

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Investing in Quality Growth Companies



AL BESSE is a founder and portfolio manager for the firm, and serves as Logan Capital's President. As a member of the growth equity investment team he is responsible for the firm's technical analysis effort. Prior to joining Logan Capital, Al was a Vice President at First Fidelity Bank serving as co-manager of the Charitable Equity Fund. During his decade at the bank, he played a key role in the formation and development of First Fidelity's \$2 billion Institutional Funds Management Group. In 1991 he was named as the bank's Institutional Investment Professional of the Year. Al is a graduate of Haverford College (BA) and The Wharton School of the University of Pennsylvania (MBA).



STEPHEN S. LEE is a founder, portfolio manager and a member of the growth equity investment team for the firm. A graduate of Lehigh University with a BS degree in accounting, Stephen holds NASD Series 7, 24, 63 and 65 licenses. Before founding Logan Capital with his partners in 1993, Stephen was previously employed at Mercer Capital Management and Merrill Lynch. His involvement in the community includes serving on several Investment Committees and Foundation Boards, including the Investment Committee of The Pennsylvania Horticultural Society. He is also a trustee of The Gladwyne Montessori School.



DANA H. STEWARDSON is a founder, portfolio manager and a member of the growth equity investment team for the firm. He has been in the investment business for twenty five years and has served his clients as a portfolio manager for several investment firms including Mercer Capital Management, Edward C. Rorer & Co. and Kidder, Peabody & Co. He serves on the boards of The Harriton Association, Bryn Mawr, The Wyck Association, Philadelphia, and as Chair of the Parents Council of The University of Pennsylvania. Dana is a graduate of Ohio Wesleyan University (BA) and is a member of The Financial Analysts of Philadelphia.

SECTOR – GENERAL INVESTING

TWST: Why don't we start with an overview of Logan Capital Management, and the portfolio that you want to discuss today?

Mr. Stewardson: For an overview, as I think you may know, we started our firm at the tail end of 1993 as growth managers in Philadelphia. Philadelphia is traditionally a "value town" so there weren't really that many growth managers around here back then. Al Besse, Stephen Lee, and I comprise the growth team and our assets are just under \$1.6 billion now. We manage two growth portfolios here at Logan Capital: "Logan Large Cap Growth" with a market cap of \$5 billion and "Logan Growth" which has a market cap of \$1 billion and above. Both strategies employ similar research tools and we'll get into all of those. During the last 16 years as a firm, we've also employed others who have brought separate investment talents to the firm including a concentrated large cap value portfolio, fixed income, GARP investing, and a high dividend international ADR portfolio. But the three of us manage the firm and focus on running the growth portfolios.

TWST: How has it been over the last 12 to 18 months with all the volatility and the turmoil in the markets for your growth investing?

Mr. Stewardson: Obviously growth investing has been one of the most challenging areas of the market – but it's also been very rewarding in the last 9 months. We did under-perform in 2008; it was one of the few years that we had significant under-performance. It was a super challenging environment for really every asset class, but I think growth in particular. We observed that the high quality and liquid growth equities – like the ones we hold – were often viewed as the easy redemption money. In other words, in a market where you couldn't sell what you wanted to, you sold what you could. As a result, a lot of great growth names were punished with emotional selling pressure.

On a brighter side, in 2009, we had superb performance and a huge recovery. We'll get into that and talk about what we see coming up in the next year or two and it is fairly positive.

TWST: The year ended better than it started and you did find growth opportunities in the market later on.

Mr. Stewardson: Yes. One of the key reasons why is, we had a positive bent going into the year – although in retrospect, we were a little bit early, since the bottom didn't come until March. But we were looking past the first quarter and we saw the economy improving and invested that way and it played out nicely.

Mr. Lee: As a follow-up to that, our process really stems out of three components, and actually the process is really about making decisions where all three inputs converge. We start with an economic overview and then use a top-down fundamental component which has both quantitative and qualitative inputs. One of the advantages Logan Capital has is that we also use technical work to support the economic and fundamental work and we use the technicals to look at very long periods of time.

One of our conclusions was that the flight to safety had been overdone. Certainly there were a lot of economic challenges, but we believed that the financial markets had stabilized and we didn't expect to see another seizure in the credit market. If you go back and look over 20, 30 years of data, you'll see that analysts and investors have historically been very quick to cut earnings expectations too deeply – only to have earnings bounce back. Seeing the stabilization take hold, we felt we that the second half of 2009 would produce more upside earnings surprises than downside disappointments.

The other thing our process brought to light was that there had been a dramatic overselling in the good quality growth companies that would likely turn out to be the earnings leaders. We run a quantitative process that ranks companies on their forward looking earnings

expectations. What we saw is that although everyone's expectations had been reduced, the companies in the portfolio were seeing their estimates were being cut less than the broader universe as a whole. In other words, our companies were still the relative earning leaders. What we ended up doing is really retaining companies that we already held in the portfolio based on first that overall relative earnings out-performance, they were being cut less.

Second, on the more traditional qualitative component of our fundamental process, we really took the time to look at what management was doing in a very dynamic and challenging environment and whether we thought that they would be able to execute well and adapt to a changing environment. In many cases, not only did they execute well, they actually came out of the challenges in a better position with greater market share than before, since some of the competitors had closed up. Although it was difficult, we kept the companies we owned, stayed, then went back and looked historically when markets finally recover, what industries and sectors, what types of companies tend to do well, what company's advantages tend to do well.

Highlights

Al Besse, Stephen S. Lee and Dana H. Stewardson are the growth team at Logan Capital Management. They say that their performance in 2009 was superb and a huge recovery from 2008. They believed that early last year saw a dramatic overselling of good quality growth companies that would likely turn out to be the earnings leaders. They feel that the current recovery is following the historical norm recovery patterns. Looking at past market recoveries, the things that tend to lead led, the types of companies and the characteristics that should lead in a recovery did lead. This allowed them to stay focused and not get shaken out by one or two outlier statistics. Historically, their returns have really been driven by security selection and finding the companies that are emerging as leaders within their industry. They say that this will give them a good advantage over the next several years. Security selection is going to be a key skill as the market becomes not just a tide lifting all boats but rather a market with much more disparate returns. Companies include: [Amazon \(AMZN\)](#); [Cognizant Technology \(CTSH\)](#); [Urban Outfitters \(URBN\)](#); [Priceline \(PCLN\)](#); [Freeport McMoran \(FCX\)](#); [Apple \(AAPL\)](#).

One of the more interesting things we came up with was we maintained our weighting in the consumer discretionary names. If you look at our companies, we actually focused a little bit more towards the high end, so we wanted slightly higher end but not high-end consumers, good balance sheets, good branding, and a strong online presence. We had companies like that, **Polo Ralph Lauren (RL)**, **Urban Outfitters (URBN)** and **Amazon (AMZN)**. They really helped, giving us some good returns early in the year. We also maintained exposure to some more economically sensitive names in the materials sector, and we have a good allocation of industrials too. The consumer is about 70% or so of GDP, so it's very hard for businesses to actually grow until consumers start spending again. There's an improvement in sentiment, while it's certainly not great, it's better than it was about a year ago. We now expect to see businesses resume a lot of investments that had been put off very quickly.

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1-Year Daily Chart of Urban Outfitters



Chart provided by www.BigCharts.com

Again, stepping back and looking at those long-term numbers, seeing how they were really outliers, we can really see that this recovery is following the historical norm recovery patterns. Looking at past market recoveries, the things that tend to lead led, the types of companies and the characteristics that should lead in a recovery did lead. We stayed focused on all three components and really looked for the convergence and didn't get shaken out by one or two outlier statistics. This allowed us to really stay focused where we needed to be. As you may have seen, we were up a little over 50% last year on a nice recovery, which we think puts us in good shape versus our peers, and we're very happy with where we are on the portfolio.

TWST: Tell us about the actual process and the criteria that you're looking for in potential holdings.

Mr. Lee: In terms of holdings, every company has to be

a growth stock within its own right. So from a top-down perspective, we look at long-term data and get a sense of where the economy is in the cycle and what are the advantages and what are the characteristics that help companies prosper. Our thinking there is that the businesses and customers are more likely to spend and if there is a higher propensity for the customer to spend, that makes everything management's doing easy.

In a lot of ways, last year we needed to see the consumer recover. This year, we expect to see businesses recover and we need to see that backed up by actual earnings leadership. So we have a qualitative tool we've developed that we use for idea generation. We run our ranking algorithm on a weekly basis and the primary driving factor the change in the consensus estimates over both the short and long-term, not just for the quarter but for the current year and next year. As analysts change their numbers versus their peers, we can see what companies are starting to

emerge as leaders. We're certainly not a quantitative shop but this process helps guide us in our search for good growth names. When we see companies show up well on our quantitative work and they fit within what we're looking for in a top-down perspective, we then go to the next level and view the more qualitative component to see why those earnings are doing well, and what we want to see are companies that have pricing power.

Now, you might see earnings improvements as a result of cost cutting, but you can only cut costs so far, you can't get costs to zero. We want to see companies whose earnings have been outperforming because they actually have top-line growth or growing market share or in the case of companies like **Apple (AAPL)** creating markets that didn't exist before. That's what we want to see on the qualitative component. And then on the third component, we take a look at the technical aspects. We use point and figure charting because we think it eliminates a lot of the day-to-day noise in the markets, and certainly in volatile times, getting rid of noise is key. What we want to see is a confirmation that stock has positive and orderly technical attributes. When we see a convergence of the top-down economic work, our qualitative and quantitative fundamental work and the technical, then we know we've found a good potential addition to the portfolio. Our sell process is really the mirror of that. We don't sell just because a single component of our process. We need to see confirmation from at least two of them.

One of the challenges we certainly think is out there though we're not as worried about as we were a year ago is obviously inflation or deflation. Really the best defense to either one of those outcomes is pricing power, and that is a fundamental characteristic at our portfolio holdings. When we do finally see some inflation, we think the portfolio is well prepared.

TWST: How many holdings generally do you have in the portfolio? Is it diversified or more focused?

Mr. Besse: We currently have 46; whether that should be called concentrated or diversified seems to be a matter of debate in some circles. Some consultants look at us and say, “Oh, you’re concentrated” whereas we feel we’re diversified. In terms of sector diversification, we can be zero weighted in a sector at the low end or up to the greater of 20% or two times the sector weighting of our benchmark index, the Russell 1000 Growth. This past year, some of our heavier weightings have been in consumer discretion, technology and industrials.

Lee: Some of the newer adds we’re recently putting in are companies that will benefit as corporate spending begins to get back to normal, notably Cognizant Technology, information technology outsourcing, as well as consulting.

TWST: What are some of the opportunities that you have found during the last few months that you’ve been able to add to your portfolio and that you feel are representative of your investment approach?

Mr. Lee: Some of the more recent adds certainly did very well in the discretionaries and we’ve actually been taking some profits and trimming those positions fairly well. Some of the newer adds we’re recently putting in are companies that will benefit as corporate spending begins to get back to normal, notably **Cognizant Technology** (CTSH), information technology outsourcing, as well as consulting. One of our overall themes is that we think there’s a lot’s been going on in terms of restructuring businesses, sometimes for good reasons, sometimes for less

1-Year Daily Chart of Cognizant Technology



Chart provided by www.BigCharts.com

good reasons. At the end of the day, we now have companies that need to really go through, figure out how they’re going to operate on the going forward business and they’re certainly going to be consistent, increasing pressure on managing costs and expenses which we think creates an ideal environment for IT outsourcing as well as the consulting in terms of making businesses run more efficiently.

In addition, if you go out and look at what’s really been going on in technology, there’s a lot of talk now about “cloud computing.” We had these positions a bit on the early side, companies like **Citrix** (CTXS), and **Amazon**, which benefits from renting out computers to its supplying outsourced computing-based service. We think there are a lot of opportunities for businesses to really take advantage of technology and actually boost productivity and boost earnings. We’re looking to add in that perspective. Those have been some of the newer adds that we’ve put in the portfolio.

In addition, we think that as healthcare legislation comes to its conclusion, the uncertainty will move away, so, we recently added **AmerisourceBergen** (ABC), which is a distributor of healthcare products. But again, healthcare sector has companies like **Medco Health** (MHS) and **Express Scripts** (ESRX). We really believe that a lot of the return on the healthcare sector is going to be in stocks that can reduce the cost of delivering healthcare. Anything that happens on the legislative front will probably

1-Year Daily Chart of Freeport-McMoran



Chart provided by www.BigCharts.com

increase the number of participants in the healthcare system, so we own companies that will help reduce the cost. In terms of some of the best performers that we have, it was an interesting year in that some of the names that actually outperformed quite well were names that were somewhat tough companies to hold earlier in the year.

In terms of materials, we have **Freeport-McMoran** (FCX) and certainly copper is economically sensitive. For a while, at the beginning of last year a lot of commodities were really pricing in a dramatic slump in the economy and not really forecasting any sort of a recovery. We thought that period was a nice opportunity to maintain those positions.

In addition, we have **Priceline** (PCLN) and two things happened there. They had expanded their hotel network overseas into Europe, but the hotels weren't really using it, they weren't getting any advantage out of it. Well, the nice thing is when you have a slowdown in the economy, there are a lot of excess hotel rooms. **Priceline** had spent several years laying the groundwork so that when a lot of inventory became available, they got the benefit. Plus, we firmly believe that consumers will continue to bargain hunt and purchase things online. **Priceline's** network

novate and really have that fundamental characteristic of pricing power. Unlike a lot of Apple's peers in the PC industry, they have not had to cut prices. Similarly, **Urban Outfitters**, a good specialty retailer and product developer, has a fair amount of room to grow. They sell into some of the other leading retailers – for example Urban sells its Free People brand into **Nordstrom** (JWN), which we thought was right in the sweet spot, high-end but not incredibly high-end. That's the consumer who has the ability to spend when sentiment improved.

Lee: Priceline had expanded their hotel network overseas into Europe, but the hotels weren't really using it, they weren't getting any advantage out of it. Well, the nice thing is when you have a slowdown in the economy, there are a lot of excess hotel rooms. Priceline had spent several years laying the groundwork so that when a lot of inventory became available, they got the benefit. Plus, we firmly believe that consumers will continue to bargain hunt and purchase things online.

1-Year Daily Chart of Priceline



Chart provided by www.BigCharts.com

In addition, **Urban** had enough cash on the balance sheet, to finance their retailers' inventory. With the credit crunch, there were fears that the retailers wouldn't be able to finance the inventory for the holiday season. **Urban** had several hundred million dollars of cash on the balance sheet and offered to finance their best customers' inventories. So we were really looking for companies that had the resources, the management, and the foresight to be able to take advantage of opportunities throughout the year. Because in distress comes opportunity, and we were very happy with the types of companies we had, and we think that a lot of these names we think will continue to fare well in 2010.

Mr. Besse: To focus a little bit on the big picture, as Stephen has been saying, we looking for ways to capitalize on our belief that there will continue to be more upside surprises than downside disappointments ahead. At this stage of the game, after

Stewardson: We have an economy that's doing well but there will be some bumps in the road and it is going to keep the Fed accommodative in our opinion. And that can be the perfect environment for growth investing. Other companies in the broad market are making some strides, but really they don't have the strong earnings growth and organic growth and the modes around them that our companies deal with, makes our companies look even better.

took years to build up so there really isn't any other entrant coming in that can replicate what they have. So, we thought that both sides of the equation are doing very well. That stock was up almost 200% since last year.

Similarly, we added **Amazon**, similar dynamic, price-sensitive consumer, almost equivalent to a **Wal-Mart** (WMT) but online focused. Consumers are much more comfortable buying things online using electronic payments and getting things shipped. **Apple** did very well for us as well. They continue to in-

some of the best quarterly returns that the market has seen in 80 years, we do have to add an asterisk that is, although we are optimistic about the market, don't look for a repeat of the three quarters of 2009 that we've just come through; we aren't expecting a barnburner to continue like this.

We are not trying to forecast when this bull market will end, but what we do know is that we are in a bull market and the technical and economic indicators are giving us green lights across the board. The average life of a bull market tends to be about 3.8

years, and quite frankly, we'd wouldn't be surprised to see this bull market be shorter than that average, but for now, we're giving this bull room to run. This recovery has followed the historic script. Right now, we are looking for unemployment to peak out at current levels this quarter or next. It's important to remember that the top-line big picture unemployment number is probably the most lagging of all the indicators even though it's one of most watched. If you look under the hood, you'll see that you see monthly job losses reached their negative climax back in December-January of 2008-2009. Also, the new jobless claims component of unemployment peaked out last April and has been steadily improving since. As for consumer confidence, although the widely touted top-line number has been sort of bouncing around here, the very important sub-component of that which is future expectations has been steadily improving since early 2009. That particular indicator is very predictive when you look back and see how economies and markets recover and what indicators tend to have a highly reliable correlation with things getting better.

Besse: There's been some concern about a strong dollar tanking the market. A stabilizing and strengthening dollar probably gives the Fed more wiggle room to not have to tighten as soon as it might feel it needs to if the dollar were still in decline. Furthermore, if you look back into early 1980's, you had a time when the dollar rallied 30% while the S&P 500 rallied 28%. There is certainly some very clear evidence that a strong dollar isn't necessarily bad for the stock market.

After such a strong run, we wouldn't be surprised to see this market take a breather and consolidate around mid-year, but from what we're seeing now, we don't buy into some forecasts that have the market going all the way back to where it was at the beginning of the year. But certainly some sort of consolidation and modest pullback would not be unexpected, and would even be welcome because the market has run so hard, so fast. So we think in the long run, the fundamentals and technicals indicate that we are still in a good bull market that needs to be given the benefit of the doubt going forward.

Mr. Stewardson: We also think that the Fed is going be accommodating for quite a while. Treasury interest rates on the least risky assets have picked up, and investors seem willing to take on a little bit more risk. We have an economy that's doing well but there will be some bumps in the road and it is going to keep the Fed accommodative in our opinion. And that can be the perfect environment for growth investing. Other companies in the broad market are making some strides, but really they don't have the strong earnings growth and organic growth and the modes around them that our companies deal with, makes our companies look even better. And the focus will always come back to earnings, and that's where our portfolio is the strongest.

Mr. Besse: Adding to Dana's comment about the accommodative Fed, actually there's been some concern about a strong dollar tanking the market. A stabilizing and strengthening dollar probably gives the Fed more wiggle room to not have to tighten as soon as it might feel it needs to if the dollar were still

in decline. Furthermore, if you look back into early 1980's, you had a time when the dollar rallied 30% while the S&P 500 rallied 28%. There is certainly some very clear evidence that a strong dollar isn't necessarily bad for the stock market.

TWST: What is the sell process? What criteria do you have for triggering an exit from your portfolio?

Mr. Besse: Our buy discipline is made up of three components; a sell is often triggered by at least two of the components turning negative. It's not surprising to us two components go negative, and then have the third fall into place behind it. We find that technical analysis often gives the first warning that something might be going on with a given holding. We follow our stocks very closely and watch the charts on a daily basis, and the technical goes hand-in-hand with the fundamental and macro work. But if we do see something in a stock's price action, for example, if it starts under-performing its peer group or the market as a whole or if it starts to break down within a short-term or intermediate support levels and show signs of flagging strength,

that's when all the components come into play. On the fundamental side, we go back and reexamine our beliefs and our hypotheses, double check the earnings outlook and see if those are so intact and also make sure that the macro headwinds and tailwinds that we have projected for the current holdings are still in place. But it takes at least two of the three components to turn negative before a stock is considered for sale.

Mr. Lee: In addition, we have some sector constraints, and as an individual security approaches the 6% range, we tend to trim that security. This company is doing extremely well but we don't like it to get too big relative to the rest of the portfolio.

TWST: What is the average turnover? Was it more in 2009 because of the events in the markets?

Mr. Stewardson: Turnover runs typically in the mid-30%, relatively low for a growth manager. We attribute a lot of that to the fact that we're really looking for confirmation from all three sides, the macro, the fundamental, and the technical. Turnover was a bit higher last year but not dramatically so, but again principally that was because when we really came back to look at what companies were ultimately doing better on an earnings basis, we are comfortable that companies we held.

Mr. Besse: It usually takes a new name several weeks and sometimes several months to work its way into the portfolio from the time it first shows up in our work. It's methodical and deliberate process to add new names to the portfolio, and as such, we tend to have built in allowances for air pockets and zigzags that a stock may have along the way, and we don't get shaken out

very easily. It really does take some meaningful deterioration of two of the three parts of the methodology to get us to reverse course on stock and move it out of the portfolio. As such it keeps our turnover fairly low.

TWST: We haven't mentioned international operations. With the global economies booming, do you have any international companies, or do you focus on domestic companies with international operations?

Mr. Stewardson: We have the flexibility to have a couple ADR portfolios in the portfolio. We don't have any at this time. But the vast majority of our portfolio is doing a lot of their businesses around the world. There are a few exceptions to that. We own **Darden Restaurants** (DRI) for instance, which doesn't have international exposure to any large degree. But that's an aberration. Most of our portfolio companies are doing tremendous amounts of business around the globe; American management, American accounting, American location, but global in reach.

TWST: What do you think is distinctive about your investment approach at Logan Capital Management that differentiates you from other growth managers?

Mr. Lee: Historically, our returns really have been driven by security selection and finding those companies that are really beginning to emerge as leaders within their industry. We actually think that that will be a very nice advantage over the next several years here. We are going to get into a period where it really becomes not just a tide lifting all, but rather a market with much more disparate returns. We think security selection is going to be a key skill, and it's something that our process brings to the table.

As we see the economy move forward here, we think it will create a good environment for growth stocks, especially where quality companies can really differentiate and show themselves versus their peers. As an active manager, we like the fact that when you go back and look at the relative returns of active managers versus the benchmarks, the benchmarks are not necessarily in the top half or even top quartile anymore. We think in general it's going to be a good period for active management, and we are a good consistent growth manager that gets returns through security selection.

TWST: Looking ahead from your top-down perspective again, do you see any headwinds in 2010 that investors and growth stocks should be wary of now?

Mr. Besse: As we said earlier, that we think things will be better than many expect. There is that wall of worry that the market will continue to climb in our estimation. Certainly when you have had such a good hard long run in the market as we are mentioning earlier, we expect to have a breather. Politics is always a potential wildcard and 2010 could be a doozy. The market has some important issue to deal with – healthcare, taxation of the financial industry, estate taxes, the war and so on. And of course the big question about control of the Senate with the next round

of elections. I guess one thing that historically makes markets and investors feel a little better is when the parties are deadlocked in Washington because if you have an even distribution of power, you tend to not have rapid change. Unpredictable rapid change is something the market generally does not like. If you get into stalemate situation, the market seems to breathe a little easier in those types of environments.

History points to a positive 2010. If you look back over 30 years worth of data for expected earnings growth, the current reading for expected earnings growth on a composite basis has bounded up off of very, very low negative levels and has come back to flat. The current range is for zero to about 4% expected earnings growth. Historically, when the earning growth expectations have been in this range, the S&P has yielded average annualized returns of about 18%. So once again, we continue to believe that equities are going to be a better place to be versus bonds, because interest rates realistically can't go lower. They may stay low but ultimately they've got to go up, and that type of environment favors favor equities over bonds. As Stephen has mentioned, we think growth equities are going to have the potential to do better than other categories of equities.

TWST: Is there anything that you would like to add?

Mr. Stewardson: We may have said it, but I think we've got a great methodology here at Logan for zeroing in on the best possible companies, but what we really do best is picking those names and putting the portfolio together. That's something I think we are very, very good at. We have excellent team work here, and then just looking out, we believe that we are in an environment where growth in particular is going to be a very, very good place to be.

Mr. Besse: Our role in finding that good growth as we go forward is not so much to predict when the bull market will end but to do what we always do: assess the risk/reward trade-off of the opportunities out there. Logan Capital's methodology of focusing on global future earnings growth and backing that fundamental assessment with good macro projections and technical analysis has historically enabled us to be very good stock selectors.

TWST: Thank you. (PS)

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