

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Contrarian Value Investing in Mid- and Large-Cap Equities



JOHN P. DEGULIS is a Partner and Portfolio Manager at Sound Shore Management, Inc., which he joined in 1996. He has over 20 years of experience in the investment industry, including private and public equities, with prior employment at Morgan Stanley and Bear Stearns. He has a B.A. in economics from Northwestern University and an MBA from Columbia Business School.

SECTOR — GENERAL INVESTING

TWST: Could you please give us an overview of the Sound Shore Fund and a profile of the key management team?

Mr. DeGulis: The Sound Shore Fund is the only mutual fund we run here at Sound Shore Management. We run it the same way we do our institutional separate accounts. It's a disciplined fundamental value strategy, investing in mid- to large-cap equities. The portfolio is reasonably concentrated and represents what we believe are the best risk/reward profiles from our universe of investable stocks. Our seven-person investment team is dedicated to this product and only this product. It's a consistent strategy we have managed for 35 years for our institutional separate accounts and for the Sound Shore Fund since 1985.

TWST: How concentrated is the fund, how many stocks do you carry?

Mr. DeGulis: Approximately 40 stocks, equally weighted.

TWST: Could you give us an idea of the fund's core investment philosophy with perhaps some examples of a particular stock that has performed well in the portfolio, and how that might exemplify the fund's strategy or other valuation requirements?

Mr. DeGulis: We are contrarian value investors, so price matters, valuation matters, but it's only a starting point. Our process analyzes not only absolute valuation measures, but also relative to a company's own history. For instance, you may have a company trading at 12 times earnings when its historical normal valuation might be 15 times earnings. That's an opportunity for Sound Shore, versus a stock trading at 10 times earnings that has historically traded around the same level. We are more interested in the former, because the market has embedded an expectation of higher valuations, having looked at this company over longer periods of time. This often signals that the stock had better returns and higher growth prospects. We have to decide if there is a case to be made for those higher valuations to return. But again, this is just a front-end process to discern the opportunity set.

We then dig in and do our fundamental analysis to determine whether it is a company we want to own. You will find the overall

portfolio is cheap relative to the S&P 500. But our average stock position is going to have at least 30% more upside and a downside of 10% to 15%. We like that two-to-one ratio on an average stock. For example, take a stock like **Cardinal Health** (CAH); it's in the pharmaceutical distribution business and the hospital supply business. **Cardinal** had grown through acquisitions and diversified themselves over the years. Unfortunately, it was poorly managed at the end of that process. They brought in a new management team, led by George Barrett. They spun off their manufacturing businesses and were refocusing in on the core. The stock was trading a couple of years ago with a p/e of around 10 times. That is cheap relative not only to the overall market, but also to **CAH's** long-term history of being around the market multiple of 15.

After identifying the stock as "cheap," we peeled back the onion to take a look at the underlying operations, and we found that management was doing a couple of things that intrigued us. One, they were growing **CAH's** generic business which had been underpenetrated for them versus their competitors, **McKesson** (MCK) and **Amerisource Bergen** (ABC). The company was also growing a specialty business and had generated high expenses in their pharmaceutical distribution chain that led to margin pressure over the years. As **Cardinal** grew through acquisition and diversifying away from the pharmaceutical distribution business, they had taken their eye off of the operations of what really was the core. Refocusing in on that and growing in areas that had higher returns has borne good fruit.

Cardinal is now back to growing, increasing margin, taking market share while continuing to diversify their hospital supply business. They are also growing into the home supply business, which is a big growth market, as you might imagine. All of that has been aided by a good capital-return policy. This was a balance sheet that was underlevered. They were generating a tremendous amount of free cash flow. The dividend was very small at the beginning of our analysis. They have now taken that dividend up to where it's above the market at 3%, and we think actually will continue to go higher. The company has purchased stock with some of their excess capital as well.

All this adds up to a much more meaningful return of capital to shareholders at a time when they have been strengthening the operations as well. So at Sound Shore, we were looking for both the change in refocusing on the core pharmaceutical distribution business as well as a change in **Cardinal's** capital allocation policy — returning more capital to shareholders — as two important catalysts. The stock has performed well over the last couple of years, particularly well this year where it's up over 60%, and the market is starting to reflect a lot of the changes that Mr. Barrett and his team have instituted at **CAH**. That's a quick snapshot of a kind of name that would be in the Sound Shore portfolio.

TWST: What's the actual process like for finding stocks and approving them? How many portfolio managers actually look at and value a stock?

Mr. DeGulis: We have seven investment team members, three portfolio managers and four analysts. We are all dedicated to this product and only this product, which is quite unique in today's marketplace. It's a veteran team. You have our two founders, Gibbs Kane and Harry Burn, over 30 years of experience; myself and Jim Clark, who is another partner at the firm, have over 20 years of experience; and then our additional three analysts each have 10 years or more industry experience.

On any one position you will have a two-person team driving most of the due diligence, typically a portfolio manager and an analyst. They will report to the investment committee, which is Harry Burn, Gibbs Kane, Jim Clark and myself, and make recommendations for a "buy" or a "sell" on a particular stock. And the due diligence is typically done over months, if not years. **Cardinal Health** would be a good example. That's a stock that we had been doing work prior to purchase for about two years and spent a lot of time with the management teams there prior to purchasing the stock. That is an important component in our analysis — we won't make an investment unless we've spoken with company management.

Sound Shore believes in maintaining our sell discipline, so we set a price target, and when a company reaches that target it is sold. Of course, we do make mistakes unfortunately, as you do in the investment business, but we know that's part of the process. You have to keep your feet moving, and the investment committee also provides the accountability there. When a particular position is underperforming our expectations, we may have made a mistake. The team will review it and make a decision.

TWST: What does Cardinal Health look like going forward? Is close to being fully valued? What do you see for that stock ahead?

Mr. DeGulis: It's not quite to our price target. We still see some value as they continue to drive performance out of the newly acquired home supply business that they bought last year. You may have seen they just announced a joint venture with **CVS Caremark (CVS)** to drive more efficiencies in the pharmaceutical purchasing organization. We think that's also going to be a tailwind for **CAH**. And the company is continuing to return cash to shareholders as well. We have a price target that's in the mid-70s for **Cardinal Health**, so it's not quite to the target.

TWST: I see that Sound Shore turned in a very good performance over the past year with that 37%. What would you say were the significant factors that contributed to this strong performance?

Mr. DeGulis: When we get it right at Sound Shore, it is the stock picking that drives outperformance. It hasn't been any one stock, it hasn't been any one industry; it has been a lot of breadth. When we look across some of the better-performing stocks in the portfolio, you will note that there is a diversification by industry. Whether it was **Southwest Airlines (LUV)** in the airline industry or **Life Technologies (LIFE)**, which is in the life science industry; **State Street (STT)**, a well-known custody bank; **Google (GOOG)**, certainly a household name as it relates to Internet search; or **DuPont (DD)** — five of our better performing stocks this year — there is quite a

Highlights

John P. DeGulis discusses his firm's fundamental, contrarian value strategy that focuses on mid- to large-cap equities. Mr. DeGulis believes the current environment is showing that operations inside of a company are driving individual share performance as opposed to the macroeconomy. He is also seeing more cooperation between boards, managements and shareholders. Mr. DeGulis gives examples of companies that fit within his firm's investment strategy.

Companies discussed: Cardinal Health (CAH); McKesson Corporation (MCK); AmerisourceBergen Corporation (ABC); CVS Caremark Corporation (CVS); Southwest Airlines Co. (LUV); Life Technologies Corporation (LIFE); State Street Corporation (STT); Google (GOOG); E. I. du Pont de Nemours and Company (DD); Texas Instruments (TXN); Novartis AG (NVS); Citigroup (C); Marsh & McLennan Companies (MMC); QUALCOMM (QCOM); Agilent Technologies (A); Pfizer (PFE); Applied Materials (AMAT); Tokyo Electron Limited (TYO:8035) and Sanofi (SNY).

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As we discussed, a stock initially hits the screens if it looks cheap relative to the market and relative to its history. Our analysts begin doing the work, and oftentimes there is a reason that we might set it aside or it doesn't complete the process. We certainly look at a lot of candidates that ultimately do not make it to the portfolio. But the ones that we deem to be most attractive we follow very closely. The analyst will pick a price point and often a fundamental catalyst that might lead us to purchase the stock. We try to drive the decision-making down to that team of two who are closest to it. The investment committee provides accountability for the firm to make sure that the commitments that have been made in the initial purchase as it relates to fundamental performance and price performance are held through to the end investment.

lot of breadth across industries. And when we have good performance, typically that's the way you see it.

We have an equally weighted portfolio of around 40 stocks, so we are going to have contributions from more than one name when we perform well. The best news is that the market has had more breadth. Correlations are beginning to come down from extreme levels that you saw in 2008 and 2011. People forget that stocks can be driven by what's happening inside the company more than what's happening outside. Even though the macro clearly is important and we pay attention to it, we are getting back to an environment where operations on the inside of the company and how the management team is allocating capital are beginning to drive individual share performance again. And when that happens, usually it's a good fit with our investment process.

TWST: Can you give us some idea of Sound Shore's global investments?

Mr. DeGulis: We have always invested in large-cap companies, which gives you exposure to big multinational companies that have operations all around the world. If you look through just the revenue for the companies in the portfolio today, about 43% of it is derived outside the United States. We are used to looking at companies that compete globally, that have operations in Europe and in Latin America and Asia, whether it's a **Texas Instruments** (TXN) or a **Novartis** (NVS) or a **Citigroup** (C). These are international companies, and we have always thought of them that way, done the research that way. Whether they are domiciled in the United States or in Switzerland or in Singapore it is increasingly less important than where the operations are, and instead we look at how they are doing on a fundamental basis.

1-Year Daily Chart of Cardinal Health

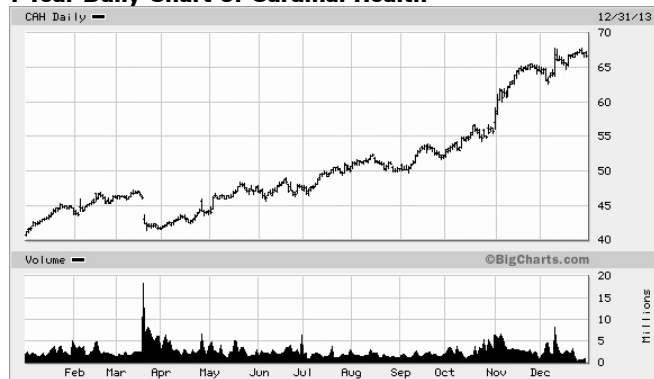


Chart provided by www.BigCharts.com

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At Sound Shore we are comfortable investing in multinational companies and always have been. Today's portfolio is about 80% categorized as U.S.-based and 20% outside. Having said that, many of the companies headquartered in the United States are some of our most international businesses, **Citigroup** being a good example as well as names like **DuPont**, **Marsh & McLennan** (MMC), **Qualcomm** (QCOM), for instance. These are businesses that are very dependent upon what happens all around the world.

TWST: Do you see any trends emerging or significant catalysts on the horizon that might prompt your team to justify significantly rebalancing the portfolio?

Mr. DeGulis: We are constantly rebalancing the portfolio. You will find little changes all the time, instead of one big change. The portfolio is evaluated one investment at a time. We will rebalance down to an average — 2.5% — position size if a holding has outperformed but has not quite reached its final target, like **Cardinal Health**, for example. In the interim, the team is constantly looking for the best holdings we can have at any one time, a collection of 40 stocks that we think are the best risk/reward profiles in the marketplace.

If there is any theme that I would like to mention that I believe is notable in today's marketplace, it is the concept of company management teams treating shareholders like partners now. That's been cyclical over time. The pressure from activists that you are seeing in the newspaper are notable, but underneath those headlines there is actually a lot more cooperative relationship between the boards of directors, the management teams and the shareholders. We are finding these dialogues constructive, and management teams are as accessible as they have ever

been. And because the balance sheets for a lot of these companies are extremely strong — they hoarded cash and refinanced their debt and paid very close attention to expenses — given how tough the economy has been over the last five years, managements are now refocusing on investing for growth, and if they don't need the additional money then they are returning it back to shareholders.

Sound Shore's clients have benefited from this, and our portfolio has a lot of names that have returned a tremendous amount of capital to shareholders in the form of share repurchases and dividends. I cited the example of **Cardinal Health**, but I could also give you a list of other names in our portfolio that have done the same. I call it “the revenge of the shareholder” — a theme that will endure I think for a number of years here, and one that my colleagues and I think will continue to surface value.

Management teams are now refocusing on the businesses that they are best able to run. If there is an ancillary business that would be better owned by someone else, where the company could receive an attractive price and reinvest the proceeds or return capital to shareholders, they are doing that. And so we have a number of names in the portfolio that are benefitting from that. **Agilent Technologies** (A), for instance, is splitting themselves in two. **Pfizer** (PFE), which was a good stock for us last year, but we since sold, is basically splitting themselves into three. You are seeing this across the board, refocusing of operations and selling off noncore assets of companies if they don't see them additive. So that continues to be a theme within the markets, which also is helping Sound Shore's portfolio.

TWST: Did you have any upside surprises this year or disappointments in particular holdings or sectors?

Mr. DeGulis: There are always surprises, and I would say in a year like this, clearly they have been more positive than negative for us. I referenced **Life Technologies**, which was one of the better-performing stocks this year that ended up getting taken over in an acquisition that was certainly not anticipated. The M&A market continues to be active, and I think will continue to be active. We see that as being another notable driver of performance.

1-Year Daily Chart of Life Technologies Corporation



Chart provided by www.BigCharts.com

We are value investors. If we own positions that are cheap, you get the occasional takeover that will surface value for you in the portfolio. We are also seeing some of our portfolio holdings making acquisitions, and those stocks are going up on the announcement, and the reason is it all depends on who the management team is and whether they are making a reasonable investment. The market is applauding their courage to invest in growth at a time when people are still being very cautious with their capital.

Applied Materials (AMAT) for instance, one of the leaders in the semiconductor capital equipment business, is run by Gary Dickerson, who is a very capable executive. He is purchasing **Tokyo Electron** (TYO:8035), one of **AMAT's** peers, which was an undermanaged business but one that fits strategically very well with him in the market. The market took a look at the price he paid, which was very reasonable, the synergies that were likely to come, the strategic fit, and saluted this acquisition. **AMAT** stock went up, which is sometimes a sign that you are still in the earlier stages of an M&A cycle, but they are surprising for us to see. We certainly have had some disappointments.

A stock like **Sanofi** (SNY), which is the multinational pharmaceutical company based in Paris, is going through its peak period of absorbing patent expirations. The company's top line is being impacted by some loss of revenue due to these expirations this year, which has led to a hit from an earnings perspective. That was anticipated at the beginning of year, but it has held the stock back more than we

running this portfolio within this firm, we think in rolling five and 10-year periods and comparing that to both absolute measures of performance and then relative to the market. We believe that's the best way to add value. Looking out at the landscape of investment strategies, an increasing amount of money is run on a very short-term basis, which drives a peculiar behavior. I don't think it has a lot of value. My partners and I would certainly encourage investors to continue to look over longer periods of time as they allocate their capital.

TWST: Aside from Cardinal Health and some of the others you mentioned, do you have any long-term favorites that you could share?

Mr. DeGulis: We don't overweight any particular name in the portfolio, because we appreciate that we can't predict exactly when a holding may hit its peak outperformance on a relative basis. We like all the names we own, or they wouldn't be in the portfolio. It's a reasonably concentrated portfolio, so it's hard for us to pick favorites. Sound Shore

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would have thought. However, we are looking ahead to **SNY's** ability to grow again in 2014 and 2015, and given today's valuations we think it's an attractive position, but it was underperformer for us this year.

TWST: Overall, where do you see the stock market headed in the coming year or two, and what investment advice would you offer investors in this market environment?

Mr. DeGulis: It's always tough to predict the stock market looking out 12 months. We don't have a particular firm forecast. I would say, in spite of a very good market return over the last five years, you have to remember what happened in the preceding five, if not 10. Take a look at rolling 10-year returns in the S&P 500. The decade from 2000 to 2010 was as bad a 10-year performance in the S&P 500 as we have had in the last 100 years. In fact, it was negative. People began to believe that stocks were too volatile and too risky. Yet the end of that period was about the time stocks started to do a lot better. So we're reticent to give a forecast for any 12-month period other than saying that the market is now only back to a normal valuation at 15 times earnings.

At Sound Shore we think our prospective list of companies that we are looking at and the ones currently in the portfolio are very attractive, and we think we can make money with these stocks. There is still a bias in the institutional marketplace that's concerned with the volatility of stocks, so we don't think that sentiment is particularly high over a longer-term basis. Short term it's very high, given the move in the stock market this year, but that doesn't really tell you where the stock market is going to be 12 to 24 months from now. We think we are at a more normal valuation, which would provide good return prospects going forward.

In terms of advice for investors, ours is to keep a long-term perspective. That's the way we run the portfolio, that's the way we would encourage folks to think about investing. You should only invest money that you truly have a long-term horizon. Our team is always looking out two to three years for any individual investment. As we think about

has been in the business managing value equity portfolios 35 years — long enough to know we don't know exactly how the next 12 months may play out.

TWST: Do you have any other information about the fund that you would like investors to be aware of?

Mr. DeGulis: I think what's important is to understand that Sound Shore is a focused firm which is privately held and has had the same strategy for 35 years. The managers here are the partners, and they are totally dedicated to this product. So not only is the value of the firm entirely dependent upon the success of this product, but our entire profit sharing plan for all the employees at Sound Shore Management, Inc., goes directly into the shares of the Sound Shore Fund. And so it's a substantial investment directly in the mutual fund that sits right alongside our clients. We think our alignment of interest is very strong.

The other notable item is that we recently introduced the Institutional Class, ticker SSHVX, of the Sound Shore Fund. So we now have the Investor Class, ticker SSHFX, which is the original, no-load share class launched in 1985, and we have an Institutional Class for institutions and the 401k market. It has a minimum investment of \$1 million and a lower expense ratio than the Investor Class.

TWST: Thank you. (VSB)

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