

THE WALL STREET TRANSCRIPT

Edited version

TWST: Would you start with an overview of Global Capital Management and what you do there?

Mr. Hammerschmidt: Global Capital Management was founded in 1998 by Anthony Soslow. The firm started as a bootstrap operation with friends and family assets and has grown today to a little more than \$1 billion. When I joined the firm in the early spring of 2004, we were at approximately \$100 million and so, the true growth in assets has occurred over the last three years. And we are a seasoned group of portfolio managers who have come together to build something very special for our clients.

TWST: To what do you attribute this successful performance?

Mr. Hammerschmidt: Back in 1990 a study was conducted by our founding partner of those factors which influence equity returns. The study ran from 1974 to 1990. In 1998 and again in 2005 the study was repeated... And the conclusion of that study: there are 3 factors which most influence equity returns...and they are Value (V), Quality (Q) and Business Prospects (E).

Let's think back to 1990. Investors were very excited about Value Investing.....as Value had outperformed Growth in 1988, 1989 and 1990.

But by 1993 many of these same investors were disenchanted with Value as Growth had outperformed in 1991, 1992 and 1993. The mid 90s saw a mixture of styles...the late 90s saw Growth and from 2000 thru 2002 Value.

So the Number ONE responsibility we have to our investors is to provide them with consistent excess returns.

We know those factors which influence equity returns: Value, Quality and Business Prospects.and our performance comes from the disciplined application of this proven process. We evaluate VQE - week in – and week out – month in – and month out –

We are also strong believers in the CORE CONCEPT. There are companies in our portfolios that look like traditional Value Stocks with P/Es of 6, 8 and 10.....and there are some companies in our portfolios that look like traditional Growth Stocks with IBES expected EPS growth rates of 18, 20 and 22.

Together we create a 35 to 40 stock portfolio. 35 to 45 stocks is the fulcrum between risk and return. It has been academically defined by Roger Ibbotson and it affords us the best chance to generate an alpha while diversifying enough to stay close to our benchmark indices. Now in choosing to use 35 to 45 stocks, we severely limit the capacity of assets we can manage...but that is the tradeoff we accept to maintain a limited risk profile with

our client's money. And while this diversification rarely leads us to the top decile in any one year, our consistent application of the VQE process delivers top decile performance over a 4 – 5- and 6 yr time frame as evidenced by our two other products; SMID Cap and ALL Cap which have longer track records with Global Capital Management.

Before I joined Global, I was a founding shareholder with an extremely successful equity manager. I was there over 12 years when I left to manage a large sum of money for a wealthy family. During this time Tony Soslow approached me and so began the recruiting process. I liked what I saw within Global Capital, and the performance of the SMID and ALLCAP were very attractive. So I spent about two to three months in the fall and winter of 2003 looking at the transactions of the past 5 years to really confirm that this VQE process did indeed work in different environments. What I discovered was exciting and so I signed on. Again, at that time the firm had about \$100 million under management.

I manage a mid-cap portfolio. There is a group called the Quaker Funds in Valley Forge that did a national search to replace an existing manager who was closing to new assets. I guess it's nice to be in the neighborhood so we, along with several other firms, made presentations to the Board. The Board really liked the All Cap and the SMID Cap performance and our philosophy, approach and process. Plus, to be considered for the Quaker Family of Funds you must be an independent manager. There really is only one type of entrepreneur and that is the successful one because unsuccessful entrepreneurs don't last very long. We are a 100% employee owned firm with most of our liquid assets invested in our products. The Quaker Board was very familiar with my track record at my previous firm where I was either the lead portfolio manager or co-manager responsible for about \$5 billion across three products. Quaker selected us and we received the fund with about \$60 million. There was an automatic sell with the changing of managers by one wire house and so the fund assets decreased to about \$40 million. Today, a little over 2 years later, we are up to \$155 million.

TWST: What is the investment climate like at this time and looking ahead for the rest of the year for your mid-cap strategies?

Mr. Hammerschmidt: We are a pure bottom-up shop. We don't make investment decisions based on top-down analysis, but certainly, as portfolio managers, there are discussions that take place around the water cooler daily. We have some concerns. One year ago, the market had great concerns that there would be a hard landing, and one of the pieces that I had written in our monthly commentary for the Quaker Funds was "Hard landing, Soft landing, How about What Landing?" Certainly we did not expect the economy to feel any real pressures throughout the last year because of the economic strengths overseas, and many of the companies that we invest in have a significantly growing presence in the international marketplace.

If I have any capabilities to do forecasting, I still do not believe we're going to see a recession in the near term, even in early 2008. It is an election year, which does cause

some problems for the market, but overall, we still think that 2% to 3% GDP targeted growth is a reasonable expectation and achievable.

TWST: Your VQE process will still pick out the right mid-cap stocks.

Mr. Hammerschmidt: Absolutely. What I like most about the process is that it does a really nice job in first identifying high-quality companies that are undervalued. Then Phil, Tony, and I roll up our sleeves and vet out the data all in an effort to determine whether or not that business is actually getting better. In the Mid Cap space our Universe begins with 800 securities. Of these, approximately 350 of these companies are “high quality” meaning that they have low debt to equity ratios, low earnings variability, high profit margins and low overall variability. Of these 350 companies ½ are undervalued and ½ are overvalued...and we are looking for those companies with the most improving business prospects. I can tell you that when I first arrived here, the process was showing many bank ideas. Finance stocks were strong and getting stronger. Around March of 2006, there just weren't any banks showing up, many of the banks that had been trading at 8 to 12 times earnings and growing at 8 to 10 times earnings were now trading at 15, 16, 17 times earnings, and so many of the banks were not showing up well in our work and therefore, they just weren't getting through our process. As such, we started to shy away from banks as early as last summer. Even today, while a few banks have started to come through the process, we are still not seeing anything like you would have seen in 2002 through 2005 because I have gone back to those years and looked at the work. So the process has done a nice job in steering us away from financials. We have been underweighted in that area.

When we are looking at a company we review 10Ks and 10Qs - Income Statements - Statements of Cash Flows. We carve out non operating gains – we add back non operating losses. We talk directly with the companies.....all in an effort to vet out the data and confirm that indeed this company is high quality and has improving business prospects.

I think it's probably important to say at this time that we are very, very strict in what gets into the portfolio just as we are very strict in the number of positions in the portfolio. As I said earlier, we hold 35 to 45 stocks in the portfolio, but I can tell you, that number is really something more like 38 to 41 companies. We feel that's the proper place to be able to generate a significant alpha while still being able to diversify risks.

Our portfolios, when constructed, will historically be in eight or nine of the ten broad sectors of the S&P. We can be ten for ten, but it is difficult finding utility stocks that have a high profit margins and low debt. We do find them from time to time, and when we do, we invest in them with great vigor and anticipation, but what we set out to accomplish is to go to bed every night knowing that we have a portfolio that is undervalued or cheaper than the market and that we have a portfolio that holds high quality companies with low debt, companies with consistent earnings and low overall variability. If business is getting better then each morning when we come in we will have a company that is worth

more than the night before, yet is combined with a portfolio of companies to minimize risk in case of unforeseen events or competition.

TWST: What is your definition of mid cap before we talk about stocks? Do you stick to those limits strictly?

Mr. Hammerschmidt: It's interesting where the definition falls. I would tell you that the historical definition is \$2 to \$10 billion, but it really has been creeping up over the years based on the Russell and S&P400 benchmarks. I would define it now more like \$2.5 billion to \$15 billion range. It's rare that we will add a company in the \$15 billion range. We really like to search for companies in the \$2.5 billion to \$5 billion range and if we are right on the cycle or earnings play then we find that we can own stocks for doubles and triples owning them three, four, or five years.

TWST: Could you tell us about some of the stocks that you feel are representative of your investment process and the reasons you found them attractive?

Mr. Hammerschmidt: A stock that has been a terrific performer for us that we identified early on was **Johnson Controls** (JCI). Johnson Controls makes technical and facility management control services for industrial buildings. In other words, in this rising energy price environment, they help buildings run for less money. But they are best known as an automotive parts manufacturer making car seats and parts for automotive interiors like door systems, overhead interiors and instrumentation panels. And, of course, they make car batteries.

Johnson Controls was purchased in the portfolio mid to upper \$40s range. Today it trades close to \$115. My valuation work at the time of purchase figured Johnson Controls to be worth about \$110. Looking today at VQE we see that Johnson Controls has a debt to equity ratio of .57 (up from .26 due to the York acquisition) versus the current Market Average of .82. Johnson Controls has very consistent low earnings variability and a beta of just 0.91. It's current P/E is 17.5 but it was 14.6 when we purchased it... and it has a Price to Value ratio of 0.71 while the market average is 0.69, but down from a 0.82 level in the early summer.

A couple of quarters ago they bought York International, the heating and air conditioning company here in Pennsylvania. I now believe the company is worth something closer to \$125. But if you were to break up this business into its parts you would see that their traditional automotive sectors grow at about GDP plus 2 to 3%. Their battery business has very little growth...until lately when hybrid engines became a reality. Their power management business has been growing north of 30% a year. Here is a company that has transformed itself while not stepping outside of the boundaries of their balance sheet or their expertise. They are high quality. They are undervalued. And they have improving business prospects.

Now, our work told us up at around \$125 that the company did not have value anymore and so, if one of our three factors goes away, we will cut back the position to 2%. We start all positions at 2%, then once we confirm that we are right with improving earnings we will raise it to 3%, and sometimes even to 4%, and then watch it grow. We've never had a position up at 8%, but we reserved the right to hold one that large. At \$125 the V of the VQ&E went away. They still had quality, they still had significant earnings momentum, but they weren't undervalued anymore and as such, we cut back the position to 1.5%. I'm waiting for an opportunity to add back to the stock somewhere around the \$105 if we get an opportunity in this current pullback.

TWST: That's a great company. Do you have another one that you can describe?

American Eagle Outfitters (AEO), is a company that I purchased at about \$20.30, it has since split 3 for 2, so that would be about \$13.50. **American Eagle Outfitters** is a retailing company targeting the 15 to 25 year old market. Their current success is in dorm ware and intimates for teen girls. We purchased the stock in all three of our products; SMID-Cap, Mid-Cap and All-Cap. The company had value, it had quality, and it appeared that earnings prospects were turning.

After our original purchase their same-store comp sales fell surprisingly and so we cut our position from 2% back to 1.5%. It appeared that we might have been early and as such, we have a discipline for that. What was actually happening was that the company was clearing their shelves out to get ready for their new line of the dorm ware I just mentioned. I believe they call it AE Girl. As such, the stock underperformed for about 2 months but then something happened that all investors love to see; a member of the board of directors purchased one million shares of the stock. That gave me pause and reflection to surmise that maybe these shelves are cleared and business is going to get better. The stock went from \$13 to \$35 in a year! We pared back on our position around \$32 for the same reasons as we did with Johnson Controls. The stock traded through its valuation level. Currently, it's trading at \$26 and it's one of my larger positions, I just added to it at \$22 about two weeks ago. We've also noticed that recently, the same insider has been just completed buying an additional one million shares. I like what we are seeing here.

TWST: What is the turnover of stocks generally?

Mr. Hammerschmidt: It has been as high as 60% and that's because the cash flows for the fund have been very positive. As for the number of complete sales and new initiated positions I have invested in 54 companies over the past year with 14 complete sales. In other words, 26 of the 40 companies held in the portfolio at the beginning of the year are still in the portfolio.

TWST: What is the sell process?

The sell process is quite simple. If two of the three characteristics of VQ&E go away, we sell. If one of the three goes away we pare back to 1.5%. What this does is to allow us on the value side to get companies at a reasonable price. The quality helps us to mitigate risk. So if for any reason we purchase a company and we are wrong on earnings, we rarely see a blow up. Most often it becomes a value trap and the stock gives us little or no upside. If we get it right and the stock sees significant earning acceleration, like with American Eagle and Johnson Controls, then our discipline allows us to hold on to the position and manage our weightings as long as earnings are continuing to improve without the complete sale and the hope of getting back in. I have seen stocks get expensive and stay that way for a long time. Maintaining a core position of 1.5% to 2%, even though the stock has no V can still significantly drive performance.

TWST: I was going to ask you about the new ideas. Does your research team have candidates on the reserve bench waiting to go in just as an opening?

Mr. Hammerschmidt: Yes, our process starts with the 800 companies in the Russell 1000, from number 200 to 1,000 in the Russell 1000 universe and once we go through the process, we find weekly that we have somewhere between 70 and 100 ideas that will get through the quality and the value process. Of those 70 to 100 companies will be the 40 positions that we currently hold. What we have left are 35 to 40 ideas sitting on the bench that are waiting for our vetting out process. And that is where we spend most of our time. We run the process over the weekend. On Monday mornings we come in and pour through our existing holdings confirming their VQ&E. We make notes to follow for the week and then we move on to the new ideas list. Sometime later in the week, once we have vetted out the data on the new ideas we will gather together as a team and discuss the companies. What's interesting here is that I have a strong background in energy, autos and transportation, and industrials; Tony Soslow, our senior partner, looks at health care and technology; Phil Mendelsohn has an industry background in banking and he does the retail and the banking stocks for us. Our strengths fit well with one another.

The three of us will share the ideas and go through the process. If it comes down to an insurance company that looks really attractive or a multiple number of insurance companies, then I will look to Phil for his important input; just as Phil will turn to me for energy and industrial ideas. Once we develop a strong feeling for what each of us wants to own we do one last thing. We use a software analysis tool called BIRR Analysis. BIRR is for Burmeister, Ibbotson, Ross, and Roll. I have an MBA from Duke University and Edwin Burmeister is a professor there and a friend of mine. I think Roger Ibbotson, Stephen Ross, and Richard Roll are pretty well known names in the industry. They developed in the '80s a software tool that allows you to go in and look at the risk characteristics of the portfolio.

What we do is we measure our existing portfolio versus the overall benchmark indices, and then with our new ideas, run it through the process. The software answers questions like will adding a particular company lower or increase overall portfolio risk?

Now, we are not really concerned about tracking error, but if I can look at an energy company and I can look at a healthcare company, and I believe that both have the same expected alpha of, let's say, 20%, then which one makes the most sense to the overall risk of the portfolio. I think historically, many managers would look at the benchmark and try to match the weightings. We focus on adding the company that will lower the risk of the portfolio.

TWST: What are the differentiators that distinguish your mid-cap strategy from other firms? What are you bringing to the table that others might not?

Mr. Hammerschmidt: The one thing that we find our clients are interested in hearing from us is that we call ourselves inclusionary, not exclusionary. The average value manager will say, "I will look at companies with P/Es less than the S&P". They want to look at 16, 15, 14 P/Es, and so they narrow their universe of those 800 stocks to companies that have P/Es less than that of the indices. Then you have a growth manager out there who will say, "I'm looking for companies with IBES expected earnings growth rates of 18% or higher". And so, they will narrow my universe that way. We use an inclusionary approach. We look for companies that have the most positive characteristics of VQ&E. There are companies in our portfolios that look like traditional value stocks with P/Es of 6, 8 and 10.....and there are some companies in our portfolios that look like traditional growth stocks with IBES expected EPS growth rates of 18, 20 and 22.

Our other distinguishing characteristic is our commitment to Quality. We don't like companies with high debt. We have several measures of quality, and for us, the most important thing is that we mitigate risks in the portfolio by having the highest-quality stocks in there. Let me give you a quick example of that. If you went back to 1970 and you owned a portfolio of high-quality stocks you find today that your portfolio slightly outperformed a portfolio of low quality stocks, but you would have achieved those returns with one-third less risk! What our portfolios historically have done in the All Cap with its seven-year track record, and the SMID Cap with its eight-year track record, and now with this Mid Cap where we have been managing for two years or so, is that we really do tend to significantly outperform in down-markets. We like to say that we have our best defense on the field and that we win with defense. If the market goes down significantly, we tend to outperform there, and by preserving capital, we have a better base to start on when it heads back up, and as such, we tend to generate quite a bit of out performance that way. Now Marc Dent, my partner and our Director of Marketing, is going to say something to this.

Mr. Dent: Just real math. The proof of this quality bias in John's portfolio is certainly evident this quarter through September 5. John had outperformed the Russell Mid-Cap Value Index by 204 basis points, with a great downside capture ratio, consistent with our other products, and very consistent with our philosophy, approach, and process.

TWST: Do you see any potential problem areas or challenges ahead that investors should be wary of, particularly in your mid-cap arena?

Mr. Hammerschmidt: If you had asked us this a year ago, we would have said, we have some problems with the amount of leverage that's in the financial system and in banks, particularly. Now that this risk is finally finding its way into re-pricing itself in the marketplace, I still have real concerns about energy. My expertise, as I said, has been in energy for 20-plus years. I respect an \$80 oil price but there is a part of me that doesn't understand that price at all.

If you had asked me two years ago, I would have told you I thought we would be in the low \$50 range this year and as such, the premium that sits out there concerns me because it seems to have a real floor in that \$68 to \$72 level. And we are all aware that potential ceilings can burst whenever some extraneous international risk event takes place, whether they are problems in West Africa with governments or whether they are something as awful as we experienced back in 2001 in this country. Energy prices are a real concern to me. We could get some blips up through the \$80 level and as such I'm still very, very attracted to the oil service sector. Now, that said, I can be in love with the oil service sector but if the companies don't come through our VQ&E process then we will not invest in them. Our disciplines are such that this portfolio has got to be cheaper than the benchmarks, it has to have high quality companies because that's what protects us when we are wrong or if something happens that causes strong corrections in the marketplace. I can be as bullish as anybody in a particular company, but unless there is that underlying discipline we can't own it.

TWST: Is there anything that you'd like to add that we didn't touch on in this interview?

Mr. DENT: I think to summarize, at the end of the second quarter, we've painted a pretty descriptive picture as to where we thought the risks lie in the market. In this quarter, we've seen a lot of that come to fruition. As an investment manager with a philosophy, approach and process that's focused on quality and valuations, if we get into a situation where the markets really decline and they go down 20% or 25%, we've consistently seen those quality and valuation characteristics kick in and our portfolios go down less.

Now, with this great expansion that we've had coming out of the recession of 2001-2002, we certainly could see another slowdown in the economy over the next 6, 9, 12 months. If that occurs and the market starts to discount that, I think our strategies will certainly shine on the downside. And if not, and we continue to see moderate growth, the growth characteristics embedded in the portfolio usually do well. We find our clients use us as kind of an all-weather manager. We have good downside capture and good upside capture. If you stay with us over a three, five, seven-year period, investors typically are happy with the results.

Mr. Hammerschmidt: I would like to add that we may never be your client's top manager in any quarter because we don't dial-up the beta when we get bullish, and then

try to predict when the market is going to correct and pull it in. We have a fully invested mandate. We create portfolios with key risk adverse characteristics so that in full market cycles of three, four and five-years we gravitate towards the top of the manager's performance lists. We are a top manager in our All Cap and Smid Cap products and we see it building in this Mid Cap.

TWST: Thank you. (PS)