Equity Quality Return
Investment Policy

Objectives, Performance, and Benchmark

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

"Satisfactory absolute returns" are judged to be at least commensurate with the risk taken. Each company is assigned a "required return" which reflects our assessment of its risk. The greater the risk, the higher the required return. This return (or discount rate) is used to calculate the present fundamental value of the company's future cash flows. EQR endeavors to pay a price which is significantly lower than fundamental value. The margin of safety between price and value helps to assure that the required return is earned, while also serving as a potential source of return when our estimate of value is on target. "Absolute" means the return is related not to the general level of stock prices, but to the specific rate chosen which reflects the company's risk. The objective is to generate a sound absolute result in the long run regardless of general stock market returns.

"Satisfactory relative returns" means exceeding 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 defined as a period of at least ten years. In the short run, returns may vary widely, either positively or negatively, from our absolute return expectations and the S&P 500. EQR 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. The review of fundamental information – such as business descriptions and debt, profitability, and valuation ratios – is the most effective method for assessing the risk of the 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 securities, primarily common stocks, registered with 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 the securities of companies legally domiciled in the United States and Canada. Securities of companies legally domiciled outside the United States and Canada may comprise up to 20% of the market value of the portfolio.

EQR invests in companies of all sizes including large, mid, and small capitalization firms. 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.

The EQR strategy endeavors to remain fully invested. However, cash is oftentimes held. EQR seeks to own a select portfolio of companies with the orientation of a private investor and will therefore 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.

Investment Quality

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

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

1. Net earnings 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 its 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 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 seeks to balance diversification and concentration. A portfolio is successfully diversified when its overall return is protected from unexpected adverse results in individual holdings, industries, countries, or other risk factors. The benefits of concentration include a limited portfolio of investments with the highest probability of success and a deeper understanding of each investment.

The following portfolio holding guidelines were designed to assure proper diversification while capturing the benefits of concentration. The EQR holding target is twenty companies 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 deep investment knowledge, exceptional quality, and extreme under-valuation.

Holding Period and Sell Discipline

The anticipated holding period of a new investment at purchase is at least ten years. Companies 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 higher than value to assure that selling is more profitable than holding. 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 gains. The highest return portfolio for the risk may include some companies that pay high dividends and others that pay low or no dividends. Investor cash needs will be more profitably satisfied by investing in fixed income securities outside the EQR strategy or harvesting capital gains rather than limiting our selection universe to only income producing securities.

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

Tax Sensitivity

Taxes are minimized whenever possible. The portion of the EQR strategy that is in taxable portfolios is considered in our investment decision-making.