

# FLIPPIN, BRUCE & PORTER

*I n v e s t m e n t   C o u n s e l*

## **Flippin, Bruce & Porter**

*is an independent investment management firm that offers equity and balanced portfolio management using an investment approach that is value in nature. Located in Lynchburg, Virginia, FBP was formed in 1985 and now has 26 employees. The firm's activities involve independent discretionary investment management for retirement, endowment and individual portfolios. FBP also manages two no-load mutual funds. Our current asset base (as of 12/31/10) is approximately \$1 billion. FBP is 100% owned by current employees.*

## **OUR INVESTMENT PHILOSOPHY**

First and foremost we are value managers. That is, we invest in high-quality companies which we believe are significantly undervalued.

Our philosophy centers around understanding the natural behavior of markets and investors. Consequently, we consider the following points in determining the value of potential investment candidates:

### ***Human Emotion.***

Understanding human emotion is key to being successful in the investment management business since investors tend to overreact in their optimistic views as well as in their pessimistic views. As investors overreact to near-term events, they create overvalued and undervalued security prices in relation to a company's long-term outlook.

### ***Price and Risk.***

Most of the companies we buy are high-quality, large-capitalization companies. These securities move in and out of favor over time. Therefore, we believe risk is related to price.

### ***History Matters.***

We believe that in a given ten-year time frame major corporations go through periods of being in favor with Wall Street and periods of being out of favor. We further define a stock's valuation by analyzing five financial ratios: price/sales, price/book, price/cash flow, price/earnings and dividend yield over this ten-year time frame.

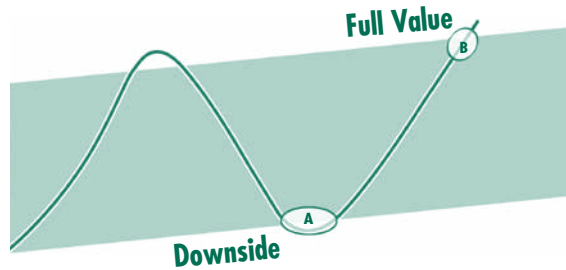
### ***Fundamental Analysis***

#### ***Uncovers Value.***

Finally, an in-depth study of a company's fundamentals and future prospects allows us to determine its true business value.

## THE OBJECTIVE OF OUR INVESTMENT EFFORT

FBP Stock Approach Chart  
Security Price Cycle  
(Exhibit I)



Everyone wants to buy stocks low and sell them high. However, an important distinction among managers' buying styles is the timing of the purchase. Our Stock Approach Chart (Exhibit I) is a longstanding visual description of the Flippin, Bruce & Porter investment process and it also captures the cyclical nature of security prices. We use this chart often in discussing our long-term approach to investing and have found it to be beneficial in explaining the objective of our investment efforts.

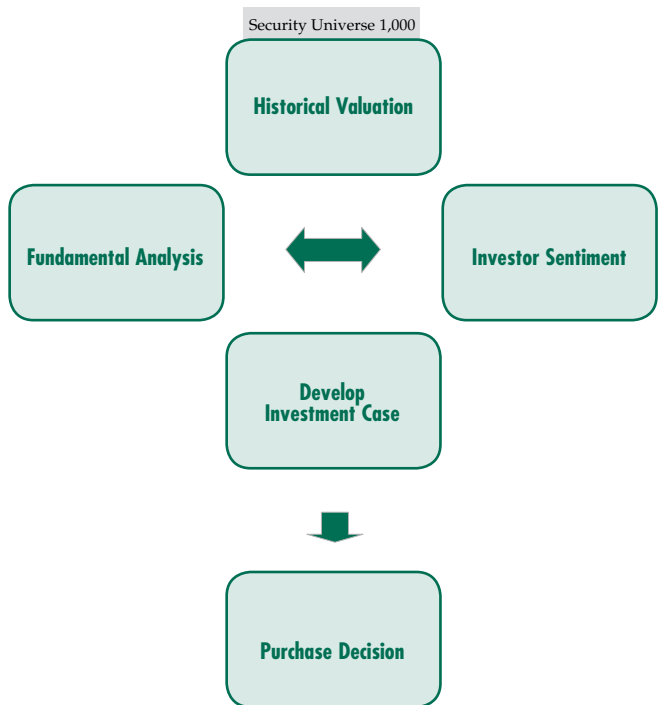
The time from peak to peak is approximately ten years. FBP's research effort begins early in the cycle, as a company falls out of favor and its stock price declines toward an eventual bottom. As part of our security selection process, we establish three price targets for each company followed. These *downside*, *fair* and *full value* targets are determined, monitored and adjusted on an ongoing basis.

Our goal is to begin purchasing at point A, which is at a significant discount to our *full value*, thus providing a *margin of safety*. As company valuation measures, fundamentals and investor sentiment improve, the security price will increase. As this scenario continues to develop, the stock will move through our fair value range and eventually toward our full value target. Our exit strategy is implemented at point B. The average holding period for stocks in our portfolio is five years.

## OUR APPROACH TO STOCKS

The overall investment process includes analyzing *historical valuation* ranges, researching company *fundamentals*, reviewing *investor sentiment* and developing price targets (Exhibit II). Using a large capitalization universe of approximately one thousand companies, our research group screens five historical valuation factors: price/sales, price/book, price/cash flow, price/earnings and dividend yield. Based on these factors, stocks trading in the bottom third of their ten-year historical ranges are identified.

Purchase Discipline  
(Exhibit II)



These stocks are examined further from a fundamental standpoint. This fundamental analysis includes a detailed historical review of a company's profitability, financial flexibility, return on capital and management's track record. The objective of our fundamental effort is to identify catalysts that will be long-term drivers of value growth.

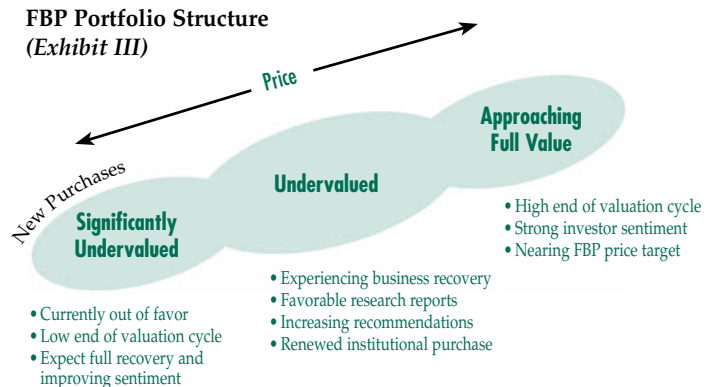
Additionally, investor sentiment is judged by reviewing Wall Street buy and sell recommendations, evaluating the tone of written research and institutional commitment.

Our research group then develops an investment case outlining valuation, fundamentals and sentiment. This investment case is then presented to and reviewed by the entire investment team of portfolio managers and analysts. Using this research, three price targets are established. Downside, fair and full value targets are calculated using a 12- to 18-month horizon. This is a dynamic process and targets are continually reviewed. The last step in the approach is our purchase decision. At this time the investment case is discussed and debated. Each security is then voted upon with the resulting purchase and weighting decisions made at this level. The initial inclusion of a new security into the portfolio only occurs when the stock price is at a substantial discount to our value, thus giving us a significant margin of safety.

Holdings are reviewed daily with reports being distributed weekly. Portfolios hold an average of forty to fifty issues. Initially we will purchase a 1-3% position. We will add to partial positions as issue or market weakness permits. Our maximum allocation to a single issue will be 4% at cost, 7% at market.

## EQUITY PORTFOLIO STRUCTURE

We view our stocks as falling into three categories which we call *significantly undervalued* stocks, *undervalued* stocks and stocks that are *approaching full value* (Exhibit III). Depending on FBP valuation targets and market conditions, the percentages of these three categories within our portfolio will vary over time.



As new purchases are added to our portfolios, they are viewed as *significantly undervalued*. These are securities of companies which we believe have reached the low point in their business cycle and have, as a result, fallen out of favor with most of the investment community.

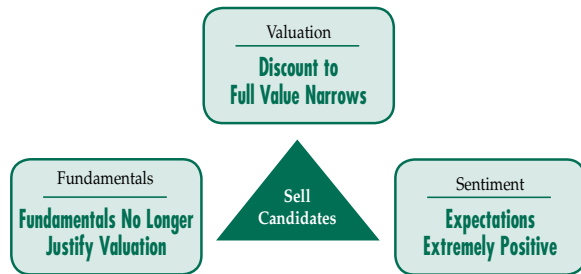
Stocks that we bought over the last one to three years that are now picking up buy recommendations make up the *undervalued* part of the portfolio and usually represent about half of our equity holdings. Such companies are experiencing varying degrees of recovery from their business cycle low points and the investment community has begun to recognize this recovery. We consider such securities, thought by many to be so-called "value" purchases, as having attractive potential for long-term capital appreciation.

The remainder of the portfolio consists of stocks we bought three to four years ago which have now picked up multiple buy recommendations. These issues are now at or near the top of our price expectation and have generally achieved renewed favor from the investment community. They are *approaching full value* and are generally candidates for sale. As money comes out of these stocks, it then flows back into new *significantly undervalued* ideas. Our goal is to create an overall portfolio that trades at a substantial discount to its true value, providing significant upside potential.

## HOW WE SELL SECURITIES

Our selling discipline is one of the most important aspects of the investment management process. Selling is based on the same three factors we use for buying stocks: *fundamentals*, *valuation* and *sentiment* (Exhibit IV).

### Sell Discipline (Exhibit IV)



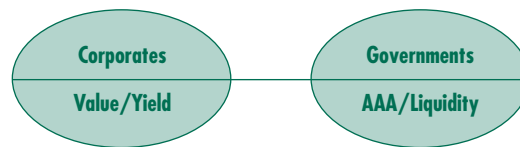
*Fundamentals* can trigger a sale if they do not keep up with valuation. This can happen either because fundamentals deteriorate or because valuations improve. *Valuation* is monitored through our price targets of downside, fair and full value and these targets are re-established periodically by our investment team. This is an integral part of our process because as fundamentals change, so can valuation. Therefore, our security management is dynamic and allows price targets to move both up and down to reflect improvement or deterioration in fundamentals. As our discount begins to narrow and fundamentals remain strong, we scale out of positions. Additionally, if investor *sentiment* changes more than fundamentals warrant, then a stock becomes a sell candidate.

## WHAT ABOUT FIXED INCOME?

As part of our balanced portfolio management, we employ a fixed income approach using intermediate government and investment-grade corporate bonds to create a *barbell of quality* structure, which produces a short average maturity with a higher-than-average yield (Exhibit V).

The two primary characteristics we look for in corporate bonds are attractive yield spread over treasuries and potential upgrades in quality ratings over the next several years. Analysis of quality rankings, sector spreads and the business cycle helps us determine which investment-grade corporate issues to select. Our focus is primarily towards the lower end of the investment-grade scale for yield enhancement to the portfolio. Bond ideas also come from our value equity research. This equity work allows us to discover quality companies that may be at the trough of their economic cycle. Our fixed income research is fundamental in nature, and primarily performed in-house. To provide liquidity, U.S. Treasury and Agency bonds are purchased.

### Barbell of Quality (Exhibit V)



We structure our fixed income portfolios to provide stability and income. Typically, we maintain an average maturity in the two- to five-year range and individual issues will generally not exceed ten years in maturity as the longer the maturity, the higher the volatility. Based on the shape of the yield curve, our interest rate forecast and the absolute level of interest rates, we will shift the average maturity of the fixed income portfolio. U.S. Government bonds will equal 5-10% per position and corporate bonds will equal 3-5% per position of the bond portion of the portfolio. Our final fixed structure will be based on our security selection, shape and level of the yield curve, and interest rate forecast.

FBP does not make significant changes to the portfolio to manipulate duration. We will shift duration depending on our interest rate outlook and risk/reward perceptions. The frequency of these changes is a function of changing market conditions.

## HOW WE VIEW ASSET ALLOCATION

The process for making asset mix decisions for a balanced portfolio is twofold. First, economic and interest rate analysis is performed. From this we develop expected return projections for the security markets. Next, each client's investment objectives, risk tolerance and constraints are considered. In general, equities comprise 40-70%, fixed 20-50% and cash is a by-product of security selection. Asset mix changes tend to be gradual shifts over time based on valuation, security selection and business cycle consideration.

## WHAT MAKES US DIFFERENT

*We are Value Managers.* To us, our approach is the purest form of value management. FBP believes strongly that investors overreact to both optimistic, as well as pessimistic news. Understanding this factor is key to successful investment management.

*Our Approach to Historical Valuations.* At FBP the historical valuation segment of our research effort focuses on multiple ratios, not just one or two. We begin with ten years of history in analyzing the following: sales, book value, cash flow, earnings and dividend yield. This provides a solid foundation for determining future value.

*We Study Investor Sentiment.* This effort gives us insight into institutional owners and their enthusiasm, or lack of, toward specific issues. We are trying to uncover unwarranted pessimism and our sentiment work is important in this effort as it leads to value opportunities.

*Investment Team Structure.* The ability to maximize investment talent is crucial to a successful investment process. At FBP our structure is designed to promote individual input – within a team approach. This makeup gives us the ability to draw out our best thinking relative to our investment ideas.

*Margin of Safety.* Strenuous analysis of the business prospects of a company and an

in-depth understanding of the future drivers of value allow us to determine the value of each company. The initial inclusion of a new security into the portfolio only occurs when the stock price is at a substantial discount to this value, giving us a significant margin of safety.

## WE BELIEVE POTENTIAL INVESTORS NEED TO KNOW . . .

Our clients are primarily endowments, foundations, employee benefit plans and individuals with equity or balanced objectives. We find that experienced investors, whether having chosen FBP to manage their own portfolios, or making decisions on behalf of an institutional account, are very comfortable with our investment strategy. We have a strict discipline both on the purchase and on the sale side and we want investors to hire us for our philosophy and not for our performance numbers. Our approach is long-term oriented. On average we hold a company for five years. We think it is important for clients to understand that the investments we make are generally not going to be perceived well by the financial publications at the time of purchase. The heavier the pessimism, the more we are convinced that we are purchasing a very low-risk investment. Finally, the companies we buy are often some of the oldest and largest companies in the country with highly recognizable names.

## DECISION-MAKING

At Flippin, Bruce & Porter, Inc. our investment committee is made up of five portfolio managers and four research analysts. Of the nine individuals, seven have their CFA designation. The experience level of our portfolio management team is high. Our investment committee works as a team with all investment decisions coming from the committee. Portfolio managers are responsible for security implementation, ongoing portfolio management and client contact.

**FLIPPIN, BRUCE & PORTER**



*Investment Counsel*

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