



## CAPITAL INCOME Detailed Investment Strategy

### Investment Philosophy

Dividend and coupon payments comprise a meaningful portion of equity and fixed income markets' performance over time. Income is a more stable source of return than capital appreciation and is imperative for certain investors. With this in mind, the Capital Income strategy is focused on maximizing current income while maintaining the capacity for capital appreciation by investing in dividend-paying equities and high yield bonds. Our investment approach is based on the conviction that a stock or bond's market price does not always accurately reflect its fundamental value. When investor sentiment, emotions, or short-term trends cause the price of a security to deviate from its intrinsic worth, we see opportunity.

### Investment Process

To uncover investment opportunities, we employ a disciplined, bottom-up investment process emphasizing rigorous, internally-generated fundamental research. Over the years we have sharpened our in-house research capabilities enabling us to tune out the noise generated by temporal factors and focus on a company's fundamentals—the true indicators of long-term performance. When we find securities that we consider undervalued, we dig deeper to evaluate risk and model the ability of the company to generate earnings over the long term under different conditions. Our rigorous research helps us find securities that are being adversely affected by misguided sentiment, unsustainable trends, or exaggerated risks. The breadth and depth of our proprietary research allows us to investigate stocks and bonds with limited Wall Street coverage that may be overlooked.

We subscribe to a team-oriented, five-stage process. The goal is to employ a consistent, repeatable approach and create a diversified portfolio of income-generating securities that exhibits attractive risk/return characteristics.

<u>Stage</u>	<u>Purpose</u>	<u>Responsibility</u>
1. Idea Generation	Identify investment candidates	Entire Team
2. Initial Review	Prioritize	Analysts
3. In-Depth Evaluation	Prepare detailed assessment of investment opportunity	Analysts
4. Peer Review	Review analysis, assess risk/return profile	Analysts/Sector Teams
5. Portfolio Construction	Buy, sell, and monitor	Portfolio Coordinators

## 1. Idea Generation

We source investment ideas from screens of financial databases and from our investment team.

### *Financial Database Screens*

We use dynamic and flexible quantitative screens designed to filter a large universe of securities to identify those providing high current income and that appear to have attractive risk/reward characteristics. These screens evaluate similar risk and valuation criteria, but can be tailored for specific sectors/industries to emphasize the most relevant factors.

### *Investment Team*

We augment our quantitative screens with ideas sourced from our Analysts and Portfolio Coordinators. Based on their industry knowledge, contacts, experience, and discussions within the Sector Teams, our investment team identifies opportunities that automated screens can miss due to data issues or other limitations inherent with screens.

## 2. Initial Review

Once investment ideas are generated, an initial review is conducted to highlight the key investment merits and risks, verify the validity of the characteristics that attracted us to the security in the first place, identify any obvious issues/warning signs that need to be addressed, and provide a rough estimate of the risk/return profile.

## 3. In-Depth Evaluation

The in-depth evaluation stage of the process is by far the most rigorous and time-consuming. This stage involves detailed research at the industry, company, and security level.

### *Industry*

Analysts conduct industry research concentrated on determining long-run margins and returns on capital. We seek to understand the factors that influence changes in supply and demand in order to determine normal industry profitability. Competitive analysis, akin to a Porter's Five Forces approach, is also evaluated to obtain a better understanding of industry risks. Our analysts accumulate a body of knowledge over years that enable them to respond to dynamic markets quickly.

### *Company*

Using the industry research as a backdrop, the Analyst conducts detailed fundamental research at the company level. This research stage is similar for both stocks and bonds. We focus on the company's long-run normal earnings power, which is the sustainable cash earnings of a company under equilibrium economic and competitive market conditions. Company analysis focuses on full cycle profitability, capital intensity, free cash flow and financial leverage. Analysts often meet with company management to better understand the company's business model by its various divisions, capital allocation policy, return potential of current capital programs, shareholder orientation, and overall competence.

Next we do a risk assessment, which entails a variety of both financial and non-financial factors. We assess the company's ability to survive temporary, short-term distress without impairing the long-term value of its franchise. This includes a review of its asset coverage, financial leverage,

historical cash flow volatility, available liquidity, access to capital, exposure to extreme events, and unusual profit concentrations.

### ***Security***

For equities, we focus our analysis on the stock price relative to the company's normal earnings power. We also employ an internally-developed, three-stage dividend discount model using market-derived discount rates. In addition to these valuation estimates, the analyst provides a risk assessment highlighting critical issues that could affect the company and its stock price. For credits, we focus our analysis on the bond's yield relative to its risk profile, which includes a detailed assessment of the company's competitive positioning, management strength, cash flow sustainability, financial flexibility, and most importantly, asset coverage.

## **4. Peer Review**

Each step of the in-depth evaluation is subject to peer review. In addition to reviewing financial models and ensuring integrity/consistency, peer reviewers play a devil's advocate role to challenge the thesis and modeling assumptions. The primary objective is to solidify our belief in valuation and security risk.

## **5. Portfolio Construction**

The equity/credit allocation hinges on the relative attractiveness of the underlying opportunities. We use quantitative tools to corroborate our allocation decision but these are decision-tools, not decision-makers. We employ a bottom-up, risk-controlled portfolio construction process designed to maximize current income while creating a diversified, attractively-valued portfolio. Portfolio Coordinators assess the relative attractiveness of opportunities and consider the complementary nature of new ideas with the existing portfolio. Portfolio Coordinators have responsibility for creating and maintaining a target portfolio for the investment strategy, generating trades and assuring compliance with client guidelines—buy, sell, and monitor.

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## **Financial Definitions**

*Free cash flow:* The amount of cash that a company has left over after it has paid all of its expenses.

*Porter's Five Forces:* 1) barriers to entry, 2) bargaining power of customers, 3) bargaining power of suppliers, 4) threat of substitute products, 5) competitive industry rivalry.

*Return on capital:* Measures how effectively a company uses the money (borrowed or owned) invested in its operations