THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

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Understanding Large-Cap Stocks Beyond GAAP Valuation

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SECTOR — GENERAL INVESTING

TWST: Please tell us the history of Toreador Research and Trading.

Mr. Resendes: In many ways, Toreador was a demand-driven product. Dan Obrycki and I started a firm called The Applied Finance Group in 1995, and we developed a really nice research following. We work with about 200 investment houses globally. As we started to work with these shops, one of the things that started coming out was for a number of their smaller accounts, they were looking for a mutual fund that followed the same tenets that we use in our research process that they use to manage separate accounts. To address that need, about five years ago, we launched the Toreador fund, which is the first fund in the Toreador family. An international fund is in the works right now and should be coming out around June 1.

The core philosophy at Toreador is a process focusing and applying three key tenets for every investment decision that consistently lead to wealth creation and outperformance: number one, understanding a firm's economic, not just accounting performance through the use of The Applied Finance Group's Economic Margin concept; number two, rigorously assessing a firm's intrinsic value through a time-proven valuation framework, rather than relying on distortive naive multiples; number three, grading company management and avoiding firms that do not understand wealth creation and quality growth.

First, we do a very rigorous job scrubbing as-reported financial information, and one of the intellectual forces behind our approach is that we want to understand a company's economic performance rather than just its accounting performance. What I mean by that is that if you look at GAAP accounting, there are numerous rules, if you will, that really distort measuring the company's performance by just relying on net income. The first is for the typical firm, net income represents 40%-45% of cash flow, and when you go to the supermarket, I have never been able to buy eggs with net income. I have to buy them with cash. If you believe that ultimately cash is what drives value behind the firm, when you look at net income, it often times only captures less than half of what determines the firm's overall value. We peel the reported accounting statements back further and look at the very fundamental, but often ignored, value drivers such as: understanding how old the company's assets are; does the company have off-balance sheet assets and liabilities which the accountants allow companies to create through operating leases that increase corporate risk; and among other adjustments, how intensive are a firm's R&D activities, which accountants require companies to immediately expense.

In our era of intellectual property determining success and failure, GAAP's stance on R&D is particularly misleading for investors. For example, **Microsoft** (MSFT), **Google** (GOOG) and **Apple** (AAPL), don't expect to get paid back on the R&D in the year they invest. They invest today with a multiyear time horizon to recoup their investment. However, accountants require that you immediately write off the R&D — we fix that problem to get to understand how well a company is truly performing. That is why we viewed **Apple** as a value stock last year, while most of Wall Street focused on p/e ratios. So we go through a multistage process where we scrub companies and we clean up these various accounting distortions, and put every firm on a level playing field.

Second, we value every firm in our universe through a proven and comprehensive discount cash flow framework that explicitly incorporates a firm's competitive landscape, the legal/political environment and current tax regimes. Then, we start to look at how one company is doing compared to another and we value every firm. We estimate an intrinsic value for every firm based on a valuation process we develop that incorporates the effects of competition very explicitly, as opposed to saying we are going to go out three or four years and then slap a multiple on a firm, which basically assumes that nothing ever changes in the firm's economic environment. We incorporate these factors and look at the effects of competition with the notion that for companies earning higher rates of return, competition tends to drive those rates of return down to average, and for firms that are doing poorly, competition tends to force these companies to improve.

We capture this through a proprietary concept we call Economic Margin Decay. If you study decay rates over time, and globally, it quickly becomes apparent that valuations based on multiples are just silly, and explains why so few firms and individuals consistently assign reasonable values to companies, and instead use course generalizations — such as growth firms or value firms — when in fact growth is required to understand value. In the same way that **Google** has the best search algorithms, understanding intrinsic value is a unique advantage Toreador has over its competitors. This allows us to understand the future performance we are paying for a firm at any point in time.

For example in 2000, quality firms traded with very low future expectations embedded in their price relative to risky firms, and as the market became unstable and overvalued, they outperformed.. We witnessed something similar in 2007, as Toreador moved to buy safety and held that position through much of 2011. In late 2011, our fund made a very explicit decision to trade out of safety. Going into 2011, we owned names like **MCD** (MCD), **IBM** (IBM), **Clorox** (CLX), **Coca-Cola** (KO), **P&G** (PG), and others that served us well through 2010. Essentially, you could go down the list, and we focused on firms that were considered to be safe — very stable cash flows, low leverage, big firms, multinational presences. However, with the euro crises unfolding in 2011, these firms were consistently being overbought as everyone reached for safety, yields and low volatility.

Highlights

Rafael Resendes discusses the investment philosophy of Toreador Research and Trading and how the three key measures of economic performance, intrinsic value and company management are applied to investment decisions. He says the financial sector is where Toreador has the greatest percent of its funds allocated at the moment. Mr. Resendes also talks about how Toreador is moving away from buying safety in large-cap names, which was the winning play from last year. He has determined the more attractive risk/return opportunities significantly shifted in favor of riskier assets. Mr. Resendes says the firm is underweight consumer discretionary and staples side.

Companies include: Microsoft Corporation (MSFT); Google (GOOG); Apple (AAPL); McDonald's Corporation (MCD); International Business Machines (IBM); The Clorox Company (CLX); The Coca-Cola Company (KO); The Procter & Gamble Company (PG); Bank of America Corporation (BAC); MetLife (MET); Hewlett-Packard Company (HPQ) and Alpha Natural Resources (ANR).

If you look at what happened last year, the top-performing firms versus the bottom-performing firms, the top-quartile firms returned about 26%, whereas the bottom-quartile performer returned a negative 30%. The top firms were roughly two to four times larger than the bottom-performing firms market-cap wise. Again, there was a clear reach for safety. The top firms were half as levered as the bottom-performing firms. Top firms' dividend yield was almost twice as much as the bottom-performing firms and the Economic Margin of the top firms exceeded the bottom ones by a factor of three, with a third of the volatility.

At the end of 2011, however, when we sat down and we spotted the value, we found that, on average, the typical firm in the safe group had to grow its sales for the next five years at about 14% a year to justify their valuation, and the question we asked is whether such performance is reasonable or not. If you look at these firms, on average, over the previous five years, they have only been able to grow at about 6.8% a year. In other words, right now, because of the reach for safety, these firms would have to grow at about more than double what they have been able to do historically, and to us, while these are great firms, they were just too expensive.

After the crash in August, we explicitly started investing in riskier cash flows as the market had unreasonably punished firms with these characteristics. For example, risky cash flow firms were priced to grow their top line at about 4% a year whereas, historically, they have been able to grow at about 10% a year. When stocks can beat their expectations built into their price, they tend to do very well, and when they can't, they tend to underperform. That's what we saw back in 2000 with the tech bubble, expectations exceeded reality and we witnessed the tech crash. We believe we were in a bubble for quality, and investors were significantly overreaching, and as a result, we restructured our portfolio to take advantage of this.

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Some of the names that we own that I think are interesting are **Bank of America** (BAC). We made a big push into owning financials over Q4 of 2011. **Bank of America** is, I think, a really unique name in the sense of it probably has normalized earnings in the neighborhood of $2 a share. We expect that for 2012 it should earn maybe $1 a share. So in simple terms, has a p/e of 7.5 — after appreciating more than 30% this year — holding that constant with $2 of earnings, we believe investors will push its value to the low teens. Our estimate of its intrinsic value is approximately $15 a share, making it a wonderful buy-and-hold opportunity.

We estimate the downside risk to **Bank of America** somewhere in the neighborhood of $6 if the market gets really jittery again. We see the upside at $15 plus. For us, 100% potential return with 20% downside even assuming 50/50 odds is a great investment vehicle. We actively search for those types of risk return opportunities, and as a consequence, we've made **Bank of America** the largest holding in our fund.

By the way, the financial sector is where we have the greatest percent of our funds allocated at the moment. We have about 28% of our fund allocated to financials, versus a market weight of 14%, primary focused on the global banks and life insurers such as **MetLife** (MET).

1-Year Daily Chart of Bank of America Corporation

Chart provided by www.BigCharts.com

Another stock where we hold a big position is **Alpha Natural Resources** (ANR). This is another stock where risk is basically pounding this company's share price to absurd levels. There are so many concerns about slowing economies around the world, and in particular China, the demand for coal, hostility again from Washington with respect to dirty energy sources that the entire coal complex was traded down massively. With ANR, we have another firm where we are buying in which investors have priced in significant negative growth going forward. Even if the company just holds par with its current level of productivity and productions, we think there is an opportunity for stock to gain 50% to 100% in the next couple of years. Again we just like the upside/downside trade-off opportunities that this stock presents.

All three of the companies I've mentioned — **Bank of America**, **Hewlett-Packard**, **Alpha Natural Resources** — embody the approach that our fund takes when we look at companies. We are letting pockets of the market basically become overexuberant and overly depressed. Markets, in general, tend to be a bit psychotic with excitement and depression. Our goal is to analyze and act. We like to identify opportunities where the market has become unreasonably bearish. Those are the types of cash flows we like to buy. We like to buy cash flows where the upside versus downside opportunity to owning a claim on those cash flows going forward puts the odds of outperformance in our favor.

We've seen in January a clear appetite on part of the market shifting away from what we consider to be overvalued safe assets more toward cash flows or assets that have greater variability, and that's starting to show up all over the place in terms of relative performance year to date. I think what might be interesting is looking forward for the year, you may have a year where the S&P actually doesn't move that much because the megacaps, that tend to comprise the winners from last year, we believe those firms are poised to underperform. So you could have the megacaps dragging the index down, and yet, you could have a majority of the firms within the index actually doing well and generating positive returns above the overall index level because it is cap weighted. The index doesn't

We believe the environment for financials is unique in the sense of offering what I call upside regulatory surprise. I think for the last three years, we've had a regulatory environment very hostile to financials from headlines to Washington's desire to capitalize on such sentiments. I think that environment will change. It is obvious an economic recovery will not reach its full potential with government at war with banks. Based on what happens with the election, if you have a regime change in Washington, I think, firstly, you have an opportunity for significant upside in terms of more favorable financial regulations. I don't think that is at all reflected in the multiples or the expectations the market is putting out for these firms. Should the government stay as it is, then it is likely the economic environment has at least stabilized, and banks will likely be a big winner from such a development. Again, this bet has those asymmetric return properties we seek.

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Another stock that we aggressively moved on and positioned in our portfolio last year is **Hewlett-Packard** (HPQ). When they had all the uncertainty concerning the company, we believe the stock was unduly punished. When they traded down into the 25, we snapped that stock up, and again, just as a point of reference in terms of how that company is priced, **Hewlett-Packard** we expect to grow in the area of 2% to 3% going forward. But right now, investors are basically pricing the company as though it's going to shrink at 10% plus a year. The market basically is saying **Hewlett-Packard** will be half of its size five years from now. We believe we have a lot of room for upside in that forecast.

1-Year Daily Chart of Hewlett-Packard Company

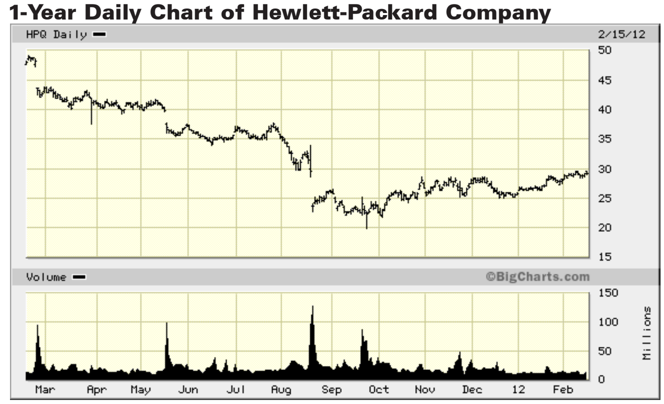

Chart provided by www.BigCharts.com

show much excitement for the year yet, intraindex, there could be a lot of churning taking place that may catch a number of money managers by surprise as the year goes on if they blindly adhere to buying safety, which was the winning play from last year.

TWST: So you constantly reevaluate your positions. What is going on in the market?

Mr. Resendes: That's exactly right. What investors buy with our process is the constant evaluation of future cash flows to figure out what assets are trading at the greatest discount to their ability to generate cash

From 2008 through most of 2011, the fund was concentrated in safer assets. We basically owned the larger, safe megacap stocks. After the crash that started in the summer and then culminated with dramatic

1-Year Daily Chart of Alpha Natural Resources

Chart provided by www.BigCharts.com

"So while such cash flow safety is nice, it is only valuable until the company reaches a certain price, after which, such a firm turns into what we call a great firm, but poor investment."

selloffs in August, we determined that the more attractive risk/return opportunities significantly shifted in favor of riskier assets.

At the fund level, we rotated out of safety and began putting on positions on companies that had less certain cash flows. **McDonald's** is a fantastic company. You can't ask for a better-run firm than that, and we owned it for years, but it is priced to grow at a level it is unlikely to deliver, and thus, poised to underperform going forward, we believe. So while such cash flow safety is nice, it is only valuable until the company reaches a certain price, after which, such a firm turns into what we call a great firm, but poor investment. It's going to be very difficult for **McDonald's** to sustain its valuation, and you can run down the list of top performers last year where that's the case.

TWST: Why do you focus on large cap?

Mr. Resendes: We launched the large-cap fund as our first endeavor because that's the area where our clients asked us to create the process. Our smaller clients wanted one core product where they didn't have to deal with a lot of asset-allocation issues. What we continue to hear is, "We'd like to have an international vehicle as well," and so that's why we launched, at least have legally started putting this international fund in place. And then the last vehicle that will kind of round out our portfolio, so to speak, will be a midcap fund.

TWST: Your sectors are weighted to S&P 500, is that accurate?

Mr. Resendes: That's mostly correct. The general tendency of the fund is to be sector neutral to the S&P 500, unless we see glaring disparities. So right now, we are overweighed on the financial side, we are underweighed on the consumer discretionary and staples side. That really reflects that bias that we've seen where stable cash flows — i.e., consumer discretionaries and staples — have been extraordinarily bid up and riskier cash flows — i.e., in the financial sector have been disproportionately beaten down or discounted, so to speak.

TWST: What is your typical day like managing the fund?

Mr. Resendes: I think a typical day depends on who is reporting, how they report, what are investor appetites. It is really hard to describe a typical day. Some days, we receive multimillion dollar cash infusions that have to be invested. Some days, we receive cash withdrawals — companies are reporting, causing us to update our expectations on the firm based on guidance that management is giving or new macroeconomic information that we receive. That's one of the things that makes this job so enjoyable, in my mind at least, that there is no real typical day.

It's constantly reassessing information, understanding where things are in the marketplace and putting your beliefs up against those of the collective, so to speak. That's one of the other aspects of the job that I think is so rewarding, is that you mark yourself to market everyday. So on a very micro level, you are getting daily feedback as to how your investment theses are playing out, and over larger periods of time, you definitely get complete validation of how they played out.

One of the things that makes our job at Toreador not easy, but certainly much more likely to deliver the types of returns our clients desire, is that we are very process oriented. We have a process that begins with evaluating the accounting information as we get it, we convert it to an economic framework, we value companies, and we then score management teams. This leads to a consistent approach to searching out investment ideas rather than relying on that "one big bet" that process-poor managers and organizations tend to emphasize.

When Apotheker was running **HPQ**, as soon as Hurd left **HPQ**, we sold the stock just because we thought Hurd did a fantastic job running the company, and we thought the company was a little bit pricey at the time and subject to downside surprise. In our minds, losing a CEO that had run the company so well is definitely a catalyst to sell. Our view proved right as Apotheker took over and fumbled with strategy and execution, and according to how the stock was ultimately priced, ran the company into the ground. The company simply needed a good manager to realize the value of the assets in place. When Apotheker was fired and Whitman hired, we liked the risk/return opportunities in the stock, and bought the stock. It was unusual for us to have rebought the stock so quickly after having sold it, but it was an unusual set of developments for such a large-cap company. I think this will be an interesting case study of management and value creation. We believe Meg Whitman brings a lot of great management skills to the table that will unlock the value in **HPQ**'s assets.

TWST: What is the best advice you would give investors right now?

Mr. Resendes: I think as an individual, one of the hardest things that happens in the investment process, and behavioral economics is really flushing these issues out a bit, is that there are so many systematic biases that people make. People put so much information on recently obtained data. In others words, if fund "XYZ" is doing well over the last year, they project that it will continue to do well rather than thinking about what is this fund doing or what's the process that the fund undertakes. When economic times are good, people believe that they tend to last forever, and when they are bad, they tend to believe they last forever. In other words, individuals tend to extrapolate too much from current information into the future rather than thinking through the fundamental forces as to what's giving rise to these things.

For example, 2000 was a horrible time to own stocks, and if you look at the expectations priced into the market, then you would see that at an aggregate level, the market was demanding sales growth that companies would never be able to deliver. For the opposite extreme, go to March 2009. At that point, people had become so bearish, you could buy the S&P with the expectation that the typical firm in it would be 40% smaller five years into the future. Unlike 2000, March 2009 turned out to be a generational investment opportunity. To me, those are the really interesting opportunities in the marketplace.

Absent those extremes, the best thing investors can do is create diversified holdings, have some exposure internationally, have some exposure to the large-cap sector, have some exposure to the midcap sector and systematically put your money away. Trying to time and trade the extremes, while great for talking heads on TV to discuss, just becomes very difficult as you are usually late and tend to get whipped around emotionally and miss the boat. But if there is only one piece of advice to take from this interview, it goes without saying that the Toreador Large Cap Core Fund should be a part of that exposure, and eventually, the world takes care of itself.

TWST: Thank you. (LMR)

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