THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Understanding What You Own and Investing in Enduring Businesses

J. JEFFREY AUXIER is President of Auxier Asset Management LLC and Founder of the Auxier Focus Fund. Prior to forming Auxier Asset Management in 1998, Mr. Auxier spent 16 years at Smith Barney — formerly Foster Marshall-American Express, then Shearson — where he was on the Portfolio Management Advisory Board and the Chairman's Council, and was Senior Vice President of Investments and Senior Portfolio Management Director. In 1997 and 1998, he was named one of the top-10 brokers in the country by *Money* magazine, winning two consecutive stock-picking contests.

SECTOR — GENERAL INVESTING

TWST: Could you tell me a little bit about the firm?

Mr. Auxier: Yes. We are a research-driven boutique firm running close to $700 million in client assets. We started the firm back in 1998. I started an investment business back in 1983 with the largest regional firm in the Pacific Northwest, Foster Marshall, which had an outstanding reputation as a value stock-picking firm. It was acquired by **American Express** (NYSE:AXP) and then ultimately became Smith Barney. We have a verified track record of my investment decisions dating back to 1989. I personally have many holdings that date back 34 years.

TWST: Of the funds that you are connected with, do they have any unique investment philosophy?

Mr. Auxier: Yes. We set up the Auxier Focus Fund in 1999 right at the market top — the highest market cap versus GDP in history. I put every penny of my retirement into the one fund and have consistently invested every year. According to Morningstar, managers of half of the mutual funds in the U.S. have zero invested. Less than 10% have $1 million invested. I committed 100% of my retirement and have continued to invest all the way through for the last 17 years.

Our fund has a very wide latitude with flexibility to really focus on compounding and protecting in down markets. When you study and appreciate the enormous power of compounding, you look hard at the downside risk. Each day, we want to quantify how much we can lose as well as the enduring nature of the business. We focus on the compounded return, sound capital allocation and making exceptional buys. We don't really fit into a style box.

TWST: Do you think that the fund, for a lot of people, fits their retirement needs and planning for retirement?

Mr. Auxier: Yes. We have some clients in the fund who are in their 90s. Since we started, the average exposure to stocks has been approximately 78%; $10,000 in our fund has grown to $35,000, and that handily outperforms the S&P, which has grown to maybe $25,000. For retirement accounts, you don't get a tax subsidy for a loss. We want to make well-researched buys where the risk/reward is compelling, and the combination of higher earnings and p/e expansion can lead to a double or triple play over a number of years. We will buy bonds when attractive, like in 2008 when corporate spreads exceeded 20%, and we were well-paid for the risk.

TWST: And do you think the Baby Boomers, who are now the generation that are either thinking about retirement or might even be retired, do they still want to be involved with investments such as these, or would they prefer to be in some kind of a bank, some kind of fixed income thing? Where do their priorities lie now?

Mr. Auxier: I think if people understand that a dollar invested in 1965 requires almost $7.50 today, they would not have a penny invested in fixed income at today's price and yield levels. Purchasing power risk is really the big risk in long-term investing. What we try to do is become better business analysts so we can buy superior businesses that compound at high rates of return for long periods. If people understand what they own, it is easier to endure the inherent volatility that is normal in auction markets.

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The problem today is, few investors really understand what they own. Warren Buffett defines risk as not knowing what you're in or what you're doing. That kind of categorizes a lot of the investment behavior we see today. According to *The Economist*, over the course of 250 years, a top reason for panic in the markets occurs when a semi-informed public is pooled up and really does not understand what they own, and are therefore inclined to sell as prices decline. I think the more people understand the benefits of being an owner of a well-nurtured business over the long term, the better they can stick out the pain that difficult markets bring.

McDonald's (NYSE:MCD) is up 72,000% since their initial public offering in 1965; $1,000 in **Starbucks** (NASDAQ:SBUX) in 1992 is worth over $230,000; $1,000 in **Nike** (NYSE:NKE) in 1981 is worth over $800,000. Leading biotech **Amgen** (NASDAQ:AMGN) grew $1,000 since 1983 to a value in excess of $427,000 today. One share of **Coke** (NYSE:KO) in 1919 at $40 on the IPO is worth over $10 million today with dividends reinvested.

Highlights

J. Jeffrey Auxier discusses Auxier Asset Management LLC and the Auxier Focus Fund. Auxier Asset Management is a research-driven boutique firm. According to Mr. Auxier, the fund doesn't fit into a style box. It has wide latitude and the flexibility to compound and protect in down markets. Mr. Auxier wants to make well-researched buys with compelling risk/reward. He believes it is important to understand what you own and to invest in enduring businesses. In addition, he strives to protect and maintain compounding through daily research. Lastly, while many managers have 0% to 10% invested in their funds, Mr. Auxier has invested 100% of his retirement into the Auxier Focus Fund. Companies discussed: American Express Company (NYSE:AXP); McDonald's Corporation (NYSE:MCD); Starbucks Corporation (NASDAQ:SBUX); Nike (NYSE:NKE); Amgen (NASDAQ:AMGN); The Coca-Cola Co. (NYSE:KO); Wal-Mart Stores (NYSE:WMT); Teledyne Technologies Incorporated (NYSE:TDY); Costco Wholesale Corporation (NASDAQ:COST); Monster Beverage Corporation (NASDAQ:MNST); Wells Fargo & Co. (NYSE:WFC); Citigroup (NYSE:C); American International Group (NYSE:AIG); LyondellBasell Industries NV (NYSE:LYB); Dow Chemical Co. (NYSE:DOW); DuPont Fabros Technology (NYSE:DFT); Zimmer Biomet Holdings (NYSE:ZBH); Biogen (NASDAQ:BIIB); CVS Health Corp. (NYSE:CVS); Medtronic plc (NYSE:MDT); UnitedHealth Group (NYSE:UNH); Cerner Corporation (NASDAQ:CERN); Merck & Co. (NYSE:MRK); Intel Corporation (NASDAQ:INTC); Cisco Systems (NASDAQ:CSCO); PepsiCo (NYSE:PEP); Waste Management (NYSE:WM); Hertz Global Holdings (NYSE:HTZ); J.C. Penney Company (NYSE:JCP); Amazon.com (NASDAQ:AMZN); Sears Holdings Corp. (NASDAQ:SHLD); Kraft Heinz Co. (NASDAQ:KHC); Philip Morris International (NYSE:PM) and Berkshire Hathaway (NYSE:BRK.A).

Understanding businesses and what's a good business is far more profitable when compared to the return on fixed income. It's definitely worth becoming better educated, because really, the perception is that fixed income is safe. Right now, interest rates are at 5,000-year lows. We've never seen rates this low — and prices this high. It is crazy to have $12 trillion of bonds with negative interest rates globally. Central bank balance sheets have expanded to $18 trillion, which is unprecedented. So there is risk in fixed income.

I would say that there's a huge misperception of risk. People think they're safe in banks or safe in government bonds, but it couldn't be further from the truth. Purchasing power risk is kind of the invisible risk. We believe it is important for investors to really know and understand and then commit to good businesses, good managers. What makes a good management, a good enduring business model? This emphasis is more important than trying to forecast markets. Warren Buffett invested $28 million in **See's Candies**, I think, in 1973. And he's pulled out over $1.8 billion. Amazing.

Understanding the power of high compounded returns in exceptional businesses is really critical to study.

TWST: And for retail investors, that means that they need to have patience and not sell at the wrong time and not buy at the wrong time, and those are unique skills sometimes.

Mr. Auxier: Yes, it pays if you can find great managers that you can partner with over long periods, like Sam Walton with **Wal-Mart** (NYSE:WMT), Henry Singleton of **Teledyne** (NYSE:TDY), Phil Knight of **Nike**, Jim Sinegal of **Costco** (NASDAQ:COST) to name a few. It's going to be volatile. The average stock fluctuates 50%. That's just normal; that's normal volatility. You know, typically, the stomach is, according to Peter Lynch, the key organ in surviving the markets. But yes, if you understand the power of compounding and the power of a good business that executes, you can see it is hard to beat that category of investment.

I think **Monster Beverage** (NASDAQ:MNST) is up over 22,000% since January 3, 2000. But you know, in order to get those kinds of returns — right now, the problem is you get a lot of consultants in the way; they won't let the client know what they own. It's all pooled up, and so I think it's really important to understand those businesses and the managers, and then ideally, if you find a good one, you need to stick with it.

TWST: And did you want to highlight a company that you find interesting?

Mr. Auxier: Well, right now, with market levels high, you've got to work a lot harder. We're seeing pretty good value in businesses that have some problems, but they're fixable problems. For instance, **Wells Fargo** (NYSE:WFC) has been in the news for their problems, but with Tim Sloan, the new CEO, they should be able to fix that issue. They have a tremendous advantage with their deposit base versus the rest of the industry.

Citigroup's (NYSE:C) another one. The stock is down from over $500 in 2007. I mean, it's still at maybe $60, and you've got Michael Corbat, he's actually a really good banker, and you're looking at potentially $70 billion being returned with the new rollback in regulations to shareholders in these bigger banks.

TWST: So if the Trump administration were able to cut back on some of these regulations, and maybe do some tax reform and things like that, that would help companies like Citigroup and Wells Fargo?

Mr. Auxier: Yes, I think just reasonable regulation will help. Understandably, you have had tough regulations in financial services because the last go-around, in 2008, many major firms had levered up to 100-to-1. Now we are starting to ease up. There are opportunities also in companies like insurer **AIG** (NYSE:AIG), which has a new CEO in Duperreault, who could improve the intrinsic value given his strong operating history.

In banking, the Financial Choice Act that passed the House proposes to ease some of the most onerous restrictions, especially on small banks. This might help general banking valuations, which at 12 times earnings trade at a steep discount to the overall market. We are not counting on tax relief until 2018 at the earliest, but deregulation has traditionally been good for the growth in the overall economy and lending.

TWST: That would be another thing that would be good for the economy, some tax relief.

Mr. Auxier: Yes, it is helpful to look back at the Tax Reform Act of 1986. At the time, it was the most radical tax relief package in history. Over 2 million new companies formed in the 1980s after that legislation.

But an equally positive development back in 1986 and today is the major declines in energy inputs. When energy went parabolic in the 1970s, high inflation led to historic low price/earnings ratios. On the flip side, when energy crashes, you've had some of your highest stock market valuations in history. After 1986, energy crashed some 60%, and then in 1998, we had another energy crash when oil dropped to $10 a barrel.

Today, the shale revolution is leading to another drop in energy inputs, natural gas, gasoline. This together with heavy investments in all the alternatives — i.e., wind, solar, battery — has led to very attractive energy relief. That bodes well for very high-quality businesses and the service sector as well. In a service economy, low energy inputs are a big deal. So while we are seeing a glut of many goods globally due to advances in data analytics and easy money over eight years, the services index is a strong offset.

TWST: And are you following any company in the energy sector you care to talk about?

Mr. Auxier: Well, we would rather go the chemical route, like **LyondellBasell** (NYSE:LYB).

TWST: Do you want to talk about that company a little bit?

Mr. Auxier: Yes. They pretty much make ethylene, which is a building block for plastics. They benefit from low

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natural gas inputs. The U.S. is one of the cheapest producers of natural gas globally. **LYB** pays a 4.5% dividend, 8 times forward earnings, with over a 4% free cash flow yield. We have **Dow** (NYSE:DOW) and **DuPont** (NYSE:DFT), which Ed Breen is going to split into three new companies. Lower energy inputs like natural gas and the potential for further restructuring and consolidation make chemicals interesting.

1-Year Daily Chart of LyondellBasell Industries NV

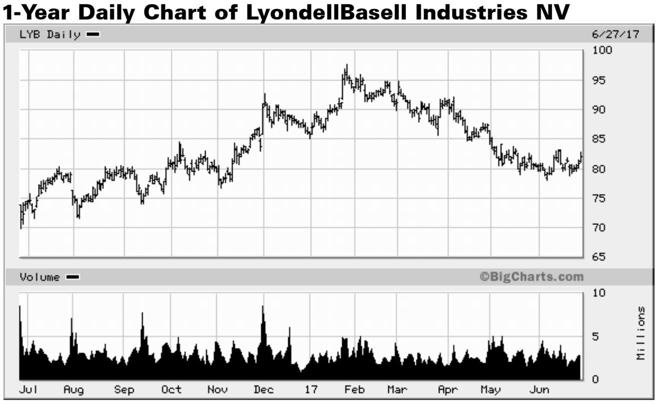

Chart provided by www.BigCharts.com

TWST: And any other sectors that you're following besides financial services and energy and chemicals?

Mr. Auxier: We like selective health care names where the demographics are attractive. Over 10,000 Americans are turning 65 every day. **Zimmer** (NYSE:ZBH) is a leader in hip and knee replacements, which tend to peak at about 68 years of age. Today, the average Baby Boomer is close to 68. The stock at year end was trading around 12 times earnings and had high free cash flow.

And with the new deregulation, we like **Amgen**, the number-one biotech company in the world, at 12 times earnings, $38 billion in cash, $6 billion in free cash flow. When you can buy leading biotech businesses for that low valuation, it has been a historically attractive entry level. **Biogen** (NASDAQ:BIIB) is another industry leader, research-focused, that's trading around 12 times earnings and, again, with the leading position in MS and Alzheimer's. **CVS** (NYSE:CVS), at 13 times earnings, is another attractive name transforming the retail side of health care.

TWST: With some of these drug developers, are there still concerns that were brought up during the presidential election about the price of drugs, and is that an issue for some of these companies?

Mr. Auxier: Yes. That's what has created the buying opportunity. In the last six months, another high-quality medical device company, **Medtronic** (NYSE:MDT), dropped to 13 times. Persistent uncertainty and gloom provide the price points attractive to the long-term investor seeking the double-play return. Some positive fundamentals in addition to the underlying demographics is the potential streamlining of some of the regulations with the new FDA chief Gottlieb. Safer drugs could get to the market quicker. Yes, you have a lot of headline risk — negative headlines that tend to impact the stocks — but the bottom line, if the cash flows are strong and if the cash flows are up over 10 years, the stocks are going to track those fundamentals.

So we focus on cash flow and free cash flow, and these companies are just drowning in free cash. For instance, 40% of **Amgen's** sales are free cash. They have $38 billion in cash on the balance sheet, which could benefit from tax repatriation. In 2018, you could repatriate a lot of these foreign cash assets. Then, the scale operators like **UnitedHealth** (NYSE:UNH), which has grown from our cost of $47 to $181 through execution and the successful use of data analytics. We made that investment at the height of gloom and uncertainty surrounding the implementation of the Affordable Care Act.

We also have companies like **Cerner** (NASDAQ:CERN); they are digitizing medical offices. We like to be on the right side of the digital transformation with these businesses. There are exciting advances in the cure for cancer through immunotherapy with compounds like **Merck's** (NYSE:MRK) Keytruda.

So you know, there's all the negatives, but when you break down and you look at each individual business — we typically go through 1,200 companies a year — if the business is executing and if the cash flows continue to move up, those stocks should grow in value. Our experience over the years has led us to believe that buying high-quality businesses at 11 to 12 times earnings in the face of pessimism and gloom has been a good bet long term.

1-Year Daily Chart of Zimmer Biomet Holdings

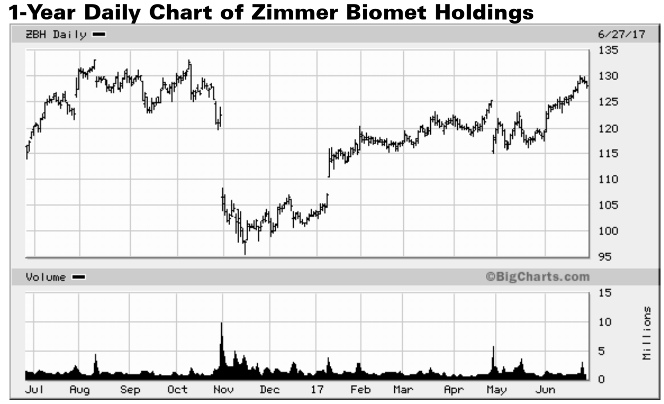

Chart provided by www.BigCharts.com

TWST: And you mentioned CVS, is there anything particular about that company that makes it a little more competitive than some of their colleagues? I know they have that MinuteClinic, which might be how some of health care will be delivered a few years from now. Anything in particular you like about CVS?

Mr. Auxier: Yes, ultimately, I think with data analytics, you're going to have the data — you won't need to actually visit the doctor, but if you've got good reliable data, you'll be able to go to the **CVS** walk-in clinics, MinuteClinics. And I think that's going to be a big factor in reducing health care costs. This should also help attract customers in an age of online competition.

CVS has been a leader in the data analytics, so they'll have the data on the customers to help in prevention, too. The trend is toward online delivery for many products, but consumers typically go out to purchase fresh food, health care services and their drugs. Pain and sickness is a good motivator to go to a store offering numerous health solutions like **CVS**.

TWST: So go in person as opposed to ordering it online or something?

Mr. Auxier: Yes. The entire retail industry is being transformed and restructured. We're looking at more bankruptcies this year than in the last recession, like 50 this year in retail. We glutted the retail store space in general and the malls in particular. And so we have over 4,000 store closures so far in 2017, and we still have too much space. In food, you've got the steepest food deflation since 1959, and people are going to the store shopping for fresh food, fresh produce and, you know, kind of their pharmacy purchases face to face.

combined with share buybacks and what have you, we've reduced the supply. The supply/demand actually for companies has been very favorable. We could have a melt up in the tech space, but that would really need to be monitored, as cash flows don't support many of the company valuations we are researching. And bond investors are not being compensated for the risk at today's levels.

TWST: When you say they don't know what they own, is that like they don't know the details of the company, the management practices of the company, those kinds of things?

Mr. Auxier: Yes, and what happens is, when you have a sustained period of up markets, like 1999, everyone is pooled up, and they're OK as long as prices are increasing. But when highly valued, high-expectation stocks start to torpedo the indexes — dropping 10%, 20%, 30%, 40%, 50% — the pain is unbearable for many. From 1999 to 2009, we survived the worst 10-year period in the U.S. market history. Nobody was talking about being passive at the bottom. The peak in indexing took place in 1999. We saw two 40% declines, and people don't hold on to things they don't understand.

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TWST: And when you talk with investors now, when you talk about 2017 and 2018, what are some of the concerns that you're hearing from them?

Mr. Auxier: I think the big concern is we've expanded the global central bank balance sheets to $18 trillion, and that's $4.5 trillion in the U.S. That has driven interest rates in developed countries to historic lows. If interest rates move up 2%, if you look at a 30-year bond, you're looking at almost 30% loss on principal. On a 10-year bond, you're looking maybe at 80% loss on principal. So it's not only purchasing power risk, but interest rate risk, and then, how does a company endure through that challenge?

Also, you've got record funding in technology. The venture capital funding in 2015 and 2016 has been off the charts, which could be contributing to a brewing bubble in tech again. There is a plethora of private technology companies trading in excess of $1 billion valuations where there is questionable valuation and price detection. Back in 1999 and 2000, we had over 400 IPOs that flooded the market with supply. The IPO market has been really shut down in 2016 comparatively.

So you've retired a lot of public stock — roughly 3,000 companies since 1997, 6,500 private equity firms — and that

Everyone says they are long term, but working closely with clients as we do, the pain in declines is very difficult. They will check out of the game emotionally. A big key to keep the client compounding is to protect their assets first, and then they will be long term if they see and understand a systematic approach that seeks to minimize risk. To keep the client compounding, they need to stay in the game. You need flexibility and a wide mandate to protect during major declines.

I remember like yesterday the carnage of 2000 to 2002. Blue-chip **Intel** (NASDAQ:INTC) had a great run in the 1990s, then dropped 80% back in the 2000 to 2002 market decline. Today, it is still 50% off the $75 price level back in 2000. **Cisco** (NASDAQ:CSCO), once valued over $600 billion, dropped from $85 to $15, sinking the indexes. It is still down 63% from that high. **Lucent** dropped 99%.

You are just trying to avoid these hits. Over 15 years, just one out of five firms survive in America. It requires not only voracious learning — you've got to be a voracious researcher — but also, you have to educate the clients to have the right temperament and approach to the markets to survive the real tough markets. I remember during the thrift crisis in the late 1980s and industry-leader **Wells Fargo** took a hit from $245 to $45.

I have survived numerous crashes since 1983, and it's very unsettling for clients, but we believe we can add value through a persistent daily research effort, the proper detached temperament and years of cumulative knowledge, the importance of cycles, and understanding changes in supply and demand. The difference in our approach is, with individual businesses, we know ahead of time what we want to own, so in market declines, we can quantify the risk/reward to take advantage of compelling bargains.

TWST: Do you think also in this kind of environment there are some benefits going with either a boutique or a smaller independent firm rather than some of the big names for investors?

Mr. Auxier: Oh yes, I think integrity is critical, as is having skin in the game. Clients want accountability, a choke factor, who they can choke in tough times. Also, dealing with smaller sums of money provides for greater flexibility. Big pools of money should have warning labels explaining how size is the anchor of performance, and in declining markets, you have little protection. If the markets suffer a major decline, they are stuck; they can't protect.

Like I mentioned before, managers of many of the largest funds have very little of their own money at risk. We saw what happened in 2008 after most of the big brokers had sold their stock in the public market. As private partnerships with their own personal money on the line, they operated far more prudently and survived steep recessions, even depressions. Once they all went public, it was other people's money, and that's when you saw the leverage creep up — 50-, 60-, 100-to-1.

You need a strong balance sheet to survive. It is also important to be in enduring businesses. I remember back in 1983 there were over 30 initial public offerings in personal-computer stocks. Prices and euphoria skyrocketed. We avoided the mania and were buying **PepsiCo** (NYSE:PEP) on a Mexican accounting scandal and **Waste Management** (NYSE:WM), which was hammered by rumors of Mafia associations. **PepsiCo** and **Waste Management** are still around, but most of those PC companies did not survive. In fact, PC prices are down over 90% since that time.

To benefit from high compounded returns, you need to make sure the business will be enduring. With all of the data being generated, we are seeing exponential change, while most of us are still thinking in a linear way. Look at the impact of **Uber** on, say, **Hertz** (NYSE:HTZ) rental cars or taxis, or **Airbnb**. These are very rapid in their disruption. Look at **Amazon's** (NASDAQ:AMZN) impact on the malls, the carnage in **J.C. Penney** (NYSE:JCP) and **Sears** (NASDAQ:SHLD).

One of the keys to mitigate such risk is a voracious daily research effort in order to see trends far in advance. We price all of our stocks by hand, and we own them. Many I have owned for 20 or some 30, 35 years. We have **Kraft Foods** (NASDAQ:KHC) at I think $3, and it's like $90; I think **Philip Morris** (NYSE:PM) at $2 originally, and it's $120. So over time, you want to really know these businesses, and if they're still executing and innovating, you want to hold on.

We had a local company, **Precision Castparts**, and **Berkshire Hathaway** (NYSE:BRK.A) bought it for $235 this last year. We had some stock with a basis of $1.30. It was not unusual to see 60% fluctuations in that stock. With the cumulative knowledge, it gets easier to hold in the declines.

I think the problem in our industry today is no one really knows what they own. You have all these investment committees, and no one knows who's really accountable for the track records. It is difficult to have the intimate knowledge to quantify the true risk/reward. There's no way to determine odds. The power of compounding is so phenomenal yet underappreciated. It is vitally important to protect and maintain compounding through a dedicated daily research effort. There are no shortcuts.

TWST: Thank you. (ES)

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