Lateef

INVESTMENT MANAGEMENT

We strive to build a portfolio of "Rembrandts and Monets"—unique treasures with enduring value acquired at attractive prices.

Introduction

Founded in 1974 by Khateeb A. Lateef, Lateef Investment Management, LP, provides professional portfolio management to individuals for taxable and retirement accounts, and to corporate pension plans, charitable foundations, and academic endowments through separately managed accounts.

There are seven primary ways in which Lateef differs from other investment management firms:

- We focus on absolute returns, and have an excellent track record of preserving capital and outperforming the S&P 500 with less risk.
- Our investment process is research intensive, clearly defined, and has been consistently applied for over 30 years.
- Our investment team has over 100 years of portfolio management experience.
- Our opportunistic investment approach provides flexibility to take advantage of ever changing market conditions.
- Our portfolios are concentrated.
- We focus on the long term.
- Lateef team members are invested heavily in the firm. We prosper only if our clients prosper.

Our goal is to preserve and grow capital for our clients at a rate superior to market averages on a long-term basis. We do this by buying and holding outstanding businesses with a sustainable competitive advantage led by an owner-oriented management team of high integrity. Then we patiently wait to buy these companies when they are at a price below their intrinsic value. We limit risk by relying heavily on our own intensive research and collective experience.

Our goal is to provide financial peace of mind for our clients by generating superior investment returns while minimizing risk through our intensive due diligence, unwavering methodology and steadfast dedication to quality and integrity.

The Lateef Team

We are dedicated to providing our clients with superior investment results, timely and compliant reports, and responsive and professional client service. Lateef is led by the Executive Committee of Founder K.A. Lateef, Chief Executive Officer Ryan Willson, and Chief Operating Officer/Chief Financial Officer Justus Leachman. Functionally, we are organized into three areas: Portfolio Management, Operations and Compliance, and Client Service and Marketing.

Portfolio Management Team

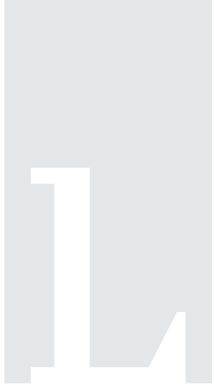
Our Portfolio Management Team has over 100 years of collective investment experience. All research and portfolio management decisions are made by the team, then implemented across all client accounts. Together, we decide which stocks are owned in client portfolios. Our team-based structure is built on the foundation of a clearly defined investment process which includes 25 distinct investment criteria and a strict pricing discipline. The team consists of Khateeb Lateef, CFA, Scott Chapman, CFA, Quoc Tran, and James Tarkenton, CFA.

Khateeb Lateef, CFA, founded Lateef Investment Management in 1974. Prior to forming Lateef Investment Management, he was a General Partner at Hambrecht & Quist as Research Director since 1970. In 1964, Mr. Lateef joined Glore Forgan, Wm. R. Staats, Inc., which later merged with FI Dupont. At the time of the merger, Mr. Lateef was Vice President and voting stockholder in charge of West Coast research. In 1959, he joined the Trust Investment Department of the Bank of America as a securities analyst. He received his BS degree from Fordham University.

Scott Chapman, CFA, MBA, joined Lateef Investment Management in March, 2002. Previous positions included Senior Portfolio Manager, Director of Large-Cap Growth Strategy, and Research Director at Dreyfus Founders Asset Management, and Senior Portfolio Manager and Director of Growth Strategy at HighMark Capital Management where he earned a five star performance rating by Morningstar. He received his BS degree from Santa Clara University and his MBA, Finance, from Golden Gate University. Scott taught investment principles to CFA candidates in San Francisco for seven years.

Quoc Tran, MBA, joined Lateef Investment Management in November 2005. In 2002, Quoc joined Wallace R. Weitz & Co. as Head of Private Client Services, Portfolio Manager, and Research Coordinator/Analyst. There, he contributed to the management of over $8 billion in client assets, personally managing and generating superior returns for institutional and high-net-worth family accounts. Previously, he spent five years at Goldman Sachs and Co. as an institutional sales professional, leaving the company as Vice President and Director in the Equities Division. He received his BA degree from Bates College and his MBA in Finance from the University of Chicago.

James Tarkenton, CFA, MBA, joined Lateef Investment Management in June, 2008. Previous positions include Managing Member and Portfolio Manager at RBO & Co, LLC, Vice President and Senior Research Analyst at Oak Value Capital Management, and Senior Research Associate at Cambridge Associates. James received a BS in finance from Virginia Commonwealth University and his MBA with honors from the University of North Carolina at Chapel Hill.



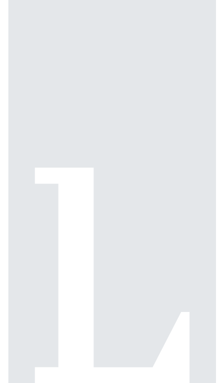
Operations Team

The Operations Team is led by Chief Operating Officer/Chief Financial Officer Justus Leachman and consists of specialists in three functional areas: Investment Operations, Compliance and Trading. The Investment Operations and Compliance professionals ensure that our books and records are maintained in compliance with federal and state regulations and that our clients' portfolios are reconciled with the custodians' records. The Traders work closely with the Portfolio Management Team to implement and execute investment decisions across our clients' portfolios.

Client Service and Marketing Team

Led by Chief Executive Officer Ryan Willson, the Client Service and Marketing Team's goal is to provide financial peace of mind for our clients. We educate prospective clients about our process and philosophy to help them evaluate whether the Lateef investment style is appropriate for their individual objectives. Our approach to investing is focused on the long term, and we take a similar approach to our client relationships. We make ourselves accessible and responsive – whether a client has been with us for three months or thirty years. Our clients receive quarterly letters discussing our investment strategy and the general market environment, along with a statement of individual portfolio holdings.

Our firm has been structured in such a way that our interests are directly in line with those of our clients, and we do our utmost to assure that every relationship is a long and prosperous one.



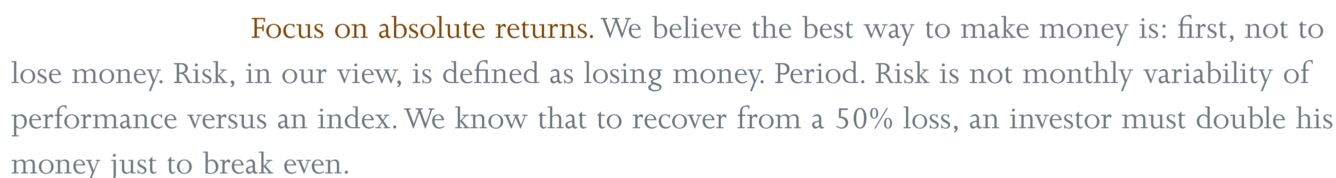
Investment Philosophy

There are 7 pillars of our investment philosophy which form the foundation of our investment process.

Long-term perspective. We view investing as a marathon, not a series of sprints. We prefer to be measured over a five year horizon but believe that three years is a minimum for judging our performance. The great-grandfather of investing and Warren Buffett's mentor, Benjamin Graham, observed, "In the short run, the market is a voting machine (influenced by popularity), but in the long run, it is a weighing machine." Stock prices in the short run may react to world news, rumors, analyst recommendations, forced selling by institutional holders facing redemptions, or speculative buying by momentum-driven investors – all of which has little to do with the underlying ability of the company to continue generating cash flow or its related underlying value. In the long run, however, stock prices track closely with earnings and cash flow. For example, McGraw Hill stock has returned 11.6% per year for the 30 years ended April 2006, compared to the 11.7% compound return for its earnings.

Stocks represent an ownership interest in a business. Because stocks can be so easily bought and sold in computer-generated trades, many are tempted to treat them as faceless trends on a chart. At Lateef, we view stocks for what they are: an ownership interest in a business led by managers who view us as co-owners. We do not sell a company just because news headlines trumpet a macro-economic or political concern. We do not use market timing tactics. We do not move to cash, use derivatives, short stocks, hedge, or use arbitrage. We focus on the business fundamentals that dictate the ability of the company to generate higher cash flow and a related higher intrinsic value.

It has been said that there are many ways up the investment mountain. We would like to be clear as to why we have chosen the investment path that is suitable for us in order for you to determine if the journey is compatible with your own goals.



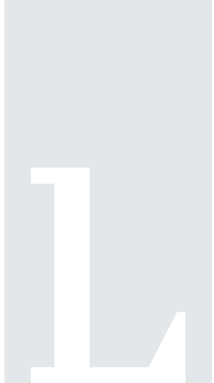
Focus on absolute returns. We believe the best way to make money is: first, not to lose money. Risk, in our view, is defined as losing money. Period. Risk is not monthly variability of performance versus an index. We know that to recover from a 50% loss, an investor must double his money just to break even.

There are two risks that we try to minimize: price risk and business risk. Price risk is the risk of paying too much even for a terrific company. For example, investors who bought General Electric in 2000 were still underwater by almost 50% in 2006, even though earnings almost doubled during that six-year period. Business risk is the risk that the competitive advantage a company once enjoyed will erode or crumble altogether, resulting in a permanent loss of capital. We invest a great deal of time in order to assure ourselves that competitive barriers surrounding the businesses we invest in are high, and that the prices we pay include a margin of safety to minimize downside risk.

Stock prices do not always equal value. We are sometimes asked if we employ a stop-loss limit on our investments. A stop-loss rule has been used by some investors as an insurance policy. For example, if a stock drops by 20% from cost, they automatically sell so they still have 80% of their capital. They sell for fear that the stock might drop much further, but panic selling locks in losses.

At Lateef, we try to understand what is causing a stock to drop in price. Intrinsic value is a relatively stable estimate of what a business is worth based on its discounted future cash flows. It is not uncommon for a stock to vary by as much as 50% from its high and low price within a year. We try to capitalize on the inevitable disconnect between a company's intrinsic value and its stock price.

Opportunistic investment approach. We believe in investing in the most outstanding businesses led by terrific managers at attractive prices – regardless of the size of the company. Many other money managers are locked into a "style-box," such as large-cap growth or small-cap value, and must remain invested in this box even when there are few or no compelling values in that segment of the investing universe. Our ability to preserve capital during the challenging years of 2000–2002 was a direct result of our flexibility to invest where it made sense to do so. In March of 2000, the Value Line index of 1,500 equally weighted companies (more representative of mid-cap companies) was trading at 13x earnings, compared to the S&P 500 index (market-cap weighted and dominated by large-cap companies), which was trading at 30x earnings. Clearly, the opportunities were in mid- to smaller sized-companies, and we made the switch.



Concentrated Portfolios. We are conservative without necessarily being conventional. Our portfolios typically have between 15–20 companies. This focused approach has three clear advantages. The first advantage is that our winners make a real difference in performance. If a stock doubles in a portfolio of 50–100 companies, the impact on performance will be small. While concentration can be a double-edged sword, our track record has proven that carefully selected companies bought at prudent prices with limited downside risk can result in sound portfolio performance with less volatility than the market. Although our portfolios are relatively concentrated, we rarely own more than two stocks in the same business. The second advantage is that our focused approach allows us to leverage our intensive research into our very best ideas. Warren Buffett has said, "Diversification is a hedge for ignorance." The third advantage is that our long holding period generally results in a good relationship with management, which is important to us as we prefer managements that think of investors as business partners.

Low portfolio turnover. Our annual turnover averages about 25%, which means that we hold stocks for about four years. This turnover reflects the ongoing process of trimming oversized weights and selling certain stocks in favor of more compelling ones availed by normal market volatility. A 25% turnover in a 15–20 stock portfolio means that all we need are three to four new ideas per year. This allows us to wait patiently for the most attractive opportunities. Furthermore, taxes can be one of the greatest obstacles to building capital, and our low turnover produces attractive after-tax returns.

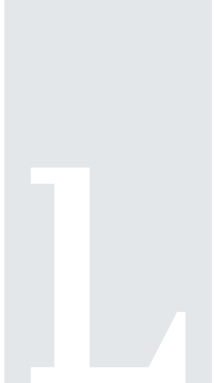
Portfolio Management Process

Our objective is to discover outstanding companies with sustainable, high returns on capital and open-ended growth, then to buy them at a "value" price. Although our investment process is relatively uncommon, it is the same process practiced by all of the portfolio managers at Lateef throughout their careers, and now polished by our collective experience.

Our Source of Ideas: "Many are called but few are chosen."

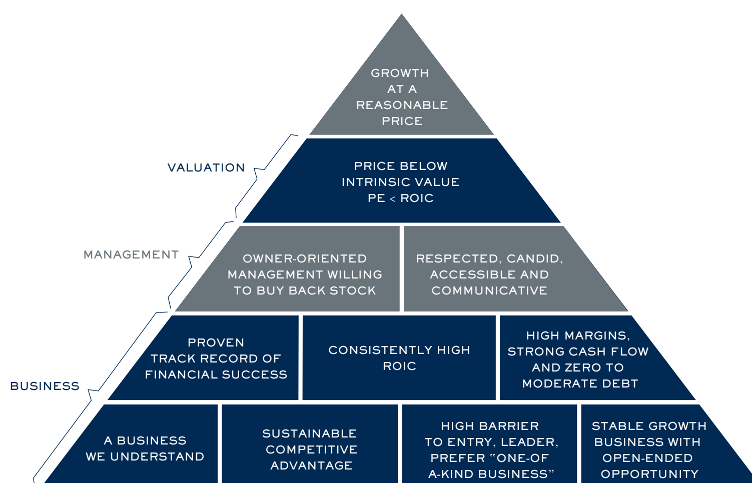
We actively monitor a Lateef universe of about 60 companies that have met our quality criteria, and we assess them daily for attractively priced entry points. A company is purchased only after each portfolio manager agrees that the company has met at least two-thirds (or 17) of our 25 investment criteria. Our investment candidates come from a variety of sources, including discussions with company executives about their respected competitors, suppliers, distributors, and customers. They may come from industry periodicals, industry trade shows, Wall Street investment conferences, Wall Street research, and our colleagues in the industry. We also frequently check the new low lists, and we review data-rich publications such as Value Line. We don't use a "black box" computer to screen for ideas, as our experience has shown this to be a "rearview mirror" method of discovering companies that are often at their cyclical peak. We have mentally screened hundreds of companies in our careers and have ruled out those which have cutthroat competition, are heavily regulated, have a principal product subject to commodity pricing, are capital intensive, or have a short product life cycle. In today's world, where data is only a few clicks away, the challenge is not in obtaining information, but in transforming information into insights and knowledge that meet our criteria.

Our investment process is research intensive, clearly defined, and has been consistently applied for over 30 years. This process is focused on one carefully crafted investment process. Our investment style, "Growth at a Reasonable Price," embraces elements of both the traditional "growth" and "value" approaches to investing.



Our Process for Evaluating a Company

The heart of our investment process is the initial evaluation and ongoing monitoring process of investments. It is the lifeblood of what we do. The following Pyramid of Growth illustrates the essence of our core criteria. Although we have 25 specific investment criteria, they boil down to finding a company with a sustainable competitive advantage and high return on invested capital (ROIC), led by an owner-oriented management team of high integrity, and a track record of success, whose stock is trading at a reasonable or bargain price.



The Pyramid of Growth

We rely heavily on our own intensive fundamental research. We visit with the management of the companies in which we invest on their home turf and build relationships with them over the years. We enjoy the "tire kicking" process, and believe the time and effort is worth the reward of a better understanding and deeper conviction in the company and its people. Once managements meet us and realize that we are interested in longer-term strategic and competitive positioning issues, they are often open, responsive and communicative with us. We prefer managements that are accessible, especially when the inevitable rumors or specious analyst downgrades affect the stock price. We need a direct and expedient line of communication to discern truth from misconception to be most effective for our clients.

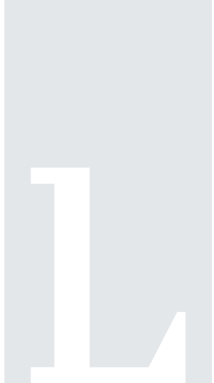
The Process of Getting Invested: "We treat your money as if it were our own."

Our accounts are separately managed and our focus is on absolute returns. Consequently, we will only invest when we believe the company's market price is attractive compared to its intrinsic value. For new clients, this process may take just a few days – if there are many opportunities in a bear market – or several months, in a bull market. We would rather take our time in making the right choices to limit downside risk than have to apologize later for losses because we responded to an urge to get invested right away. Risk, in our view, is the risk of losing money. We do not define risk as potentially falling behind a bull market benchmark for a few months while the cash is getting invested.

We invest each account individually and do not manage on a "model." Managing accounts on a model means that every account is fully invested on the first day and holds the same stocks. Lateef does not manage accounts in this way because we feel that it is imperative to not only buy outstanding companies, but it is equally important to buy those companies at the right price. Therefore, we invest accounts one stock at a time, and we will only purchase when a company is trading at or below our buy target price. When a company drops into our buy range, it is added to each portfolio with cash at approximately a 6% weight. Due to this strict purchase criteria, each account under Lateef's management may not hold all of the same securities, depending on the inception date of each account. While this process creates a higher dispersion between accounts, we think it makes the most investment sense, ultimately resulting in better performance.

When and How We Buy

The businesses that interest us are those that have a sustainable high return on invested capital (ROIC). With all else being equal, the most valuable businesses are those that deliver more cash flow and income with fewer assets. Return on invested capital is a financial measure that quantifies how much income a business earns relative to the capital contributed by both equity shareholders and lenders. Our composite top 25 holdings have a return on invested capital in excess of 20% – nearly double what the average company earns on capital, and more than double the cost of capital for most companies. For companies with no debt, return on invested capital is simply return on equity, which is defined simply as net income divided by net worth (or equity).



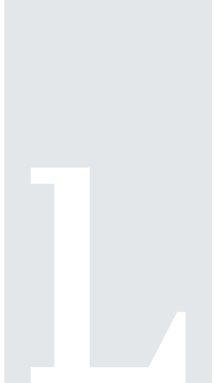
We prefer "tollgate" businesses that are competitively positioned to benefit from recurring "tolls" on spending which often leads to high ROIC. Most investors define a company's growth rate as the rate at which it increases its earnings per share (EPS). We think this is not only overly simplistic, but sometimes wrong. EPS is a result of many accrual assumptions, which may not correlate to the actual cash generated by the business.

The true growth of a business is measured by its return on capital. For example, a business that is funded with $1,000 on January 1st and earns $200 in cash for the year has a 20% return on its $1,000 original capital. At the end of the first year, it has $1,200 of retained capital, assuming no dividend payouts. If it earns another 20% on its $1,200 retained capital in year two, it will have earned $240, making its capital at the end of year two $1,440. Extending this 20% compounding forward for 3.8 years will result in total capital of $2,000, or double its original investment.

We have observed that over time, a company usually trades at a Price-Earnings ratio (PE) in line with its sustainable return on capital. Assume, for instance, that we invest in a company with a sustainable return on capital of 20%, whose stock is depressed for some temporary, nonstructural reason, and has a PE ratio of 15x. The investment should benefit from a "double play" effect. The stock should benefit from a rebound to its normalized PE of 20 as the cloud overhanging the stock evaporates, and then, the stock should benefit from the compounding of the company's return on capital, thereby increasing its intrinsic value. We limit price risk by patiently waiting for terrific companies (those with sustainably high ROICs) whose stock prices are temporarily out of favor, offering an opportunity for us to pay a PE at a discount to its intrinsic value along with a "double play" opportunity. Well executed "double plays" in a portfolio of 15–20 investments can contribute significantly to investment performance with minimal business and price risk.

We also measure a company's return on capital exclusive of any excess cash it may have on its balance sheet, indicating a more robust business profitability. Many of our companies have little or no debt on the balance sheet and have significant cash not needed to run the business.

Our portfolio companies generate excess cash over and above needed capital spending. We use other valuation metrics as a "sanity check," such as comparing a company's cash flow yield to the 10 year treasury bond. We also value companies by comparing a company's PE ratio relative to its historic ROIC for clues to better estimate the intrinsic value of the company. We might also incorporate a sum-of-the-parts analysis to value companies. After estimating the intrinsic value using these methods, we apply at least a 10% discount to the value to derive our "buy point," thereby enhancing our margin of safety. For example, if we believe a company is fairly priced at $50, we will not buy it until it drops below $45.



We believe we are unique in our emphasis on ROIC and, in particular, in using the ratio of PE to ROIC as a guide to valuing companies. Combining this approach with our due diligence to give us the conviction that a company's competitive advantage is sustainable, along with the discipline to wait for the right market price, gives us the edge to outperform.

When We Sell

Our bias is not to sell. If we must, we reinvest the proceeds only when it makes sense to do so. There are, however, five conditions under which we feel that selling a stock is necessary:

- When a position exceeds 15% of a portfolio. If an investment that typically starts with a 6% weight appreciates to 15% of the portfolio, we will consider gradually trimming the position for the sake of prudence.
- Overvaluation. If the stock price is egregiously overvalued and discounts earnings excessively into the future, we will sell. This was key to our success in preserving capital in the years 2000–2002. We are content to hold a modestly overvalued stock if we are confident that future years' earnings growth will justify the valuation.
- Deteriorating fundamentals. For each company we buy, we document our rationale for investing in the company. If subsequent events erode its competitive advantage and violate our original rationale, we will sell.
- When there's a better idea with more conviction. If we find a much better business that is attractively priced, we will sell to generate cash for the new purchase.
- When we recognize a mistake. Despite our rigorous due diligence process, we do occasionally make mistakes in assessing the management or competitive dynamics of a company. When this happens, we immediately sell to limit losses and move on to a better opportunity.

We take a practical business approach to investing. This approach applies equally whether one values a neighborhood lemonade stand, the corner grocery store, or General Electric.

Why Lateef?

- Superior long term results with an absolute return focus
- Experienced team who are owners of the company
- Unique combined growth and value approach
- Opportunistic investment approach
- Concentrated portfolios
- Low turnover that is tax-efficient
- Over 30 years of one investment style

Contact Information

Lateef Investment Management
300 Drakes Landing Road
Suite 100
Greenbrae, CA 94904
www.lateef.com

Phone: (415) 461-3800
Fax: (415) 461-0436

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300 Drakes Landing Suite 100 Greenbrae CA 94904 www.lateef.com