

THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

A Total Return Approach to Capital Appreciation



JOHN M. BABYAK is the President and Senior Portfolio Manager of Wolverine Investments, where his duties span all functional areas, including: portfolio management and research; business planning and budgeting; trading, information systems and administration; and new business development and client service. Prior to joining Wolverine Investments in 1993, Mr. Babyak held various systems engineering, sales and marketing management positions at IBM. He graduated from The University of Vermont in 1982, with a degree in Management Engineering. Mr. Babyak has written numerous articles about the markets, including the studies "Rationale for Yield-Enhanced Convertible Securities," "Covered Call Writing: Managing Risk, Enhancing Portfolio Returns," "Managing Portfolios For Optimal Tax-

Efficiency" and "Convertible Securities as an Asset Class." He is an internationally published market commentator and is frequently quoted in the securities news media, including The Wall Street Journal and Barron's.

(ZAV504) TWST: Would you tell us about Wolverine Investments and what your specific responsibilities are?

Mr. Babyak: Wolverine Investments was founded in 1988 by Warren H. Bree, who until recently was our long-time President and Chief Investment Officer. Sadly, Warren recently passed away after a brief but intense battle against pancreatic cancer, so the firm is in the final stages of completing our succession plan. Our plan commenced in April with my assuming responsibility for chairing our firm's Investment Committee meetings and was followed by our Board of Directors electing me President in June. In addition to my ongoing responsibilities in portfolio management, trading and client service, I am now overseeing all aspects of the management of the firm.

While the atmosphere around the office is a little different these days, life has begun to return to a normal pace the last few weeks. Fortunately, we're experiencing great success in 2005 relative to our specific benchmarks and the broader financial markets in general. Moreover, our spirits and self-assuredness have been bolstered

tremendously by the uniformly strong support and confidence expressed by our clients and colleagues. We feel very good about where we are and where we're headed.

So we're going to continue managing investments much the same way Mr. Bree did during his many years in the securities business. Our core competencies of convertible securities and covered option writing will remain the driving factors in our investment process. We've always portrayed our style as being well suited to investors seeking a balanced approach to the markets, but I think we will increasingly appeal to those investors who recognize that strict attention must be paid to asset protection and the management of risk. Our underlying fundamental philosophy will always be that wealth is best created by long-term ownership in growing businesses. Complementing our occasional direct investment in common stocks, we will concentrate our investment direction in convertible instruments, together with covered call option writing. We will always relish playing the role of banker for our clients, as opposed to the stock market speculator.

TWST: What is the investment philosophy? What is your investment style?

Mr. Babyak: Again, to reiterate, our basic philosophy about managing investments is that wealth is best created by long-term ownership in growing businesses. In practice, this philosophy emphasizes both preservation and growth of capital resulting in a total return approach to capital appreciation. We believe this philosophy of encompassing both an offensive and a defensive perspective will be extremely successful in the future. Consequently, the firm does not neatly conform to either a growth or value style classification, but prefers to concentrate on a flexible, balanced investment strategy. Integral to the firm's approach, and the key risk control technique that differentiates our management style, is the use of the convertible security as an equity alternative wherever feasible.

TWST: What is the outlook for your style of investing in convertibles securities, as well as covered options, at this time?

Mr. Babyak: I don't think there's a better moment to begin implementing a program that blends the two disciplines of convertible securities and covered call options. In general, convertibles as an asset class have endured a tremendous setback over the past couple of years. This was due primarily to the unwinding of the excess demand generated by hedge funds, specifically the convertible arbitrage funds. This huge demand buildup, fueled in the late 1990s on into the early 2000s in response to the market bubble and subsequent deflation in stock prices, was further exacerbated by cheap money resulting from the dramatic decline in interest rates from 2001 through 2003. So-called sophisticated investors, as well as institutions, apparently pursued what they considered the low-risk strategy of convertible arbitrage, which marries long convertible investments with short-selling strategies plus tremendous leverage or margin. These funds exploded in popularity, and understandably the convertible issues that came to market from public companies — aided and abetted by the investment banks — catered to these issue-hungry funds. This caused artificial price inflation across much of the convertible universe, thus expanding conversion premiums.

Conversely, in the past year and a half, we've seen a deflationary effect as investors have come to realize that there's no silver bullet strategy that automatically beats the market; investors discovered that convertible arb funds couldn't deliver high returns with low risk all the time. After several excellent years, in 2004 investors started to withdraw money, and the returns of these funds suffered. The trickle of outflows turned into mass liquidations. It turns out that the higher-yielding convertibles that we screen and target for our investment purposes are very different from the zero and low yielding convertibles that were absorbed by the convertible hedge funds. As a result, over the last five years our firm's performance didn't correlate on the upside, but conversely, neither have we suffered on the downside. We've been somewhat insulated from the gyrations caused by the hedge funds.

Year to date, convertible arb hedge funds are down anywhere from 4% to 6%, while we've generated positive returns for our clients this year. In fact, our yield-enhanced convertible portfolios are up over 5% year to date, due primarily to a total return approach, employment of sound fundamental analysis and good judgment, and our more conservative approach to the markets. While the convertible asset class is beaten down, it's now at one of its most attractive valuation points during the past 10 years.

In terms of covered option writing, the obvious key component is volatility. Over the last couple of years, we've seen market volatility virtually dry up, with the VIX — the Chicago Board Options Exchange measure of volatility — recently reaching its low water mark near 10 this past July. By comparison, the VIX reached its highest level amid the mid-2002 market lows at approximately 45. The last time market volatility was this low was at the end of 1994, right at the end of that era's Fed tightening cycle. Our forecast calls for market volatility to rise in the coming months as we near the end of this era's interest rate tightening cycle, and this will make option strategies increasingly more popular.

TWST: Would you describe the process that you go through before you make a buy decision on a stock?

Mr. Babyak: Our firm's overriding research process is theme-driven and combines both top-down and bottom-up analysis. You might say we are also devoted to the old adage that owning the worst performing stock in the best sector is better than owning the best performing stock in the worst sector. So we try to focus on long-term trends in the market, whether they are growth-oriented or cyclical in nature. While the average name remains in our portfolio for approximately two to three years, we normally seek exposure within certain sectors for a decade or longer.

One of the most important categories of investments we've made is in the area of energy and power, industries that have grown in tremendous significance and gained in momentum over the last two years. We are in the midst of a strong, sustainable cycle of global economic growth, and we want to be involved in companies that are prospering from this trend. Another major trend that we've been interested in for quite some time is the demography and implications of an aging population in America. We have many investments in various health-care-related fields that attempt to capitalize on this theme.

A third trend is the growing affluence of the average American, together with the huge intergenerational transfer of personal wealth that is really just beginning to take place. Similarly, the decisions surrounding how consumers spend their discretionary income combined with what they do with their leisure time is another major theme that we've followed for many years. Finally, we're interested in the technological innovations of this era in history, which can either be considered a growth trend or a cyclical trend. Our investments in information technology tend to be very targeted and follow our thesis that human productivity continues to be enhanced through technological innovation.

The five major themes I briefly outlined are driven by a macro growth perspective consistent with our investment philosophy, but the individual stocks are selected through a very classic bottom-up research and analysis process.

TWST: Is there still a dichotomy between the stocks that outperform and stocks that underperform?

Mr. Babyak: There is a vast discrepancy, which can be epitomized by another adage, “it’s a stock-picker’s market.” One can look at just about any industry, even in the energy patch, and find companies that are up 100% or 200% over the last couple of years, and also companies that are down 50%. It all comes down to execution by management.

So there’s no question that investors need to be focused on quality. One of our hallmarks is identifying quality corporate management, as well as quality of the balance sheet. Our investments in the convertible asset class tend to center around credit quality that can be characterized as medium to high. You find very few AAA or AA convertibles, but there are plenty of issues rated A, BBB and BB. That gives us a good screen in terms of credit worthiness. We build the bottom-up approach by looking at a management team that takes into account all of the various stakeholders’ best interests — from shareholders to employees and, most important, to customers.

“Dominion operates the nation’s largest underground natural gas storage system; it’s the third largest US utility by market cap, and they also happen to be the eighth largest owner of natural gas pipelines. Within the utility universe, Dominion is a very compelling large cap name that has the fastest multi-year EPS growth, while trading at the lowest p/e.”

TWST: What are some of the specific sectors that you’re showing interest in right now.

Mr. Babyak: Let’s try something. Suppose I mention the word “utility.” Doesn’t it tend to elicit a somewhat stodgy, yield-driven, slow growing kind of image? But what if I was to vaguely describe a company, one that is a large producer of energy, manages an extensive oil and gas exploration system, and also operates huge natural gas transmission pipelines and storage facilities. All of a sudden, it sounds like we’re alluding to an investment opportunity with immediate relevance and lots of sizzle, doesn’t it?

For instance, within our energy/power theme, one of our largest single investments is in **Dominion Resources (D)**, the company I just alluded to. **Dominion** operates the nation’s largest underground natural gas storage system; it’s the third largest US utility by market cap, and they also happen to be the eighth largest owner of natural gas pipelines. On the one hand, **Dominion** fits within the old

paradigm of utility, but on the other hand, they are clearly profiting from domestic and global growth trends and the accelerating demand for energy and natural resources that growing companies and economies require. Within the utility universe, **Dominion** is a very compelling large cap name that has the fastest multi-year EPS growth, while trading at the lowest p/e. **Dominion** has been strengthened recently by reducing their capital spending and issuing 10 million shares of common to raise nearly \$1 billion. Along with a very nice current dividend yield on their common, you have the basis for what is a very sound and conservative core energy/power holding.

Another name I will mention is a pure play in the integrated oil and gas business, but which isn’t necessarily a household name, **Amerada Hess (AHC)**. Until recently, they were somewhat removed from most investors’ radar screens —it’s a pretty volatile stock, and the company is perhaps best known for its investment in the oil fields in Libya. During the last couple of years, the restrictions on investment in Libya have been relaxed, and **Amerada** is now poised to gain handsomely as exploration and pumping accelerates in that region of the world.

One of the most important factors at work here is that their profitability, relative to their peers, has been affected over the last year due to a constrictive hedge that management put into effect a couple of years ago. In essence, **Amerada** has been selling their pro-

1-Year Daily Chart of Dominion Resources

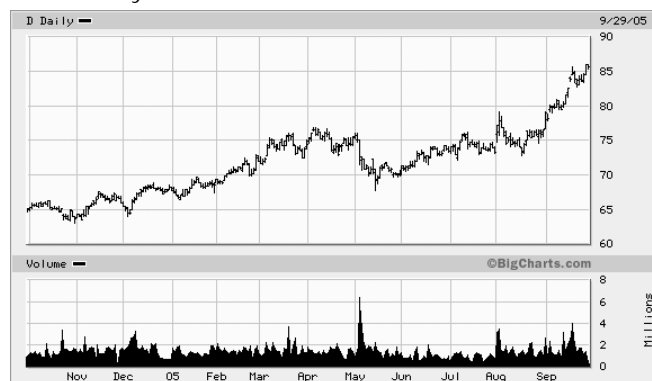


Chart provided by www.BigCharts.com

duction below market rates. As a consumer, that's great news, but for investors, it wasn't so great. The good news is that their hedge comes off in early 2006 and their earnings are set to explode. This fact is already reflected in the current stock price, and the shares, which had been climbing rather steadily, have shot up dramatically from \$90 in June to about \$140 presently. On any kind of pullback, however, further investment in **Amerada** is warranted, so we're quite positive about the prospects for the company going forward.

1-Year Daily Chart of Halliburton



Chart provided by www.BigCharts.com

I should also mention **Halliburton** (HAL), which most people know simply as the company that Dick Cheney used to work for. This company's valuation was very suppressed for a long time and it's been growing dramatically over the last two years, off of a very reasonable valuation. A few months ago it was around \$45 and it has now exploded to about \$65. No doubt, the stock is probably extended in the short term, but we think that this company is very well positioned to grow, not only in oil field development, but in the burgeoning industry of liquefied natural gas, which is expected to grow 7% to 10% a year. They're also developing another very interesting business converting gas into liquids, or the so-called GTL industry. They take the flared-off gas in the oil fields and, instead of burning it, compress it and convert it into diesel and other kinds of lubricants. This could become a very important growth segment over the next few decades. **Halliburton** management has also been very aggressive in buying back shares to reduce company debt, and they have a huge revenue backlog — in the neighborhood of \$15 billion. Much of the overhang that affected the company, such as asbestos claims and the overbilling issue in Iraq a few years ago, has been solved, and the company is poised for continued strong growth going forward.

TWST: What about another sector that you find intriguing?

Mr. Babyak: A wonderful theme for our purposes, primarily since there are a lot of convertible securities from which to select, is the aging of America and the demographic shift to an older population. Our

investments in the healthcare field serve a number of purposes from a tactical asset allocation perspective. On the one hand, there's the growth story, but on the other hand, our healthcare investments provide our portfolios with a defensive posture. Many of these companies will continue to grow no matter what the economy does, and we own the stocks and convertibles of companies that service and supply physicians, nursing homes and even the hospice facilities that compassionately care for our elderly population in the later stages of life. For investors who've witnessed the suffering that a terminal patient experiences, they know a huge amount of public and private money is spent in the care of the patient. One simply must conclude that there will continue to be huge opportunities in health care, and with all these expenditures, there must be a commensurate amount of profit being generated by the various companies servicing the aging demographic.

For example, **Apria Healthcare** (AHG) is one such company whose best years are ahead. It operates three major service lines — home respiratory, home infusion therapy and home medical equipment. Within each of these sectors, they offer services that are prescribed by a licensed physician as part of a long-term care plan. Whether that plan is three months, six months, a year or five years, **Apria** is poised to profit. Clearly, Medicare reimbursements are an important part, but in many cases, the patients and their families make the discretionary spending decision. Instead of hiring a nurse for the four hours a week that might be Medicare-paid, they may elect to engage 24/7 nursing care. Presently, we believe **Apria's** stock is somewhat undervalued, and management recently hired Morgan Stanley to explore possible restructuring offers, or they may possibly put themselves up for bid.

Omnicare (OCR), a company active in the pharmaceutical management arena, also has services related to skilled nursing and assisted living. This is a very exciting company that serves nursing homes all across the US. **Omnicare** recently purchased a company similar to itself called NeighborCare, which will add significantly to future growth prospects. Our feeling is that the Medicare Prescription Drug Act of 2006 will not affect **Omnicare's** growth, with EPS growing at 17% next year on top of this year's 15% plus, driven mainly through cost-cutting measures and synergies derived from recent acquisitions.

Our other favorite names that investors may be familiar with include **Schering-Plough** (SGP), the very large diversified pharmaceutical company, and **Wyeth** (WYE), the drug and consumer products company formally known as American Home Products. **Wyeth**, as a leading maker of prescription drugs, is growing very solidly again after it successfully mitigated its exposure to the so-called Fen-Phen diet drug litigation. **Wyeth** is poised to make some changes to its sales force, downsizing and improving its margins, and that will be very good for growth.

Schering-Plough, on the other hand, has a lot of great drugs in its pipeline, as well as drugs that are currently in the marketplace actively being promoted. One of their potential blockbuster

drug formulations is Vytorin, a drug that is being marketed as part of a joint venture distribution arrangement with **Merck** (MRK). **Scher-ing** management feels that Vytorin has the potential to capture at least 15% to 20% of the \$20 billion cholesterol drug market.

TWST: How do you feel about financial services investments at this time?

Mr. Babyak: Financial services has been a consistent theme at WHB/Wolverine for the past 15 years. In the early 1990s, the sector was severely depressed amid the recession, and we made investments based purely on a value judgment that the industry would not only survive, but also thrive, as the country became wealthier. The banking and insurance industries are very key concentrators and protectors of wealth and, when well managed, are excellent businesses to invest in. What initially started as investments in the money center banks gradually rotated into the super regionals and regional banks in the late 1990s. Currently, we have a very tar-

about five years ago. It has great top-line growth, excellent margins, and they recently bought **CitiGroup's** (C) Life and Annuity business, which will be immediately accretive to their earnings. **MetLife** has been a very steady performer over the last year, and we continue to add new funds in this name.

I mentioned earlier that we've rotated away from the big money center banks and super regionals during the past six years, but a regional, mid-cap bank we find very attractive is **Marshall & Ilsley** (MI). They primarily serve the State of Wisconsin with over 200 offices, but manage another 50 branches in Arizona, Minnesota, Missouri, Florida and Nevada. Their data processing division, providing credit card, transaction and merchant processing services, ATM management, and other electronic services, is the fastest growing part of their business. This stock is at a very attractive valuation, and the thing we like best is their convertible preferred stock that yields over 5%.

"Hartford Financial Services is now our largest holding across all of our client accounts. Second quarter earnings per share came in 6% above estimates, up 50% above last year's second quarter. Premium growth, which is the key metric that drives insurance company earnings, is set to slow somewhat, but Hartford's top line is still growing at a 10% to 12% clip — double the rate of the rest of the industry. They remain a very well diversified insurance and financial services company."

geted approach to investing in the sector. Our favorite holdings, in fact, can be found in the insurance arena.

For instance, **Hartford Financial Services** (HIG) is now our largest holding across all of our client accounts. Second quarter earnings per share came in 6% above estimates, up 50% above last year's second quarter. Premium growth, which is the key metric that drives insurance company earnings, is set to slow somewhat, but **Hartford's** top line is still growing at a 10% to 12% clip — double the rate of the rest of the industry. They remain a very well diversified insurance and financial services company. They are trading at a price/earnings of about 9, which is very reasonable, only trading at 1.5 times their expected year-end 2005 book value. Of course, this was a firm that was hit recently in the aftermath of Katrina, and we estimate that the hurricane will have about a \$0.50 to \$0.60 a share effect on **Hartford**. Global reinsurers are going to absorb about a third of those losses. That will be paid out this year, so I think this is a very opportune time to be involved in this company, which recently hit a high in the low 80s and has been trading recently around the mid-70s.

A recent strong commitment we've made is in **MetLife** (MET), formerly a mutualized insurance company that went public

1-Year Daily Chart of Hartford Financial Services



Chart provided by www.BigCharts.com

TWST: Can you recommend a contrarian bet or a special situation for investment at this time?

Mr. Babyak: I do have a few names of lower quality companies that fall outside our core investment program.

For example, I'd like to reiterate one of the companies I've recommended in the past, the **AES Corporation** (AES), which is a completely independent, electric power utility. When we last spoke about a year ago, **AES** was trading between \$9 and \$10 a share, and it's now trading around \$15, having pulled back from a recent high level around \$18 a share. I continue to like the stock and feel quite comfortable with a price target in the \$20 handle. Also, a telecommunications name that fell out of favor in 2000, but which could represent a limited risk speculation is **Level 3 Communications** (LVL3). For a little over \$2 a share, one can basically buy the equivalent of a long-term call option on the stock. From a technical perspective, near-term resistance is around \$2.50, but if the stock breaks out, I could see target prices of \$4 and \$7. Mind you, I consider **Level 3** a purely speculative opportunity, due to the huge amount of debt they have on their balance sheet. On the positive side, they're one of the few voice over Internet (VoIP) pure plays with real assets, over a \$1 per share cash on the balance sheet, and positive EBITDA and cash flow.

At this point, I'd like to tout the latest addition to our portfolio management team, Nicholas Caruso, who has a particular flair for ferreting out special situations and unique contrarian bets. So I want to ensure he receives full credit if any of the following recommendations pan out.

Just the other day we were discussing the merits of a company that I'm sure many investors have heard about, but which has fallen out of favor in last six months. With 1,000 stores across the US, **Pier 1 Imports** (PIR) is an interesting situation because it appears as though the company has failed to communicate a value proposition to consumers, with their merchandising programs not generating consistent growth. When one looks at their balance sheet and understands where the stock trades relative to book value — a little over 1.5 times — coupled with the value of their store's underlying real estate assets, you have an interesting potential takeover idea here. With the stock trading in the \$11 to \$12 range, it's certainly an interesting contrarian opportunity. Within the last two years, the stock has reached \$20 a share, so a justifiable upside target could be in the \$17 to \$18 area. **Pier 1** will either get its financial house in order, or will become ripe for acquisition as the hidden value of its underlying franchise and real estate assets get discovered.

In the healthcare field, I'd like to highlight a relatively unknown company called **AtheroGenics** (AGIX). **AtheroGenics**, listed on the NASDAQ with a market cap of about \$2.8 billion, is developing a new drug to fight arteriosclerosis. Several years ago, **Merck** targeted a company called Esperion for acquisition, but **Merck** ended up being outbid by **Pfizer** (PFE). The way we read the inside story is that **AtheroGenics'** products are actually better than Esperion's. Their latest drug just completed Phase II trials and is about to enter the Phase III of development. While there is still a ways to go in assessing the success or failure of this drug, we think

that a company like **Merck** could begin showing interest in **AtheroGenics** during the coming months. With the stock trading between \$16 and \$17 a share, we think there's a potential 50% premium above current prices over the next year or two in a takeout maneuver.

TWST: Last year, you were a big holder of IBM. Have you developed any interest in other technology companies?

Mr. Babyak: We still have an investment in **IBM** (IBM), although it is far from our largest holding at this stage, and we haven't added substantially to it in the past year. As a more attractive idea, and an investment we've returned to after a four-year absence, is a name well known to most consumers and investors, **Motorola** (MOT). They have been doing a phenomenal job of developing products that are a perfect fit with the mindset of our current culture, in this country and throughout the world. Their Razzr phone, ultra-light and very thin, sold out for most of the second and third quarter of this year. Production is running at absolute maximum capacity coming off sales growth of 35% in 2004, and it's now growing at an annual rate of 15%. Market share is on the rise, and their latest new product is an iTunes handset, which should develop huge momentum in a franchise that **Apple Computer** (AAPL) established. **Motorola's** stock for a long time didn't seem to be going anywhere off the low levels of 2002 to 2003. After a rally and pullback earlier this year, it again attained new highs recently. At around \$22 a share, we continue to think that this will be a strong stock going forward.

1-Year Daily Chart of International Rectifier



Chart provided by www.BigCharts.com

One other tech company that, interestingly enough, not only fits within our information technology theme, but also crosses over into the energy area is **International Rectifier** (IRF). **International Rectifier** is a semiconductor maker, but their chips are used in equipment that processes, refines and converts alternating current (AC) electricity to make it more useable and efficient in modern-day electronic devices. One area you would find their products is in cellular phones. Recall in the past with cell phones that you'd be lucky

to have enough juice to power it for a single day. The latest phones can now run in standby mode for two or three days before needing a recharge. As electric utility bills keep climbing, and with the price of raw energy seemingly rising endlessly, **IRF's** products help keep down the ongoing cost of ownership and maintenance to end-users. So growth is growing at a very solid 12% to 15% this year; it will probably be a little less next year, but their power management products in PCs and proprietary products continue to grow and expand market share. They recently discontinued a number of low margin products, which is helping their bottom line.

Looking at **IRF's** stock price trend, it's been quite bumpy with some accentuated highs and lows. We think, however, that as the company gets its business model in gear, gross margins will grow from 38% in 2004 to 44% this year and should reach as high as 48% in 2006. The market for power management products is growing at 20% annual rates. We feel **International Rectifier** is an excellent, targeted technology idea for the more conservative investor.

TWST: Tell us about the ways that you sell a stock from your portfolio, and what is your turnover?

Mr. Babyak: In examining the life cycle of a typical holding in our portfolio, the initial entrée is most commonly through a convertible instrument. If we're successful, the underlying stock of the convertible appreciates in value, as we pay closer and closer attention to the conversion parameters inherent to each convertible issue. In effect, the conversion price becomes a natural target price. If all goes well, we will be forced by the company to convert into the underlying common equity, which is the ultimate goal, both for the investors and the company. Company management issues the convertible in the first place because it offers a lower rate of interest compared to issuing straight debt; but by issuing a convertible, the company ensures that their common equity will not be sold too cheaply since the conversion price is typically 20% to 25% above the current stock price. From the investor's perspective, a simple notion is to think of convertible financing as basically combining a long-term call option or warrant together with a straight corporate bond.

In most cases, the convertible path represents a win-win situation for investors and the issuing company. Worst case scenario, assuming the convertible is purchased at or below par value, the investor gets his money back as long as the company remains solvent. Therefore, we also consider the credit worthiness of the public company. Best case scenario, the convertible will rise in value in conjunction with its underlying stock, and at some future point, it will get converted into common stock.

Along the way, we are writing out-of-the-money covered options to hedge or enhance the yield on that initial investment. If and when the convertible converts into common stock, call options ultimately serve as an exit strategy because the stock gets called well above our target price.

If you will permit me to use a baseball analogy, we don't swing for the fences at Wolverine Investments. We're quite content

to hit singles and, occasionally, doubles. Thus, we're playing small ball, eeking out infield hits, stealing bases, playing a defensive game and minimizing execution errors. It's this philosophy that extends directly into our investment style. The natural progression of our total position is to permit the stocks that get converted to pass through our active covered option program, which coincidentally serves as a structured exit strategy.

What triggers an outright sell decision? One key factor would be any appreciable change in the company's fundamental business. We are continually monitoring and examining what's happening with earnings projections, assessing the effectiveness of company management and so forth. With the ebb and flow of prices, it's a difficult task to filter out the noise in the market when holding a stock and making a judgment on whether or not the long-term viability of a company is threatened. In current markets, given the understandable nervousness of today's investors, a 5% to 10% pullback is not unexpected and by itself is not a cause for concern. But if a company we hold exhibits erratic price behavior, especially when compared to industry peers, or has experienced a decline of 15%, then a deteriorating technical pattern may become a key trigger as well.

A variation of our sell discipline comes into play on positions that we would like to trim back for rebalancing purposes. In this case, we sell at or slightly in the money, near-term call options against these positions as a way to receive a higher effective selling price for the stock. The greatest risk associated with this type of covered call writing is that it automatically limits our profit potential should the stock rally unexpectedly in the short term. On the other hand, prudent portfolio management dictates that we lighten up certain positions to avoid becoming too heavily concentrated, and thus decreasing individual company risk.

There are other reasons, of course, why we might exit a stock — turnover in company management, a major shift in the economic landscape that affects particular holdings, and so on. But in terms of the natural progression, following the convertible path with the options overlay is a very disciplined and methodical way of getting into and out of stocks.

Finally, in terms of portfolio turnover, ours is actually fairly light compared with the typical hedge fund, mutual fund or active equity money manager. I would say that the annual turnover of our underlying long positions is in the 30% to 40% range, which translates into an average holding period of about two and a half to three years. As we've discussed, depending on various factors, we employ option overwriting by typically selling out of the money call options, averaging two to three roundtrips per year. This additional turnover from option trading might add another 5% to 10% to our overall portfolio turnover.

TWST: It's also a great way of trying to control investment risk. How would you explain your approach to risk management?

Mr. Babyak: In our unique Yield-Enhanced Convertible (YEC) strategy, we are doing nothing more than selling covered call options against the underlying stock of the convertible bond or con-

vertible preferred stock, generating income far in excess of the current yield of the convertible. This yield-enhancing technique, in effect, monetizes the expected future return from stock price appreciation on the front-end, thus enabling the total position to achieve a more risk-averse posture.

A key consideration in implementing our Yield-Enhanced Convertible Program is the decision as to which convertibles are most attractive to write calls against. This necessarily incorporates our most important fundamental opinion and directional view of the underlying stock, and the inherent risk thereof, as well as the need to establish a time horizon for the strategy. Above all else, we must feel convinced of a moderate capital gain potential of each underlying stock within our universe of yield-enhanced convertible ideas.

Our portfolios are typically constructed with total return oriented, traditional convertible bonds and preferred stocks, with premiums ranging from approximately 10%-35%. Taking into account conversion terms and call provisions, laddered convertible positions are initiated with at least a 12- to 24-month holding period horizon. Given current market conditions, the expected performance contribution that can be attributed to interest and dividend income is a little over 4%. The expected performance contribution that can be attributed to option premium income is another 3%-4% at current market volatility. Therefore, we say the average standstill or cash-on-cash return, assuming no change in convertible prices, is between 7%-8%.

TWST: The Yield-Enhanced Convertible program sounds like it might be a good strategy to employ in a rising interest rate environment. Is it?

Mr. Babyak: Yes, indeed, it can be a very effective way of insulating clients from the gyrations in interest rates, while at the same time introducing a unique risk-management approach to owning long-term equities.

The dilemma that a fixed-income investor faces is how to maintain consistent portfolio returns and protect against inflation, all the while earning the income needed to sustain the desired lifestyle. This is where a 7% to 8% standstill return achieves an expectation of a fixed-income like approach. And again, the strategy is not tightly correlated to interest rates, so it injects a risk management control to a portfolio. We're not suggesting a client allocate 100% of their assets into this style, but in working with leading wealth managers, financial planners, private banks, and institutions around the country, a 10% to 20% allocation into a yield-enhanced convertible program can go a long way to evening out the volatility in both the equity and fixed-income markets.

To reiterate, the key tactic in our approach is nothing more than selling covered call options against the underlying stock of the convertibles that we own. This generates income far in excess of current yield on straight convertibles or fixed-income instruments. The strategy helps mitigate the risks of investing in the fixed-income arena,

while at the same time generating the kind of yields that investors need to fund their retirement or their liabilities in the case of pension plan sponsors. For endowments or foundations, that effectively manage split interest trusts, they need to have a cash flow that can fund their charitable distributions. We offer a great way to create a more efficient portfolio, both from an individual and an institutional perspective.

It is a fact that the initial convertible yield, derived from the preferred dividend or bond coupon, is set in conjunction with the then prevailing interest rates for similarly rated corporate debt. But because the conversion ratio is also set at the time of issuance, the yield going forward is influenced more by fluctuations in the underlying common stock price, not fluctuating interest rates. For this reason, we can assert that convertibles are an effective way of insulating portfolios from dramatic changes in interest rates, especially at the long end of the yield curve.

TWST: Do you have a summary statement or some closing comments?

Mr. Babyak: Investors should have a strategy or a set of strategies that are flexible, ideally providing exposure to different asset classes and alternative styles of investment. I think investors should pay close attention to the various ways that one can earn a total return in the markets, whether it be through stock price appreciation, income-producing strategies, yield-enhancement, capitalizing on volatility, etc.

Most important, investors should continue to be very aware of the underlying securities they hold, whether the vehicle is a hedge fund, a fund of funds, a mutual fund or a direct investment in an individual company. I would also echo the general consensus of professionals that the current environment remains a stock-picker's market. But individual investors can and should avail themselves of the unique advantages afforded by various risk-management strategies, whether implemented through covered call writing, convertible securities or other alternative investment vehicles.

TWST: Thank you.

Note: Opinions and recommendations are as of 9/23/05.

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