Equity Quality Return
Investment Policy

Objectives, Performance, and Benchmark

The Equity Quality Return Strategy (EQR) objectives are to provide satisfactory absolute and relative results in the long run, and to preserve capital from permanent loss during periods of economic decline.

“Satisfactory absolute results” means earning a return which is fair when considering the risk taken. Each stock is assigned a “required return” which reflects its risk. This is also the return (or discount rate) which equates its present value with its future dividends or free cash flows. The portfolio’s average required return is therefore a good proxy for its expected return – since stock price, discount rate, and corporate performance are mathematically interdependent. “Absolute” means the return is related not to the general stock market, but to the specific rate chosen which reflects the stock’s risk. The objective is to generate a sound absolute result in the long run regardless of general stock market returns.

“Satisfactory relative results” means a return which exceeds the market average in the long run. The EQR strategy benchmark is the S&P 500. The S&P 500 was chosen because it best reflects the quality of the holdings selected for the strategy.

“Long run” is a period which includes a full economic cycle of expansion and contraction in output and equity market prices. Returns may vary widely, either positively or negatively, from the absolute expected return and the S&P 500 in the short run. Stock portfolios are not constructed to minimize volatility or return differences from the market. The focus is on selecting the highest returning individual issues for the long run rather than focusing on short-term fluctuations among groups of stocks.

The evaluation of returns presents only half the picture. Risk must also be evaluated. While return data can be generated easily, the quantification of risk is difficult. Fundamental information – such as business descriptions and debt, profitability, and valuation ratios – is the most effective method for assessing the risk of this strategy.

“To preserve capital from permanent loss during periods of economic decline” means selecting companies that can withstand difficult economic conditions. Permanent loss occurs when a large portion of a company’s assets or earnings becomes permanently impaired or when an unexpected bankruptcy or liquidation occurs. The nature of a company’s business and its financial strength are carefully evaluated to determine its ability to weather adverse economic conditions.

Security Types, Selection Universe, and the Use of Cash and Leverage

EQR invests only in publicly traded marketable common stocks registered with authorized national regulatory bodies and listed on major national stock exchanges such as the New York Stock Exchange, NASDAQ, and comparable exchanges in other countries.

EQR invests primarily in common stocks with corporate headquarters in the United States and Canada. Common stocks with corporate headquarters outside the United States and Canada may comprise up to 20% of the market value of the portfolio. EQR invests primarily in common stocks denominated in US dollars. Common stocks denominated in other currencies may comprise up to 20% of the market value of the portfolio.

EQR invests in companies of any size including large, mid, and small capitalization stocks. Larger companies are more likely to be purchased because of the safety and competitive advantage which size sometimes confers. Nevertheless, quality and valuation remain primary selection determinants.

EQR's preference is to remain fully invested. However, cash is oftentimes held. EQR strategy is to own a select group of businesses with the orientation of a private investor; therefore, when a new account is established businesses are selected one at a time. EQR strategy is also to hold cash when there are no attractive opportunities and prices exceed values in the selection universe. Cash is invested only in high-grade fixed income securities due in less than one year.

Leverage is prohibited unless client directed for temporary cash needs.

Investment Quality

Quality *businesses* have a fundamental value which is sound. Quality *stocks* have a significant margin-of-safety between fundamental value and price. EQR Policy is to buy quality businesses and stocks. Quality businesses have characteristics which are described in the remainder of this section.

Net cash income is the substance of fundamental value. Therefore, business quality is contingent upon the nature, protection, and use of corporate net income. The following are required business quality characteristics:

1. Net income can be counted on for many years in the future.
2. Debt can be serviced regardless of economic conditions.
3. Capital is either productively employed or returned to shareholders.

The business factors behind a company's financials – products, markets, management, and competition – determine the financials. Two requirements among these business factors are: (a) management is competent and honest, and (b) the company has a sound competitive position. Additionally, the business factors responsible for the company's past record must be relatively stable. Continuity between past and future is an essential element of business quality.

The following characteristics of business quality are desired, but not required: (a) a strong and persistent competitive advantage, (b) a high return on capital, and (c) the potential for long-term growth. The duration of high returns and growth are estimated conservatively, since the future is unknown and high growth / high return companies attract competition.

Portfolio Diversification

EQR Policy regarding diversification is to strike a balance between proper diversification and proper concentration as described in our published investment principles. The optimal balance depends on market conditions. In over-valued markets with limited opportunities, a sufficient number of holdings must be balanced with a sufficient margin-of-safety in each holding. In under-valued markets with numerous opportunities, a sufficient number of holdings must be balanced with a limited number of the best opportunities.

The following portfolio holding guidelines were designed to achieve the balance described above. The holding target is twenty stocks, but will vary based on market conditions. Maximum security position size at purchase is 10%. Maximum security position size at market is 20%. Maximum industry position size at cost is 15%. Maximum industry position size at market is 30%. Maximum levels are rarely expected to be reached. Requirements at the maximum purchase level are exceptional quality and extreme under-valuation.

Holding Period and Sell Discipline

The anticipated holding period at purchase is at least ten years. Businesses are purchased for long run earnings accumulation rather than short run price appreciation. Many years are required for an appreciable portion of earnings to accumulate even relative to a reasonable purchase price or rapid growth rate.

Investments are liquidated for four general reasons: (1) an unanticipated change in the characteristics of the investment (2) an error in the analysis of the investment, (3) a significant price increase to over full value, (4) to purchase a security with a significantly lower price-to-value. Regarding the first two conditions, businesses and industries change and analytical errors occur. Quick action is taken after coming to conclusions in these cases. Regarding the fourth condition, while long run earnings accumulation is the reason for stock purchases, the opportunity to profit from unexpected price increases will be acted upon.

The margin-of-safety principle applies on all sales. Price must be significantly higher than value to assure that selling is more profitable than holding. The expense of selling is certain; the outcome is not. The margin-of-safety requirement for both sales and purchases generally slows purchase and sale activity, since significant margins on both sides are less frequent.

Income and Appreciation

EQR Policy is to invest for total return from both dividends and capital appreciation. The highest return stock portfolio for the risk will have some stocks that pay high dividends and others that pay low or no dividends. In our opinion, investor cash needs will be more profitably satisfied by investing in fixed income securities outside EQR rather than limiting our stock selection universe to either income producing stocks.

Companies are selected because they possess strong operating characteristics and managers who deploy net income effectively. Managers should reinvest net income only at satisfactory rates of return. Otherwise, dividends should be paid or shares repurchased (when at low or fair prices).

Tax Sensitivity

Taxes are explicitly considered in taxable accounts. The income and capital gains rates of tax paying owners or beneficiaries are recorded when available. Securities are then evaluated for purchase or sale based on expected after-tax returns.