
THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Long-Term Value Investing



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TWST: Would you start with an overview of Axiom Asset Management and its investment philosophy?

Mr. Heberg: Our firm was formed in 2003, but the investment practice here goes back about 60 years. The investment philosophy and many of the client relationships date back to a mentor we had, Fred Brenner. Fred entered the investment business as a broker back in the late 1940s, and was very successful at identifying opportunities in the value space, largely in the small cap area. Over many years, Bob Loreaux, Al Matt, Craig Rose and I worked with Fred and developed our current investment approach.

In 2003 we left the brokerage world and formed Axiom with the idea that we wanted to maintain our independent thinking, manage portfolios based on our own research, and maintain a focus on client relationships, some of which at this point were into the second and third generation. Based on our experience and analysis of successful investors and historical data, we built a value, low turnover, long-term approach.

In our view, investing is largely an exercise in probability. We identify opportunities where we think that the risk/reward is

strongly in our favor; we think that the probabilities favor our expected results, and we think we can make a lot more if we're right than we can lose if we're wrong, because clearly we're going to be wrong sometimes. We invest in companies as if we were buying the whole company. In other words, we compare the enterprise value of the business to what we think the business is worth.

That's when we get into our fundamental analysis, which involves getting to know management, studying 10-Ks and 10-Qs, comparing current to historical valuations, and looking at new products and trends that impact their business. We sometimes own the same security on two or three occasions with the idea that we look to buy near the bottom of the cycle and look to sell near the top of the cycle for companies whose businesses tend to run through various product cycles or economic cycles. We don't tend to use Street research because we've most often found value in small cap stocks, in companies with a market capitalization of under \$500 million, and in most cases they are not followed by Street analysts. Also, the long-term data suggest that small caps as a group have outperformed large caps by a significant margin.

That being said, we've also used our contrarian mindset and long-term approach to find value in out of favor large cap stocks, or in unusual securities like pipeline, tanker or hydroelectric partnerships, and convertible bonds. We've also found value in various out of favor sectors, in ETFs, or more often in closed-end funds. We do allocate funds to fixed income on occasion, but with an eye toward its value relative to equities and cash.

We have not been buyers of Treasury securities or fixed income securities when interest rates are very low, as they have been for the last several years. In those cases, in order to create income for clients' portfolios, we will look at the securities that I mentioned before. We serve high net worth and emerging affluent clients, primarily business owners and professionals, as well as retirees. Our expectation is that we will serve a family over 10, 20, 30 years because we have many, many relationships where that's been the case, and that we'll serve them for more than one generation.

we've had a very small allocation to the financial sector; we've had virtually no allocation to securities that are impacted by the slow-down in the residential real estate and homebuilding sectors.

TWST: How has your portfolio shifted in emphasis over the last 12 to 18 months?

Mr. Heberg: We've added cash and we've become more defensive in some of our positions. The strong outperformance of the small caps has led us to see a few more opportunities in large caps. We have seen relatively poor performance within the large cap growth space over a period of at least five years, going back to the aftermath of the declines after 2000. It's gotten to a point where some of the valuations in that area are compelling. Just the same, we've continued to find a few things that look interesting and a few names in our historical strength, which has been small caps, and we've been well served by our investments in the energy sector, services and technology.

"We have gone from the average account holding 5% to 7% in cash to now holding close to 25% in cash. As our uneasiness about the market has grown, we've sold at least part of positions where prices have doubled or tripled and several of our large holdings have been acquired. We've taken money off the table in securities that have been very successful for us."

TWST: How do you find the current stock environment for your type of investing?

Mr. Heberg: We have found it increasingly difficult to identify securities for purchase over the last year or 18 months. We have enjoyed a very nice run in the small cap area, so valuations in the group are not nearly as attractive as they were five or six years ago.

It has been more difficult to find stocks that are attractive for purchase and that, along with our concern with the economic risks and with valuations, has led us to build up our cash position to a point where our average account is currently holding about 25% in cash. The volatility that we've seen over the last month or so has created a few opportunities for purchase, and if these declines continue, then we're likely to see more names come on to our buy list.

It's our guess that this volatility will continue over the next three to six months at least. Our focus will continue to be on individual securities, on our companies, and how the issues that confront the economy today are likely to impact our companies. Fortunately,

The most important shift is we have gone from the average account holding 5% to 7% in cash to now holding close to 25% in cash. As our uneasiness about the market has grown, we've sold at least part of our positions where prices have doubled or tripled and several of our large holdings have been acquired. We've taken money off the table in securities that have been very successful for us.

TWST: Does the number of equity holdings in your portfolio move according to your cash allocation growing? How many generally do you have in the portfolio?

Mr. Heberg: Our portfolios are truly customized. We do an extensive job of profiling our clients when we first begin the relationship, and we build a portfolio for that client, based on their unique goals, attitudes, and personal situation. Every portfolio looks different. For example, a client who joined us two years ago would own different securities than a client who joins us today because we do not use a model portfolio where every client owns the same securities. If someone walks in the door today, the securities we purchase

are going to be securities that fit them and that we think are attractive today, and that would certainly be different from a portfolio we had built a year or two ago for another client.

We like to concentrate our investments in our best ideas so a few big winners can have a positive impact on performance. In terms of number of securities in an account, the average client will hold somewhere in the range of 15 to 20 securities. The very large

years and it's currently trading in the mid-\$30s. And, in their view, there are significant opportunities ahead in their business. They think that this strong investment cycle has two to three years more to run at least. In their most recent quarter, they reported earnings of \$0.66 a share. **Graham** is well supported by its strong and growing earnings. It is representative of a stock we've held for a couple of years that has been successful.

“Graham has very strong finances with \$20 million in cash and working capital and it has less than 4 million shares outstanding. There are significant opportunities ahead in their business. They think that this strong investment cycle has two to three years more to run at least. Graham is well supported by its strong and growing earnings.”

portfolios and some of the very long-standing relationships have a slightly higher number, but our average portfolio holds 15 to 20 securities at this time.

TWST: Would you tell us about some of the holdings that you have in your portfolio that you feel are representative of your investment approach and the reasons why you were attracted to them?

Mr. Heberg: I'll give you a few examples. We have a large holding in **Graham Corporation (GHM)**, headquartered in Batavia, New York, which is between Rochester and Buffalo. **Graham** designs and builds vacuum and heat transfer equipment critical to the productivity of process industries. The primary markets they serve are oil refineries, petrochemical plants and power plants.

Graham has a reputation for engineering that it has built over 70 years. They have enjoyed about 20% growth in their revenues over the last couple of years due to the increased investment in refineries, in petrochemical plants, and also in power facilities not only in the United States but around the world. One of the things that you'll see as emerging economies develop a middle class is they will have an increased demand for refined oil for transportation as well as for petrochemicals, notably plastics. **Graham** has seen very strong demand for their products in the emerging economies in the Far East and Middle East, as well as in the United States where there has been underinvestment, in many cases, in these facilities over the past 15 or 20 years.

Graham is a company that has very strong finances with \$20 million in cash and working capital and it has less than 4 million shares outstanding. It's a stock that we have owned for a couple of

1-Year Daily Chart of Graham

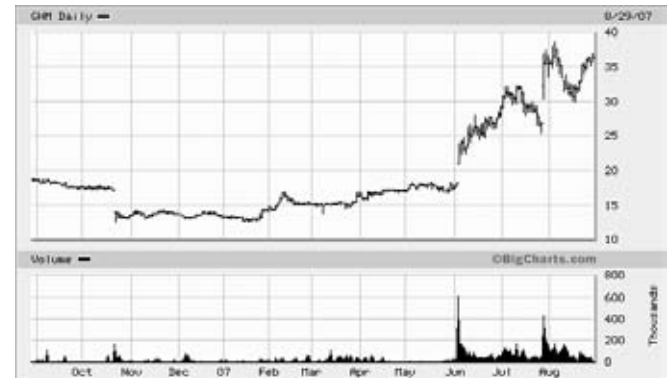


Chart provided by www.BigCharts.com

Another current holding that is an example of a stock that we've owned on a couple of occasions is called **Innovative Solutions & Support (ISSC)**. They're in Exton, Pennsylvania, which is about half an hour from our offices. **Innovative Solutions & Support** designs, manufactures and markets flat panel display systems, and flight information and monitoring systems for aircraft. Previously their primary business was in what is called required vertical separation. An aircraft has to have a system for measuring altitude and they must maintain vertical separation from other aircraft. There were mandates back in 2005, which required that a large number of aircraft be upgraded with equipment that had higher sensitivity.

We invested in **Innovative Solutions** in 2002 and 2003 in anticipation of the strong product cycle for required vertical separation. The stock moved up significantly in 2004 and 2005. We were concerned about what were they going to do after these mandates were fulfilled. At that time, we exited the stock, knowing that they were in the process of developing some new products to replace this business.

“Pioneer’s enterprise value is at a discount to the value of the rigs they own. The company holds \$80 million in cash with no debt and generates strong cash flow. Selling for less than 4 times 2006 EBITDA, Pioneer is the type of investment that suits our patient approach. When the cycle turns, we expect Pioneer shares to do well.”

In the ensuing time, the company had been developing and beginning to market a flat panel display system, which is primarily being used to retrofit older aircraft. If you look in the cockpit of an aircraft, in older aircraft that have not been updated, you see a number of dials and gauges similar to what you would see in a car, only there may be 30 or 40 of them. Aircraft operators are in the process of upgrading that equipment, which may be 20 years old or more and when they fail, it’s very difficult to repair or replace those instruments. They can replace the current instruments with a series of flat panel displays, which are not only much more reliable, weigh less, and use less power, but are also programmable and can more easily keep up with changing requirements for aircraft pilots.

As the skies become more crowded, there are going to be additional requirements on the information available within the cockpit. **Innovative Solutions** has been able to secure several significant orders in the last 12 months or so. In the most recent quarter their orders more than doubled in the flat panel space. They have recently secured an order from American Airlines to upgrade 200 American Boeing 757 and 767 aircraft; they won that contract in a competition with **Honeywell** (HON) and **Rockwell Collins** (COL).

In speaking to some of the folks at American Airlines, they felt that this product that **Innovative Solutions** had was technologically superior, attractively priced, and it was very important to them that **Innovative Solutions** can perform the retrofit in a matter of a couple of days. **ISSC** has agreements with Pilatus and with Cessna to be the provider of the retrofit flat panel kit for the Cessna Citation.

In addition, **Innovative Solutions** has received an OEM contract to install their flat panel system in the new Eclipse very light jet. Eclipse is a company that was formed about 10 years in New Mexico to build and sell a small jet for about \$1.5 million to \$1.7 million. Eclipse has orders for about 2,400 planes and expects to be delivering 1,000 planes per year within the next couple of years. They’ve begun deliveries and are ramping up their production.

1-Year Daily Chart of Pioneer Drilling



Chart provided by www.BigCharts.com

ISSC is a company, which we think over the next two or three years will ramp up their sales sharply, and we’ve seen in the past that when their sales are strong, this company can generate after-tax profit margins approaching 25%. In addition, the company has a very strong financial position with almost \$4 per share in cash and virtually no debt. We think that this is an opportunity with significant upside as aircraft owners go through the process of upgrading to this next generation of equipment, the flat panel display.

Finally, we like **Pioneer Drilling** (PDC), a provider of land contract drilling for natural gas and oil. They own and operate about 70 high quality rigs, primarily in Texas, Oklahoma and the Rockies.

Current contract rates and rig utilization are a bit soft. Natural gas prices are down sharply from their cyclical highs. This is a stock that is clearly out of favor, selling near its two-year low. However, over the past five years the number of natural gas wells drilled in the US has doubled while total production has declined slightly. The easy-to-reach deposits are almost depleted so we are going to need more rigs drilling more wells to produce the same supply. That said, **Pioneer's** enterprise value is at a discount to the value of the rigs they own. The company holds \$80 million in cash with no debt and generates strong cash flow. Selling for less than 4 times 2006 EBITDA, **Pioneer** is the type of investment that suits our patient approach. When the cycle turns, we expect **Pioneer** shares to do well.

or two or three after we make our original investment. We want to ensure that the company has the staying power from a financial standpoint as it bounces on the bottom.

In sum, our sell discipline is driven by a continual re-evaluation of the relationship of the security price to the value of the business.

TWST: What is the average turnover in your stock selection?

Mr. Heberg: The average turnover in our clients' accounts is probably 20% to 25% per year. Our average holding period on the security is going to be several years. Our expectation is that we'll hold a security for at least two to four years, but we have securities in our portfolios that we've held for 10 years or more.

“Pfizer offers close to a 5% dividend yield; with qualified dividends, the aftertax return on the income stream is more than 4%, and in our view, at 11 or 12 times earnings, Pfizer is historically cheap, relative to earnings. While the Street is negative on Pfizer, the roughly \$35 billion that they've invested in research and development over the last five years will bear fruit at some point in the next few years and when it does, the stock will be significantly higher.”

TWST: What about the other side of the process, the sell discipline?

Mr. Heberg: Our sell discipline is we attempt to purchase stocks when we feel like we can buy a dollar for 50 to 60 cents. What we generally do is continually re-evaluate the fundamentals. We're continuing to look at the company's earning power and changes, in most cases improvements in their businesses, and revaluing the company as time goes on, but typically when a security we hold for growth doubles in value, then we're going to sell a part of our position.

We are very patient, but if we see signs of financial distress, then we may exit the position. We monitor the company's finances, understanding our contrarian approach means we often purchase securities when the news surrounding a company is negative. We're looking for values, or maybe purchasing the company's securities when the business they're in is at or near a cyclical low point. We understand that we can't necessarily pick the bottom and that's why financial strength is important. There are many companies that we've invested in where we don't see an upturn in their business for a year

1-Year Daily Chart of Pfizer



Chart provided by www.BigCharts.com

TWST: Is that tied in with tax efficiency?

Mr. Heberg: It absolutely does help the tax efficiency of the portfolios. We have securities that we've held for many years, where the business prospects continue to be very good and, while the

security may have appreciated significantly, we see that the company's shares are still very much undervalued and there is still opportunity going forward for us to enjoy significant returns.

TWST: What other risk management techniques do you incorporate into your process at the security level and at the portfolio level?

Mr. Heberg: The two primary things we use are cash and the safety net of value, our determination of the value of a security relative to its underlying assets and earning power. Beyond that, in portfolios where there's an income requirement and less risk tolerance, we will incorporate large cap companies that pay significant dividends. For example, in the past we've invested at various times in **Baxter**

While the underlying securities they own have declined in value, the closed-end fund had gotten to a price where the discount to the net asset value of their security holdings was 17% or 18% and at the prices where we entered, the distribution yield was almost 9%. We understand that real estate security returns have been negative over the last six months or so, but we thought that the market had overreacted in general to commercial real estate and specifically with this security, selling pressure had created an opportunity to purchase a dollar's worth of assets for 83 cents.

We will use securities like that, securities with significant dividend yields or securities with strong underlying value to reduce the amount of risk in a client's portfolio.

"In the recent volatility, we invested in the ING Clarion Global Real Estate Fund. This is a well-managed global fund that has enjoyed strong performance, as have REIT securities, over the last several years. It was trading at almost \$25 a share and recently declined to about \$15 a share, down some 40% since February."

(BAX), we've invested in **Archer Daniels Midland** (ADM), we invested in SBC several years ago, before it merged with **AT&T** (T).

Currently one name that we've been investing in is **Pfizer** (PFE), which offers close to a 5% dividend yield; with qualified dividends, the aftertax return on the income stream is more than 4%, and in our view, at 11 or 12 times earnings, **Pfizer** is historically cheap, relative to earnings. While they have product challenges, and the expiration of the patent on Lipitor in a few years, this is a company that's been investing \$7 billion a year, give or take, over the last five years. It's our expectation that, while the Street is negative on **Pfizer**, the roughly \$35 billion that they've invested in research and development over the last five years will bear fruit at some point in the next few years and when it does, we think that the stock will be significantly higher.

The other area that we will look at is special income situations, which tend to be less volatile. For example, we've invested in master limited partnerships and closed-end funds. In the recent volatility, we invested in the **ING Clarion Global Real Estate Fund** (IGLAX). This is a well-managed global fund that has enjoyed strong performance, as have REIT securities, over the last several years. It was trading at almost \$25 a share and recently declined to about \$15 a share, down some 40% since February.

1-Year Daily Chart of ING Clarion Global Real Estate Fund

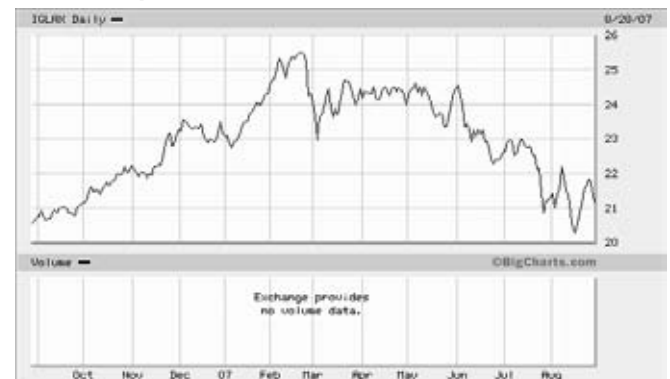


Chart provided by www.BigCharts.com

TWST: Have your investors shown more interest in alternative investments like MLPs and convertibles in recent times?

Mr. Heberg: They have. We spend a lot of time educating our clients. Our process and our focus on value takes time for clients to understand and embrace. We think it's very important for our clients to understand the philosophy that underlies the investments

that we make for them. We spend a lot of time in the beginning of a relationship talking to clients and helping them to understand our thought process in managing their portfolio, so that when we get into volatile situations, the clients can resist an emotional reaction to volatility by focusing on the companies that we own, and have a long-term perspective on their objectives and on their relationship with us.

Typically when we introduce a new investment idea or a new investment approach, for example, when we start to invest in a series of limited partnerships or if we invest in a closed-end fund, we will reach out to the clients and communicate to them what our thinking is in making that investment so that they can understand this is a type of security that they have not owned before. This is how the security works, this is the value we see and this is the rationale for our decision to include it in their portfolio.

TWST: How do you think that the investment approach at Axiom Asset Management is distinctive or differentiated from that at other companies?

Mr. Heaberg: The focus is very much long term in nature. Our expectation is that the client will maintain a relationship with us over a course of many years. One of the things that we do, which is somewhat unusual, is that while we provide our clients with monthly statements, we don't provide them with quarterly performance reports versus a benchmark, as many other advisers do. In our view, if our expectation is that our relationship is going to last for 10 or 20 or 30 years, it doesn't seem to us that our client is served by focusing on quarter-to-quarter performance. If our client is going to measure us against a benchmark, we are going to manage the portfolio so that our performance is close to that benchmark. Not reporting quarterly performance allows us to make investments with compelling risk/return characteristics, though they may not be timely. Our value-added is our ability to provide our client with excess returns, to provide the client with absolute returns, and also a comfort level that allows them to embrace our portfolio management style.

Not only in terms of turnover and holding period, but also in terms of performance reporting, we invest with the idea that we expect a relationship with our client and their family to last for many years. In fact, we have a large number of our relationships that in-

clude the second generation of a family, in many cases the third generation, and in a few cases even the fourth generation of families who have portfolios managed by us. We're looking at the idea of establishing a very long-term relationship and everything that we do is really centered around that idea.

Our approach is built around a process that works: value, low turnover, long term, small cap, concentrated, out of favor. What we do here is focus on managing portfolios for our clients to meet their objectives over many years, and our expectation is that we'll be able to provide our clients with both results and an approach that they can be comfortable is going to serve them well.

TWST: Thank you.

Note: Opinions and recommendations are as of 8/28/07.

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