to a select group of endowments, pension accounts and private wealth families. This decision was the capstone of plans I began to formulate in 1976, when I was an MBA intern in the research department of Philadelphia's Provident National Bank. I started in the investment field as a Runner/Clerk for Auchincloss, Parker & Redpath in 1967. Subsequent training included credit analysis in the International Department of Philadelphia's First Pennsylvania Bank in 1969 and portfolio management for the next five years at a Girard Bank subsidiary prior to my MBA studies in 1975.

To give you an idea of the tremendous changes that have transpired over the years, those entities today do not exist at all or in their same form. However, the lessons learned and the knowledge gained in investment management continues to thrive in the large-cap value approach to meeting the long-term investment objectives of our valued clients. Today, SCM manages some 27 advisory relationships, evenly divided between taxable family wealth clients and tax-exempt institutional accounts. Although we've been responsible for certain accounts for more than 25 years, the average length of a client assignment is 12 years. Our largest account is a $10 million endowment fund and our average family account totals $2 million. Assets under management total $50 million. One of our endowments, $300,000 today, was established in 1916 with $10,000 insurance proceeds for the benefit of a university fraternity house in memory of their son who died in World War I.

Yes, we hail from a long line of value investors here in Philadelphia harkening back to Provident National Bank; to Vanguards' Windsor Fund founded by Walter Morgan and continuing with John Neff and many local firms whose names became synonymous with fundamental research analysis of companies to identify attractive investment opportunities for dependable income and long-term appreciation. In fact, were you in my office, I could present you with a copy of the 1951 third edition of *Security Analysis* by Graham & Dodd, the seminal textbook of fundamental security research and value investing.

**TWST: What does being a value investor mean to you, and how would you describe the firm's investor philosophy?**

**Mr. Trauger:** We enjoy managing balanced accounts for clients, whose emphasis is income oriented, and believes that fixed income offers a certain stability of valuation. However, the style that best defines SCM's primary investment approach is large-cap value. Our goal is to identify financially strong companies that are either industry or niche leaders, or that otherwise possess secure product or service franchises in attractive areas of the economy. Naturally, to find value among such companies, a primary valuation tool would be discounted cash flow.

Were you in my office, I would enjoy showing you two charts prepared many years ago by Wertheim & Co., whose reputation for fundamental securities research was well deserved. If an investor agrees that the stock of companies whose earnings increase over time will be recognized by others, and ultimately the price will reflect this increase, then a fundamental analyst would investigate the sources of sales growth. Although not the only example of our research analysis efforts, the Wertheim charts provide us with a roadmap, or tree diagram, of the sources of sales growth coupled with an extensive tree diagram of the sources of earnings growth.

Clearly, when we are investigating the purchase of a stock selection, we review its fundamental characteristics, but these charts remind us not to overlook attributes that improve the stocks' appreciation potential. These factors among others that might be industry specific include: competitive advantage, cost efficiency, capital intensity, pricing power and operational power. I could go on, but industry-specific factors generally provide us with the opportunity to identify stocks when they may be trading at the low range of their price earnings trend, but yet offer prospects for appreciation over the next few years as earnings grow and other investors bid up the value of these earnings. History has demonstrated the folly of paying for earnings that are inconsistent or unsustainable.

Although the average market capitalization of an S&P 500 Index stock is $55 billion, at $30 billion average market capitalization, we would still qualify as large-cap investors. We feel this size is sufficiently large to withstand the impact of disparate economic developments better than the smaller-cap securities, and this larger capitalization helps reduce price volatility risk.

Additionally, we diversify our investments broadly over industries represented in the S&P 500 Index. Within the S&P 500 Index, one can identify up to 22 distinct industry segments from autos to utilities to airlines to technology, etc. To reduce risk, we diversify our investments among 12 to 14 industry segments, effectively covering two-thirds of the economic might of the country, while avoiding highly cyclical areas.

**Highlights**

*Howard A. Trauger of Schuylkill Capital Management discusses how his firm reviews a company's fundamental characteristics when investigating the purchase of a stock selection. He says he does not overlook attributes that may improve the stocks' appreciation potential. Mr. Trauger looks at competitive advantage, cost efficiency, capital intensity, pricing power and operational power. He also shares examples of large-cap stocks he believes are representative of this investment approach, as well as his outlook on the economy. Mr. Trauger expects slow growth in the economy over the next 18 to 24 months and for stocks to reflect this growth in their earnings.*
*Companies include: Inergy, L.P. (NRGY); Penn Virginia Resource Partners LP (PVR); Frontier Communications Corporation (FTR); Verizon Communications (VZ); Mastercard (MA); Apple (AAPL); Wells Fargo & Company (WFC); JPMorgan Chase & Co. (JPM); Bank of America Corporation (BAC) and Union Pacific Corporation (UNP).*

For example, airlines — on any given day, the airline industry's billions of capital are held captive to the whims of many interests, from weather, aviation fuel costs, regulators, travelers' discretionary income, baggage handlers. We prefer to place our commitments in industry segments, whose earnings and price activity is more stable and less subject to extraneously volatile incidents.

Lastly, we prefer not to underwrite human suffering, so we do not invest in tobacco or gambling stocks.

**TWST: Would you give us a few examples of stocks that are representative of Schuylkill Capital's investment approach?**

**Mr. Trauger:** I will first admit that the business of making long-term investment decisions for the benefit of clients is a very humbling endeavor. Let's talk about some of the decisions that have not fared well as the economy slowly recovers. About two years ago, a client asked us to develop an income-oriented investment program with some $2 million. To meet an average current yield hurdle of 7%, we set a goal to invest in securities that included a diversified list of master limited partnerships, MLPs, utilities and higher-yielding preferred stocks with five-year call protection.

**Inergy** (NRGY) is an MLP that despite its high yield has not met its moderate growth prospects and continues to underperform. It's a good company, but its product, natural gas, is embroiled in a significant supply/demand imbalance. As a result of a record warm winter that reduced demand for natural gas just when record supply is coming on stream, prices have deteriorated and the dividend now exceeds by a wide margin the average for the MLP industry. So supply up, demand down; natural gas price down, stock price down. We sold **NRGY** in favor of other MLPs like **Penn Virginia Resources** (PVR) that provides greater prospects to meet our long-term investment objectives.

When we bought **Frontier Communications** (FTR) in an income program two years ago, the current dividend yield was about 10%, a bit higher than our goal. The company proceeded to triple their size during 2010 with the acquisition of **Verizon**'s (VZ) fixed-line division. Since then, the company experienced dyspepsia as they digested this very large acquisition and ultimately cut their dividend. We sold **FTR** in favor of more dependable income and less volatility.

An example of a stock we would sell for positive reasons would be our holdings of **Mastercard** (MA) as the price of this stock increased significantly and surpassed our internal guideline of 5% of total portfolio valuations. Perhaps unappreciated by the typical investor, **MA**'s primary obligation is to process global payments, and it has no liability for the bank customers' at-risk liabilities. You have one of these cards in your purse or wallet. Its revenues are generated exclusively from the very small charge it applies to each and every one of the millions of daily processed transactions. We first bought **MA** in 2006 at a unit cost of $59, and during the past five years, its price has risen to over $400 per share. As its price rose, we sold portions of the position to take profits, to bring its percent of valuation in line with our internal guideline and to fund further diversification.

It's a bit unusual for a value manager to admit to owning **Apple Inc.** (AAPL) in that it has a well-known growth stock following. By any measure, **AAPL**'s fortunes are huge — revenues, balance sheet, cash position. At the time we bought it, the stock was selling at 12 times earnings, p/e, the low of its 12 to 19 times range. Since then, its p/e has expanded, it has begun to pay a dividend and it announced a $10 billion buyback of its stock.

**Wells Fargo** (WFC) and other big banks like **JPMorgan** (JPM) and **Bank of America** (BAC) are the equivalent of what oil is to industrial production. Despite the myriad and worldwide financial problems we've faced, without the services of this industry to facilitate our worldwide daily transactions, we would not be able to prosper. We've owned **WFC** or its predecessor bank and certain of its preferred issues since 2004. We've seen the bank survive the 2008 debacle. In 2008, when their preferred stock values were cut in half, we continued to hold our positions. My credit analysis experience helped convince us that the preferred dividend was secure, and today, those issues are back to par.

**Union Pacific** (UNP) is the largest public railroad in the North America. It operates on 32,000 miles of track; owns close to one quarter of the Mexican railroad; 2011 revenues of close to $20 billion were generated by the transport of coal, industrial and agricultural products, chemicals and automotive parts. Ten to 15 years ago, when the country was faced with record wheat and crop harvests, the railroads couldn't find their boxcars — not so today. Clearly, this is big freight at its level best, and as the economy improves, more freight will move on a much more efficient platform than in years past.

**TWST: What is your outlook for the economy, and how does it inform investment decisions?**

**Mr. Trauger:** Good question. There are a lot of opinions on that, and it's been our experience that most investors' opinions and reactions depend on their investment horizons. In our opinion, growth in the economy over the next 18 to 24 months will slowly, perhaps grudgingly, improve and the low operating margins corporations established when they faced the real test at the beginning of this terrible recession will improve and lead to better earnings announcements. Stock prices of soundly fundamental, well-managed companies should reflect these improvements in a more stable economic environment.

We're buying stocks, the likes of which we mentioned, with the full understanding that there will be worldwide headline-grabbing incidents from Europe, Iraq and other locations. Despite the fact that these pronouncements lead to disruption in investor confidence, as has happened in decades past, we like the pace of the growth of this economy. We've seen the investment business for the past thirty years. We've seen the day when a 16-million-share day on the NYSE practically stopped the floor. We like the pace of the growth of this economy because with our 18-to-24-month investment horizon, we can take our positions in quality stocks when they are trading at today's lower p/e levels. We've identified industry segments and specific stocks that will likely benefit as the economy improves and as the fright factor diminishes.

**TWST: Given your investment approach, how would you describe the investor, who you believe is going to be the ideal match for Schuylkill Capital Management?**

**Mr. Trauger:** By late 1999, in making presentations, I wore a tie that had a cheetah on it and I'd start my speeches by pointing to the tie to remind the listener that cheetahs and value managers were endangered species. The value approach does not work all the time, for instance late 1999 in the tech bubble, or 2008 when nothing worked. But when it does work over time, its results can be compelling for the investor. Investors who have been attracted to our value approach are those who appreciate disciplined management and fundamental analysis consistently applied to identifying quality stocks that provide demonstrated earnings and dependable dividends. I wrote my MBA thesis on ERISA, and we've gathered quite a few clients who rely on companies that provide stable earnings and dependable income.

**TWST: What is the significance of your firm's name?**

**Mr. Trauger:** Schuylkill is a Dutch word for "hidden river." Shortly after the Dutch founded a trading post with the present limits of Philadelphia on the banks of the Delaware River and expanded west into Pennsylvania, they soon found an uncharted tributary of great value. Hence the name, Schuylkill River. We seek hidden values.

**TWST: Thank you. (MES)**

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