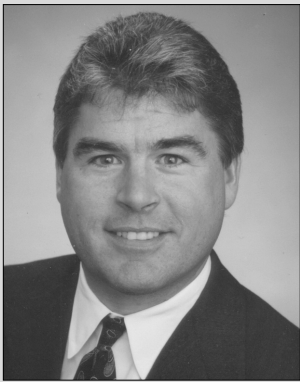


THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

Check Capital Management



STEVEN CHECK founded Check Capital Management in 1987 and Blue Chip Investor Fund in 2002. As Check Capital's Chief Investment Officer and the Fund's Portfolio Manager, he is responsible for overall investment policy as well as the decisions that implement that policy. Mr. Check describes his style as "growth at an unreasonably low price" — an approach that owes much to the insights of Warren Buffett (whom he regards as the dean of American investment philosophy). Mr. Check also serves as editor of the nationally respected newsletter, *The Blue Chip Investor*, which, like his firm and Fund, focuses on underpriced stocks of blue chip growth companies. An advocate of applying engineering principles (such as rational problem-solving and ensuring a margin of safety) to the field of money management, Mr. Check holds a BS degree in Electrical Engineering from Iowa State and a Master's in Engineering from the University of California, Irvine. He lives with his wife, son and daughter in Southern California, where he is a golfer and dedicated long-distance runner. Mr. Check frequently competes in marathons and considers the discipline, individualism, energy and endurance necessary in running to be equally valuable in the long-term management of investment portfolios.

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TWST: Tell us about your firm and Blue Chip Investor Fund.

Mr. Check: Check Capital Management is a 16-year-old firm whose clients are primarily individuals and whose equity assets topped \$300 million near the end of the last decade. We manage individual accounts and a mutual fund called Blue Chip Investor Fund. Managed-account clients give us, on average, \$400,000-\$500,000 to invest; those who can't meet our \$250,000 account minimum place their assets in the Fund. We invest using a prudent, loss-averse approach. Prior to opening a managed account, Check Capital's representatives generally meet with individual clients to discuss investment time frames and what exactly, to us, constitutes appropriate stock market investments. The point is to ensure that assets placed under our equity management are considered by clients to be "longer-term" — that is, assets committed for three to five years. As for those placing money in the Blue Chip Investor Fund, since we

can't meet them all individually, we maintain a fund website specifically designed to educate and keep them informed.

Some managed-account clients approach us with assets that don't have the proper time frame for stock market exposure, meaning money that must be accessed on an ongoing basis to pay living expenses. We assist these clients by setting up a bond portfolio ladder to produce income as they need it.

TWST: What are the characteristics of the companies that you're looking for?

Mr. Check: We generally stick with stocks of blue chip growth companies. They're usually industry-leading businesses with minimum earnings of \$100 million a year. Most of the stocks are large cap, although in fact around 30% would be considered mid-cap names. These are success-story companies, corporations that have been around a long time — 10, 20, 30 years. They're generally dominant in their niche or industry, with clear indications that they will continue to do well.

TWST: How does volatility in the market impact your investing?

Mr. Check: It has very little impact whatsoever. As I stated earlier, the money we manage that is committed to equities is longer-term money, so our clients aren't forced to sell at low prices in order to meet the daily costs of living. Thus, market volatility barely touches us. Actually, volatility (especially the downside) in the market probably helps us in the long term, because the companies that we invest in generally repurchase their stock. In a depressed market environment, this repurchasing can be done at lower prices, which quite often benefits earnings per share in the future.

TWST: Have you shifted the emphasis of your investing at all in the face of bear-market conditions?

Mr. Check: No. We've remained steadfast in the face of influences that have convinced many other managers to question virtually all their prior assumptions about the market. Over the years we've stayed the course with what is genuinely a conservative, long-term investment philosophy. In the late 1990s, when most people were interested in technology stocks at very high valuations — and it was enormously tempting for money managers to go that route — we withstood that temptation. As a result, we didn't lose money in the ensuing tech crash. Using exactly the same set of principles, there's no need to change what we're doing in the current environment.

In a down market, there *is* one thing we do differently. We have discussions with our clients regarding adding money, if possible, to their stock portfolios to exploit the bargain-pricing of so many issues.

TWST: What is your investment decision-making process? How do you screen down to find the companies that you want to invest in?

Mr. Check: First, we identify companies that are earning \$100 million in profits. There are about 600 such companies in the United States. Then we look at the historical characteristics of those earnings. We want to find companies that have grown their earnings in a consistent way over, say, a 10- or 20-year period. Third, we drill down on the rate of growth. We generally focus on companies where the expectation is that they'll be able to continue growing their earnings at double-digit rates.

Once we've employed those screens, we're left with roughly 175-200 companies. Then we'll take it a bit further and a bit more subjectively. We recognize that we're looking at unqualified successes in terms of the past 10 years, but what are the chances of these companies *remaining* successful over the next 10 years? If they're in a fast-changing industry like technology, we're doubly reluctant to assume that they will still be leaders in 10 years. I'm not suggesting that we reject all technology companies, just that we remain exceptionally careful.

In addition to inspecting earnings statements, we review cash flow statements. It's one thing to have good earnings, but it's quite another to have substantial *cash* earnings. When we consider

buying a stock, we always see ourselves as becoming part-owners of the business (which, in fact, is true of stock ownership). We ask ourselves whether, if we could buy the entire company, it has the particular attributes of a firm we'd want to own, and, if so, would we want to buy it at the current price.

With this business-ownership mindset, we're much more interested in cash earnings than accounting earnings. If a large percentage of earnings must regularly go toward maintaining plant, equipment, etc., that's not nearly as favorable as when the earnings are free to be paid out to the owners.

So, ultimately, we end up with only 140-150 companies that we think are of sufficient quality to buy — *if* they're available at the right price. Thus, we must continuously monitor the fundamentals of each prospective "buy," showing the patience and discipline to wait for that ideal price.

TWST: Is it strictly a bottom-up process or do you do any top-down work in industry and sector analysis?

Mr. Check: We're aware of what's going on in industries, in the market and with the economy. But largely it's a bottom-up approach. We look at the market stock by stock or company by company. We note whether companies are facing a headwind or riding a tailwind. We're often significantly weighted in certain industries, but not by design. It's just that we often find the best value in a certain area of the overall market. So our approach is generally thought of as bottom up.

TWST: How diversified is the Blue Chip Investor Fund and how many stocks do you generally have in the Fund?

Mr. Check: It is, according to the SEC, an undiversified fund. We try to keep the number of holdings at around 20-25. So it's fairly focused relative to other mutual funds. But contrary to the logic on Wall Street, we've always believed diversification was more effective at reducing returns than preventing loss. The Blue Chip Investor Fund, like our managed accounts, follows a simpler logic: find the very few blue chip companies that have defied the odds (and their size) by remaining innovative, competitive, driven. If there are only a handful of such firms available at a reasonable price, those are the stocks you hold.

TWST: What about p/e ratios? How do they figure into your methodology?

Mr. Check: We like companies whose stock p/e's are between 10 and 18, which is quite attractive. Instead of p/e, though, we prefer to think in terms of *earnings yield*, or "e/p." If the p/e is 14, the earnings yield is 1/14 or 7%. 7% is attractive relative to what one could make today in a money market fund or bond. Thus, it makes sense now to own stocks with such a high earnings yield rather than devote assets to interest-bearing investments. There are always at least a handful of industry-leading firms whose stock e/p's make them worth considering for immediate purchase.

TWST: What triggers an exit? Tell us about your sell discipline.

Mr. Check: On the buy side, we have a point at which we think the stock is attractive for purchase. On the sell side, we have a similar point where we intend to take profits. I should point out that, on the buy side, we might get one chance every five, six or seven years to purchase the stock of a company that we follow. So opportunities don't come often. After we buy a stock, it's usually a two-to-three-year hold for us. The sell price is also based on valuation. Provided company fundamentals remain intact, there's a point above which one would certainly be overpaying for a stock. We try to sell at those points.

On the other hand, if the fundamentals of a business we own deteriorate, we will often sell rather quickly. We work hard to identify companies that are unlikely to experience negative earnings surprises. However, there will always be some. In my experience, you're generally better off erring on the side of selling quickly versus waiting for fundamentals to get better. Management will always be optimistic that they can turn things around in one or two quarters, but, in my experience, it often takes much longer.

TWST: That brings up the question of management. Does a portfolio of 20–25 companies enable you to keep closer tabs on management performance and credibility?

Mr. Check: I don't know how a fund portfolio manager can intimately follow 100-200 holdings; it's tough enough to closely track the 20-25 companies that we own. However, the Internet has made following fundamentals easier. The SEC's EDGAR database, for example, contains a wealth of information. This information is available through several user-friendly websites. So the answer to your question is yes, a smaller fund does mean we know our holdings better.

TWST: How do you control investment risk?

Mr. Check: We control investment risk upfront by making sure that our clients' asset allocation is prudent. There are no guarantees in the stock market, but the market is, ultimately, always rational. If the earnings of a business grow X% over 25 years, the stock will increase by a similar percentage. Stock prices and earnings converge over the long term. Over shorter periods, though, there's less of a correlation. Initial stock valuation has a large impact on returns over spans of less than five years. Nonetheless, if you buy a stock of a good company at a good price, there's nothing to prevent the stock from declining 30% or more in the short term. However, the price will eventually gravitate toward the intrinsic value of the business. Actually, there are market forces that dictate this.

We don't use stop losses or anything similar. We simply try to ensure that we have enough time for a stock to recover if it initially drops after our purchase. It's very unusual for a stock bought at a depressed price, where earnings growth remains relatively consistent, not to produce a meaningful profit over three to five years. So we reduce risk by buying exceptional companies at attractive prices, and then we give ourselves enough time for the stock to perform.

TWST: What type of investor do you have and what are their concerns and expectations at this time?

Mr. Check: Our average client is about 60 years old. Roughly half our clients are retired. If they're retired, they're often living off their assets. It's a significant responsibility to manage such people's assets and that responsibility remains foremost in our minds. Therefore, we're not trying to "win the Wall Street game." We're dealing with people's life savings. Our first duty is to ensure that these hard-earned savings will provide clients with what they hoped for: a comfortable retirement. Again, that starts with the proper asset allocation and prudent investing.

While remaining cognizant of this responsibility, we also strive to achieve good performance. It has been my observation in looking at successful, enduring money managers that they're usually the ones who lose the least amount of money. Consider that again — the best managers *aren't* those who hit the most home runs but the ones who have relatively few losing trades. Our approach is consistent with this, and we hope that our 20-to-30-year track record shows we not only outperformed the market but did so in a relatively risk-intolerant way.

TWST: How important is tax efficiency to your Fund?

Mr. Check: Our typical holding period of two to three years naturally plays into tax efficiency. Our taxable gains are usually long-term capital gains. Besides consciously trying to take long-term gains, we don't let taxes dictate our investment approach. We find little or no value in holding stocks up to a decade to delay taxes when the consequence is suffering subpar performance.

TWST: When you sit down with potential investors, what are the key reasons you give them to invest with you? What do you bring to the table that other money managers don't offer?

Mr. Check: I think we bring an unusually rational approach to investing. Proper investing largely comes down to common sense and the discipline to adhere to a well-researched methodology. There are pressures on Wall Street continually tempting asset managers to do the wrong thing so as to look better in the near term. What we bring to the table is the discipline, diligence and conviction to shoot for lasting success rather than immediate gratification.

Regarding our methodology, we're entirely open with prospective clients. We first explain our "growth at an unreasonably low price" philosophy and show how our methodology puts that philosophy into action. Then we get down to the details of how we identify the companies that comprise our universe and how we calculate buy and sell prices. We're often told that we're unusual in how thoroughly we "educate" prospective clients.

Something that makes us nearly unique among money managers is the fact that we offer two choices of management fee schedules. One choice is the industry norm: an annual fee of 1% of account assets. Our second choice, available to accredited investors, is a fee based on the account's profits. Under this arrangement, we charge the client 10% of profits, billed annually. If there are no profits, we don't get paid. Many clients hire us under this arrangement.

TWST: What advice would you leave with investors today who are thinking of buying stocks? Is it a stock-picker's market?

Mr. Check: To a large extent, I *always* think it's a stock-picker's market. Even if it doesn't appear to be that way at any particular moment, stock-picking (within a well-reasoned framework) is ultimately what separates the better investors and managers from the crowd. The fact that the stock market is inevitably rational is comforting. The time frames, though, aren't always convenient. Investors need to intimately know what they own, be careful regarding the price they pay and have the patience to wait for their intelligent planning to pay off.

TWST: What are your goals as a manager and what is it that you want for your clients?

Mr. Check: I'm a relatively young money manager in my forties, but I've been professionally managing my own and other people's money for the better part of two decades. I plan to be doing this indefinitely. My personal goal is remaining aware that however successful I become, I have much to learn. As for clients, I'll continue to help them with their investment needs, provide them with sensible financial advice, and try to deliver the kind of returns that *they* judge to be worthy.

TWST: Is there anything that you would like to add to give a better picture of your views?

Mr. Check: Investors should look beyond short-term "macro" events when they're buying a stock. You can always find reasons to worry or not to buy. If you were looking to buy a local business in your community, you'd determine the long-term financial prospects of the business. You'd be aware of political and international events, but in most cases they probably wouldn't have a material impact on whether you'd buy the business. One should take that same approach to stock investing.

Also, when investors read or hear investment advice, they should research the giver of that advice. You want to discover if recommendations are coming from someone with a good, long-term, verifiable track record. In other words, you must prove to yourself that the person is worth listening to.

TWST: How do you obtain your research, Steve?

Mr. Check: Our research is done in a grassroots manner. I own shares of each of the 150 companies in our universe. We review all the annual reports. We listen to conference calls with management. We monitor what management is doing with company resources, such as free cash flow. We don't rely on Street research.

We do note what other successful money managers are doing. We might see something that they're buying and that may give us an idea. But ultimately, we live by our own convictions. Everything we do fits within our intricately constructed model.

TWST: Are you always fully invested or do you raise cash?

Mr. Check: We're often *not* fully invested. However, we never intentionally raise cash, because that would be a function of trying to time the market, which we know is a fruitless endeavor. We end up with cash in our portfolio when we sell a stock and can't find attractive reinvestment opportunities. We'll sit with cash as long as it takes for something that fits our criteria to come along.

Even in a depressed stock market, where good values abound, it may take us a long time to become fully invested. If your goal is to own 20 stocks, and you can only find 10 that meet your criteria, there's nothing wrong with waiting for the others. In fact, that is what you *must* do. While others give in to what seems to be a relentless urge to be fully invested, we submit to only one urge: to invest with unwavering discipline.

TWST: Thank you.

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