REPRINTED FROM MAY 28, 2012

THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Dividend-Paying Stocks Prove Competitive With Alternative Investments

RICHARD A. LEDERER is the President and Chief Investment Officer of Lederer & Associates Investment Counsel. He cofounded Fish & Lederer Investment Counsel, Inc., in 1986. The name of the firm changed to Lederer & Associates in 1996. Mr. Lederer was previously Vice President of Winrich Capital Management and Senior Investment Officer of Security Pacific National Bank. He has 34 years of investment management experience. Mr. Lederer graduated cum laude with a B.S. in business administration from the University of Southern California and attended the graduate school of business at San Diego State University. He is a member of the CFA Institute and the CFA Society of Los Angeles. Mr. Lederer serves on the board of directors of the Prager University Foundation.

TWST: Please start with a brief history of the firm and an overview of the firm today.

Mr. Lederer: Lederer & Associates Investment Counsel was founded in 1986. We manage equity, fixed-income and balanced portfolios. We currently manage about $130 million in assets. We serve individual and institutional investors and manage accounts for trusts, estates, foundations, charitable organizations, corporations, and pension and profit-sharing plans. We also have 10 years of experience in handling large institutional portfolios, such as Taft-Hartley plans.

Our mission is to create lifelong relationships with every client by earning the role as their trusted investment adviser. All of our portfolios are managed separately and tailored based on client goals and objectives. Our only revenues are management fees that are fully disclosed, and these fees increase or decrease commensurate with changes in the market value of client portfolios, which aligns our interest with theirs.

TWST: How would you describe the overall investment philosophy and approach to portfolio management at Lederer & Associates?

Mr. Lederer: We combine what we believe is a common-sense investment philosophy with a disciplined process that is designed to keep client portfolios fresh with our best ideas. We have a long-term track record managing two distinctive styles of equity portfolios.

Our growth strategy is based on growth at a reasonable price and is focused on mid- to-large-cap companies with the potential to provide long-term capital appreciation. Our value strategy is based on equity income and is dedicated primarily to large-cap companies with an emphasis on dividends, dividend growth and total return. We also offer a blended growth and income approach for clients desiring a combination of our two core strategies.

On the fixed-income side, we seek to minimize credit and interest rate risk by carefully selecting issues with short- to intermediate-term average durations using primarily a laddered approach to maturity selection. Based on client goals and objectives, we establish a target mix of stocks, bonds and cash. We like to think in terms of layering portfolios. Cash serves as the foundation. It is the safest and most liquid of all investments. However, the yields are typically lower than those on bonds and many dividend-paying stocks.

At the opposite end, real estate and interests in privately held businesses are the most difficult to convert to cash in a timely manner. We believe the core portion of a portfolio should be the stocks and bonds that provide higher returns than cash, but are much more liquid and generally more stable than real estate and privately held businesses. Our job is to manage the core portfolio for clients — that is stocks and bonds — because we think these assets should be the basis of any serious investment portfolio.

TWST: Is there one particular portfolio strategy you'd like to focus our discussion on today?

Mr. Lederer: I think our dividend strategy is compelling in an environment of extremely low interest rates. Dividends receive preferential tax treatment, which makes dividend-paying stocks highly competitive with most alternative investments after taxes. These stocks should also benefit from an aging demographic that is seeking income on an increasing basis in a world where there is so little yield in terms of savings accounts, money market funds and CDs.

I believe stocks that not only provide solid dividends and good yields today but have a history of increasing their dividends over time will continue to be attractive to more and more investors. However, we don't try to buy the highest-yielding stocks because such equities are more like bond substitutes. We think investors reward dividend growth even more than just dividend yield, and it's our belief that the combination of a good, solid above-average dividend yield to start off with and the dividend growth will provide attractive total returns for investors over a period of time.

TWST: Are you finding a better set of opportunities in particular areas of the market, whether it be sectors or industries or by market cap ?

Mr. Lederer: Our favorite stock is **Apple** (AAPL), which will begin paying a quarterly dividend of $2.65 per share this summer. At an annualized rate of $10.60, the dividend yield works out to 2% at the current price of $530. In addition, there is ample room for dividend growth given that the initial payout is only about 20% of the company's projected earnings for the next 12 months.

Moreover, **Apple** is not only perhaps the world's greatest company, but it might be the most undervalued stock, as well. Although people are a little bit concerned because the stock has performed so well over the last five or 10 years, I think it's important to recognize that the company's earnings have grown even faster than the stock price. Therefore, the price/earnings multiple has actually contracted significantly over the last several years, so much so that the stock is now trading at about 11 times calendar 2012 consensus estimates of around $48 per share. The valuation works out to less than nine times earnings net of the company's $110 billion cash position, which equals $116 per share.

Importantly, we also think that the company's products, including the iPhone and the iPad, are still relatively underpenetrated and have room for quite a bit of additional growth. We think it's a very compelling value when you consider the fact that the stock is trading at a multiple that's well below the S&P 500.

As far as areas that may not be as well covered or as well owned, we think there are a couple of interesting stocks that serve the underbanked market. For example, **First Cash Financial Services** (FCFS) is the leading owner and operator of large-format, full-service pawn shops in the United States and Mexico, with a total of 732 locations. They had same-store sales growth of 13% last year and earnings growth of over 20%. The company has very strong finances and cash flow that should continue to support the acceleration of new outlets and acquisitions.

Meanwhile, the stock is trading at 13.5 times this year's earnings in a year where they are expected to grow about 20% and 11.5 times next year's earnings. So we think **First Cash Financial Services** is an attractive small- to-mid-cap growth company.

Along those same lines, a company that's better known in terms of its name, but that we think is underappreciated as a stock, is **Western Union** (WU). **Western Union** also serves the underbanked market, if you will. They're the leading provider of money transfer services in the world, and they operate through 500,000 agent locations in more than 200 countries. They have more than eight times the number of locations than **McDonald's** (MCD), **Starbucks** (SBUX) and **Wal-Mart** (WMT) combined. They have a very good distribution system coupled with a trusted brand that has been around for 160 years.

The business generates a lot of excess cash flow, and the company has used the free cash flow to increase its dividend and buy back stock on a regular basis. Just in February, the board increased the dividend 25% to an annualized rate of $0.40 per share. With the stock trading at about $16.75, the dividend yield is 2.4%, or a little bit higher than the S&P 500.

Meanwhile, the company's guidance for 2012 is about $1.75 per share, so the stock is trading below 10 times this year's earnings even though it is expected to grow earnings this year and next at least 10%. We like both **Western Union** and **First Cash Financial Services** as somewhat smaller- to-mid-cap companies in a similar sector addressing the needs of consumers who either don't have a bank or don't have much of a banking relationship.

Highlights

Richard A. Lederer of Lederer & Associates Investment Counsel discusses the firm's common-sense investment philosophy that combines a disciplined process to its value and growth strategies. He says the firm's approach to dividends is compelling in an environment of low interest rates. Mr. Lederer focuses on dividend-paying stocks because they benefit from preferential tax treatment, as well as an aging demographic that is seeking income. He also talks about the potential for major fiscal headwinds to take place in 2013. Mr. Lederer shares his favorite holdings. He says commodity-related industrials, utilities and financials are typically underrepresented in the firm's portfolios versus technology, consumer staples, consumer discretionary, health care and business services.

Companies include: Apple (AAPL); First Cash Financial Services (FCFS); The Western Union Company (WU); McDonald's Corp. (MCD); Starbucks Corporation (SBUX); Wal-Mart Stores (WMT); Eaton Corporation (ETN).

TWST: Are there any sectors you're cautious about?

Mr. Lederer: Generally speaking, we're cautious about commodity-related and/or highly cyclical companies because we think they are more difficult to analyze, more difficult to project future cash flows. We also think those types of companies are better trading vehicles than long-term buy-and-hold situations. I think they really have to be bought and sold right. That said, there are some companies that might be called "soft cyclicals" that have somewhat uneven earnings, but typically grow earnings from one cycle to the next.

An example is **Eaton Corporation** (ETN), which we own for our dividend strategy. We tend to favor the higher-quality, less-cyclical-type businesses, such as **Eaton**, that have a good track record in paying dividends. **Eaton** is a diversified manufacturer of power management solutions, including electrical and hydraulic components and systems for the automotive, truck, aerospace, construction, and oil and gas markets. **Eaton**'s businesses are well balanced geographically and across the economic cycle. The company increased its dividend most recently 12%, and the stock is trading for less than 10 times this year's earnings and has a dividend yield of 3.6%.

Outside of our dividend strategy, we typically do not own utility companies because they don't generate much growth. As a general rule, we underweight financials because we think most banks lack the transparency in their financial statements that we would like to see.

To summarize, I'd say commodity-related industrials, utilities and financials would generally be underrepresented in our portfolios versus other areas, such as technology, consumer staples, consumer discretionary, health care, business services, and those types of economic sectors and industries, which we think, generally speaking, provide more interesting investment opportunities.

TWST: What factors would lead to a decision to exit a holding at the firm?

Mr. Lederer: We reduce or sell positions once the upside potential has diminished due to high valuation, lower yield or deterioration in the competitive advantage and fundamental outlook. We also sell a stock when there are better opportunities elsewhere. In most cases, we sell because the stock has performed well.

However, in some cases we end up selling a stock at a lower price because the fundamentals deteriorated and the outlook no longer warrants holding that stock at that price. By having these sell disciplines, we believe it helps limit downside risk while keeping the portfolio fresh with our best ideas.

TWST: What does the firm use as a benchmark?

Mr. Lederer: We use the Russell 1000 Growth for our growth strategy and the Russell 1000 Value for our value strategy. We also compare our numbers to the S&P 500 because we know it's a highly publicized broad market index.

TWST: Is there anything you'd add about Lederer & Associates in terms of what sets the firm apart from its peers and competitors?

Mr. Lederer: One of the things that I think is important is we're owner operated. I founded the firm back in 1986, and I made a conscious decision to grow the firm in a manner in which I could continue to manage the portfolios, because I enjoy managing money more than I do managing people. Had we grown by just accepting any and all accounts, we would have had to add a lot more people, and then I would be more responsible for managing people than managing money.

I truly love what I do. I love managing money, and I think it's somewhat unusual for the founder and the owner to be the hands-on money manager, who also speaks to clients. Most firms have several departments with numerous layers of staff, where the marketing person might go speak to clients, and the client really never talks to the person who is actually managing the money. So I think we're unusual in the sense that our firm is of a size where my associate and I can manage money and speak directly to clients.

TWST: Any thoughts or advice for investors to wrap up?

Mr. Lederer: We're paying close attention to the potential for major fiscal headwinds to take place in 2013. The so-called Bush tax cuts are set to expire at the end of this year. Unless these rates are extended, the tax on ordinary income will rise from 35% to 39.6%, while the tax on qualified dividends will skyrocket from 15% to 39.6%. The tax on capital gains will also jump from 15% to 20%. Should the health care bill pass, there will be an additional 3.8% on all income other than wages. As a result, the tax on dividends could wind up being 43.4%, which would be a near tripling of the current rate.

There's also the forgiveness on 2% of the payroll tax and the unemployment extensions that will expire at the end of this year. You've got a lot of fiscal drags both in terms of higher taxes and a somewhat lower growth in government spending that could cause major headwinds next year. The Congressional Budget Office estimates those fiscal headwinds could reduce GDP by about 3.8%. Merrill Lynch put a report out suggesting 4%; and Morgan Stanley projects as high as 5%.

If we're growing the economy now by 2% to 2.5% and we have a 4% to 5% drag on our GDP, we would be immediately in recession with negative growth rates of somewhere between 1.5% and 2.5%. What happens with these different taxes and unemployment and Social Security will have a major effect on how fast or how slow the economy grows next year. The likelihood is, no matter if the Republicans or the Democrats win in November, that all of these things won't happen at the same time. But if left unaddressed, they actually all do expire at the end of this year. So we're watching that very closely.

We're hopeful that we can manage our way past these fiscal headwinds, and we're hopeful that there can be some major tax reform so that we can actually spur economic growth while also addressing the spending issues.

In the meantime, we're sensitive to valuation. Right now, the consensus earnings estimate for 2012 for the S&P 500 is around $105 per share, so the market is trading for less than 13 times this year's projection. The average p/e over a long period of time has been closer to 15 times. As such, the market is trading at a sizable discount to its historical valuation, which suggests some of the negatives are already factored into the current market. Nevertheless, we're mindful that directionally conditions could get tougher in 2013 than they have been, say, in the last three years.

TWST: Thank you. (MN)

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