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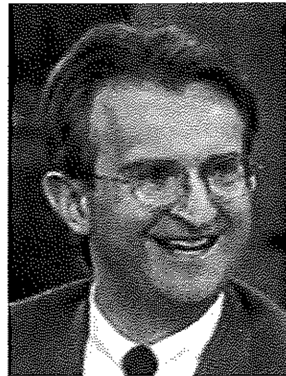
THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

MONEY MANAGER INTERVIEW

Winans International

KENNETH G. WINANS



KENNETH G. WINANS has been an internationally recognized Investment Professional since 1982. Prior to founding Winans International in 1992, he conducted investment analysis and portfolio management for several of Wall Street's oldest and most prestigious institutions. His research has been featured in articles published in "The Wall Street Journal" and he has made special guest appearances on CNN and CNBC. He has served as a Committee Member to the San Francisco chapter of A.I.M.R. and currently he is a Faculty Member for the Graduate School of Business at St. Mary's College of California.

Highlights

Kenneth G. Winans manages both stock and fixed income portfolios, focusing on mid to large cap U.S. growth stocks. He looks for companies that not only have good momentum in stock price, but also strong sales and bottom-line growth. On the fixed income side, he focuses on mid-grade corporate bonds. His strategy is to buy and hold the paper until term, with maturities no greater than ten years. At least in the near term, he thinks larger cap stocks will continue to outperform small caps and foreign issues.

Companies include: Automatic Data Processing (AUD); Lucent Technologies (LU); Federal National Mortgage (FNM); Eli Lilly (LLY); America Online (AOL).

SECTOR – GENERAL INVESTING

(GAT506)(6666) TWST: Won't you bring us up to date on Winans International?

Mr. Winans: First off, our business has grown quite rapidly since our last interview. We now manage approximately $67 million for 135 clients, versus $40 million one year ago.

We manage both stock and fixed income portfolios. We focus on mid to large cap U.S. growth stocks, which has obviously been the place to be for the last five years. We are looking for companies that not only have good momentum in their stock prices, but also strong sales and bottom-line growth. On the fixed income side, we focus on mid-grade corporate income. Our strategy is to buy and hold the paper until term with maturities no greater than 10 years. We're looking for companies that can meet the debt service needs of the paper. I'm less worried about revenue or EPS growth for these investments.

TWST: How do you allocate assets for your clients?

Mr. Winans: Our client base has grown very diversely due to our expansion. We have some clients that are 100% in stock, with our aggressive investors using margin. And then we have some people that are 100% in bonds. I would say that on average, our clients have a mix of approximately 60% in stocks and 40% in bonds.

TWST: Tell us a bit about your client base. What kinds of expectations do they bring with them or concerns?

Mr. Winans: To answer the first part of that question, I think the publicity that Winans International has received from interviews in "The Wall Street Journal" and my TV appearances have generated a lot of interest in our program. We're no longer considered a small, California money manager. We get a lot of referrals from accountants and lawyers across the country.

You talked about clients' expectations. I think the hardest thing is dealing with people who are relatively new to investing in the stock market. I try to convince them that the S&P 500 will not compound at 30% a year in the long run, but will be more in line with 18% if you look at the 15-year average. So it's trying to temper some of those expectations into a more realistic long-term strategy.

TWST: How do you describe your equity investment process? You're looking for growth. What do you consider to be a good business?

Mr. Winans: The preliminary research effort is primarily done through a computer model that I designed while I was an analyst. We're very much geared to quantitative analysis. To me, it is based on numbers coming through the computer system, and whether they, in fact, make sense based on historical valuations.

Through database screening, we narrow down a field from about 9,000 down to 300 companies. From that 300, I look at their relative valuations. In other words, if I look at the price to sales and price to earnings of that stock over the last 10 years, where are they right now within that range? Also, I compare these companies against other growth stocks in their industries. That is, I compare a stock like **Microsoft,** which is hitting record valuations, to other high tech stocks. From this point, I like to find stocks that have had temporary corrections for whatever reasons from those highs. A typical stock I buy is 10-15% off of its 52-week high.

One of the other things that we do is to use stop-loss orders on new acquisitions. Our rule is that if a stock falls more than 15% from where it is originally purchased, we trim the position by 50%. I find that a lot of our investors really like this, because they feel that too many times, the inter-year market volatility causes them to suffer high short-term losses.

TWST: Now how did you determine that it would be 50%?

Mr. Winans: If I'm looking at the typical portfolio having 30-40 stocks, meaning that I'm looking at positions between 3% and 5% of the entire portfolio, none of the positions are going to be exceptionally big within the portfolio. So 50% is used in order to bring the exposure of a 5% position down to an insignificant 2.5%.

The stop loss placement of 15% came from research that indicated that if $30 to $50 stocks fluctuate outside of that range, they typically enter a significant downtrend. In other words, we're not being stopped out just because of the inter-day noise of the stock, but because there is a change in trend.

TWST: How do you manage tax implications within that strategy?

Mr. Winans: If we break down our client base, probably 30-40% of our investors have taxable accounts. I am held responsible for tax considerations. As investments age over a number of years, a lot of considerations have to be made on whether or not using the stop at that point would make sense. When I talked about the stops initially, it was on new positions. With older portfolios, we use hedges to protect against market volatility. The type of hedge that I typically choose to use is short selling the S&P 500 depository receipts. A lot of our investors used to use the short against box strategy, which now the government will not let you do under the new tax laws. But I find that my clients like the market hedge because they have good individual stocks. What we're really concerned with is not so much a failure of the stocks to perform as much as it is a concern about overall market volatility.

"Automatic Data Processing does a lot of database work and actually is the largest payroll service company in the United States. Their revenues are growing at 18% a year and earnings per share at 14%. As far as I know, they have never really had a bad quarter. It's just one of those great stories."

TWST: Do you continue to own any of the stocks in the portfolio you talked about two years ago?

Mr. Winans: Certainly, we have most of them: **Abbott Laboratories** (ABT), **American Express** (AXP), **Anheuser-Busch** (BUD), **Danaher** (DHR), **Merck** (MRK), **Omnicom** (OMC) and **SBC Communications** (SBC). We did sell out of **Molex** (MOLX). That's no longer there. I would add that, over that two-year period, we have added a lot more high tech stocks. We have large positions in **Microsoft** (MSFT) and **Cisco Systems** (CSCO).

TWST: When did you buy Microsoft?

Mr. Winans: When we had the October correction of 1997, I stepped in and bought it across the board for all clients.

TWST: And how about Cisco? Same time?

Mr. Winans: Yes, the same time.

TWST: Now, tell us what you would do with the shares of Microsoft and Cisco at current prices?

Mr. Winans: That's a question that I get asked a lot, and I think that every money manager is in the same boat. Part of me is really excited because these positions have done so well. But what was at one point in time a 5-10% position in a portfolio suddenly is 15-20% of a portfolio. After consulting clients about the risk of having that large a position in their portfolios, we generally trim these positions back by 50%.

TWST: Some think that with Microsoft at an extreme market multiple, it's not a healthy thing for the market. That this is "bubble.com." What do you think?

Mr. Winans: I'm very concerned about the market right now, but maybe for reasons different from what you're hearing from other people. I completed an analysis of this great bull run we've had since January, 1995. And what I've found is that each of the declines has gotten worse. The first decline in 1996, which I remember was the **Motorola** correction, was 10%. The first decline in 1997, which was caused by the Fed raising interest rates, was a 12% decline, followed by October's 16% decline. The decline we had last year because of Russia and the impeachment scandal was 21%.

1-Year Daily Chart of Automatic Data Processing

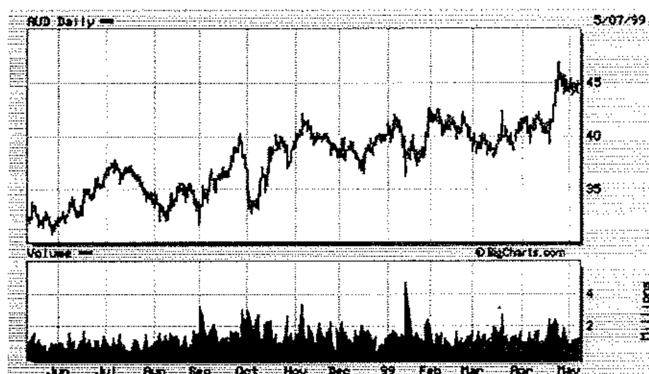


Chart provided by www.BigCharts.com

Clearly there is an increase in the volatility of the market in percentage terms. And I do not believe that this is going to subside anytime in the near future. It would not surprise me to see the DJIA back around 8,000 at some point in time between now and February, 2000.

Remember, this is part of being an old bull market. As the stock valuations increase, you can expect volatility to get higher. I firmly believe we'll see the Dow hit 14,000 between now and the year 2007. But it's not going to go straight up. We will have some years that get pretty ugly.

TWST: How do you position your portfolios having said that?

Mr. Winans: It's really a combination of the things that we just talked about. I have been selling the companies that have had disappointing revenue and earnings growth.

TWST: Will you mention some names?

Mr. Winans: Sure, **Molex, Lear Corporation** (LEA), and **Computer Sciences** (CSC) fit into this category. Basically, we have sold out of these companies because we can find other companies in their industries that have better prospects for growth.

Also, I have been moving stop orders up in the event that we have a situation similar to what happened with **Rite Aid** (RAD), where an individual stock just simply blows up. I have positioned stops where they will prevent a client from taking a real hit on an individual holding, but won't across the board stop out the entire portfolio if the market was to moderately decline.

"Lucent Technologies. In its short history, it's done nothing but go straight up, and with its recent little correction off its highs, I think it's a nice play in here. Revenues are growing on average at 14%, with earnings per share growing at 74%."

In addition, we have placed hedges on older taxable accounts. With new money coming into the portfolios right now, I have asked new clients, as well as existing clients who had given us new money, to give me a 120-day window to find investments for that money.

Last, but not least, we've had a lot of people who have switched their asset allocations more toward bonds. With interest rates climbing from their lows set last October, I'm able to find some corporate paper that I really like.

TWST: Are you theme-driven or industry-driven in finding places for new money?

Mr. Winans: Both. I believe that any portfolio expected to perform well for the remainder of this bull market has to have strong exposure in four areas: high tech, financial services, health-care, and telecom. I'm trying to make sure that we have adequate representation in all portfolios within those four sectors. It does not mean that every client is going to have the same exact stocks, but out of 40 stocks, I would hope two or three would represent each of those sectors.

TWST: What are you emphasizing currently?

Mr. Winans: It's funny you ask that, because I ran my Buy list just before the interview. There are four that I wanted to mention to you today. First is **Automatic Data Processing** (AUD), which I put down as a computer hardware/software company. They do a lot of database work and actually are the largest payroll service company in the United States. Their revenues are growing at 18% a year and earnings per share at 14%. As far as I know, they have never really had a bad quarter. It's just one of those great stories.

Next on the list is **Lucent Technologies** (LU). In its short history, it's done nothing but go straight up, and with its recent little correction off its highs, I think it's a nice play in here. Revenues are growing on average at 14%, with earnings per share growing at 74%. What can you say? It's just a great story.

"I like Fannie Mae. You're dealing with the largest secondary buyer of real estate mortgages in the U.S. Unlike other thrift plays, Fannie Mae has really held up well. Even when you find situations where interest rates are going up, I find Fannie Mae does not have the same sensitivity to interest rate movement as other financial service plays do."

On the financial services side, I like **Fannie Mae** (FNM). You're dealing with the largest secondary buyer of real estate mortgages in the U.S. Unlike other thrift plays, **Fannie Mae** has really held up well. Even when you find situations where interest rates are going up, I find **Fannie Mae** does not have the same sensitivity to interest rate movement as other financial service plays do; revenues growing at 14% and earnings per share growing at 13%.

Last but not least, I still like the big drug stocks, and my pick is **Eli Lilly** (LLY). They have positioned themselves well. They don't have the same problem a lot of the other drug companies have with important patents expiring. They actually have a lot of new products in the pipeline that are expected to produce good results over the next couple of years. You're looking at revenue growth of 16% with earnings growing around 16% as well—just a great story.

TWST: Some would add Asia, ex Japan as a growth area. What do you think?

Mr. Winans: I'm not a big fan of direct foreign investing. I feel that in a global economy, those companies that I just mentioned to you, as well as any other growth stock that you could buy on the New York Stock Exchange, are in fact, international companies. I find that with the sophistication and convenience of our markets, most Americans are better off keeping their money here and letting those U.S.-based companies expand operations abroad.

In fact, the 15-year return of foreign mutual funds has been 12% compared to the S&P 500's 18%. So to me, it's not really compelling to put money there.

We're all concerned about the valuations on the large cap U.S stocks. But does it make sense right now to be putting money in other areas that have their own sets of problems?

So at least in the near term, I think big stocks will continue to outperform small caps as well as foreign issues.

TWST: Have you found any opportunities in the Internet boom?

Mr. Winans: Absolutely. A holding that I have added to as recently as last December is **America Online** (AOL). Now that it is officially an S&P 500 stock, certainly it's fair game for us. My problem with the Internet stocks, and I'm sure you hear this from other managers, is that if you have any orientation at all toward fundamental analysis, it's hard to find a reason to buy companies that don't expect to make money for at least the next couple of years. Also, if you look solely at revenue analyses, they're trading at huge multiples. So the problem is finding stories that fit my style of management, and right now the only one that barely does fit is **America Online.**

"Eli Lilly have positioned themselves well. They don't have the same problem a lot of the other drug companies have with important patents expiring. They actually have a lot of new products in the pipeline that are expected to produce good results over the next couple of years."

1-Year Daily Chart of Eli Lilly

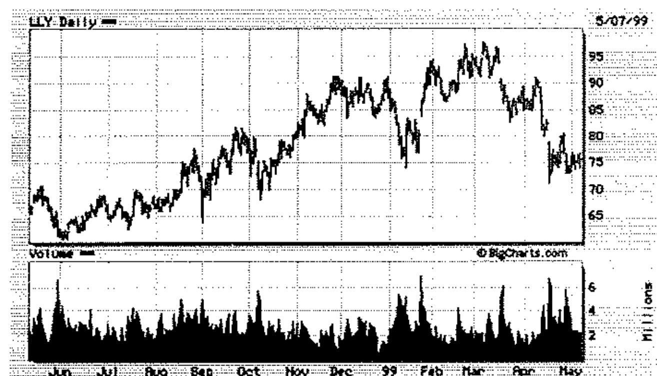


Chart provided by www.BigCharts.com

TWST: Please explain why you have ruled out the small cap growth stocks.

Mr. Winans: Let's look at the returns of the small cap mutual funds for the last 15, 10 and five years. (By the way, the data that I'm giving you comes from Morningstar.) Small cap mutual funds over 15 years have produced an 11.4% return versus the S&P 500's 17.9%. Over the last 10 years, they've produced 13.7% versus the S&P's 19.2%. And in the last five years, it's 12.4% versus 24.1%. I just don't find that to be really compelling to want to step into.

I'm sure there will come a point in time when small cap stocks will have a good run. But the problem is, if you think about why the big cap stocks have done what they have done in the last five years, a lot of that is the increase in retirement plan inflows. And when I talk with investors, they tend to view their retirement money differently from other money. They want to be in safer stocks. And they perceive that to be bigger cap companies.

TWST: Did you address liquidity in the smaller Internet stocks? Will people keep buying the IPOs?

Mr. Winans: I remember other times in the past when other hot stock groups acted as the Internet stocks do today. In the late 1980s and early 1990s, the biotech stocks were the rockets of the time. It seemed like any stock in the biotech region, back in that time frame, was instantly going to have a huge multiple. It didn't matter what they did. They just happened to have the right name. And they happened to be a company in the right industry.

But as time moved on, many of those stocks blew up. We were left with some wonderful companies like **Amgen** (AMGN), and the people who bought it early did very well. But I believe that somewhere in the very near future, people will begin to take profits from these Internet stocks. And you will begin to see the volatility move in the other direction.

TWST: That was my point. Who's going to buy them to take the profits?

Mr. Winans: I have a hard time believing the institutions will. A lot of them have the same problem that I do. The rules they use to manage money don't allow them to step into these companies. Simply put, if these companies don't begin to produce the profits that they have been promising Wall Street, I think there are going to be problems.

1-Year Daily Chart of America Online

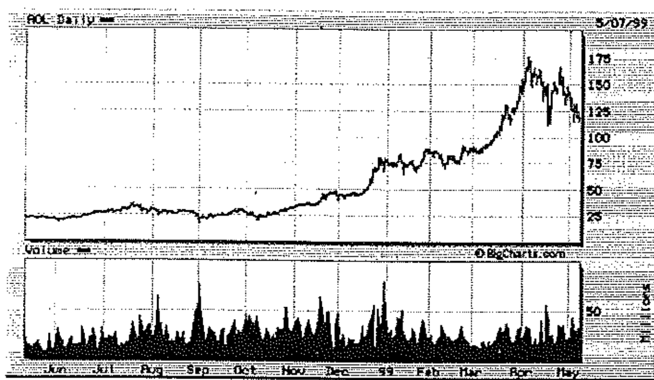


Chart provided by www.BigCharts.com

For instance, last Christmas we all heard about how much in goods and services people were buying over the Internet for Christmas. Yet **Amazon.com** (AMZN) still managed to lose money, whereas **Barnes & Noble** (BKS), and **Borders** (BGP) and other more conventional competitors did very well and also have Internet access.

Now, **Amazon.com** has told the Street that they will begin to make money in the last half of this year. If they do not begin to show that, I believe that stock will be in for a very rough time. Again, you're dealing with fluff and it's pretty hard to get a handle on them. But to answer your question, I think you're looking at a classic bubble. People will build them up to a point where there's a speculative excess and then it just pops. I think when it pops, you'll see these things fall as much as 50% from their current values.

TWST: And a question about your model that you told us earlier was born from your experience as an analyst. What kind of analytical tools do you rely on and has anything become more or less important to you over the years in analyzing stocks?

Mr. Winans: The models that I designed initially started back in 1982. We were experimenting with using databases and the screening devices on those databases. What we now use are simply more sophisticated, more capable models. But basically, their genesis still comes from the idea of screening down a group of stocks and letting the screens tell you what's moving. I know that ability allowed us to move into the real growth engines for the US economy.

It is interesting to note that I find there's actually information overload. A lot of people who do not have a strong discipline do find themselves tending to get moved by specific pieces of information that happen at one point in time versus another.

TWST: What do potential clients ask you that I haven't, which might give a better picture of what you're doing?

Mr. Winans: I think you hit on the main points. Tax efficiency is a big issue right now. We have a lot of people who have had very bad experiences with mutual funds, who have not understood why their fund posted these great returns. Yet, they get a tax bill at the end of the year for the turnover within the funds.

We get asked a lot about our ability to deal with a bear market. There's a real concern that the managers on Wall Street have no bear market strategy. Simply put, they are not able to tell you what they will do in that scenario.

Another issue is customer service. We have been able to maintain a high level of customer service, where people have direct access to me. I find that a lot of investors are very nervous right now. They realize that they've made a lot of money in the last five years. And they don't want to give big chunks of it back. So they need to have more communication with the people managing their money.

TWST: Is there a case for the bears?

Mr. Winans: Yes, there is. Although we are in a postwar economic expansion and the Dow could hit 14000 in the future, I do think the current high valuations are a very real threat. You have fewer and fewer stocks participating in this rally. This is typically a sign of a later stage bull market. The fact that interest rates have gone up since last October is another bad sign.

We haven't spent any time talking about Y2K. I do think we have an event-driven scenario happening this year for the markets, very similar to the Gulf War, where you know something is going to happen on a set date. I believe that by June or July publicly traded companies will begin to give their investors a detailed breakdown on Y2K compliance. This could induce a 20% correction.

TWST: Is there anything you wanted to say about the fixed income side of your approach?

Mr. Winans: I talked earlier about bonds. There are good quality corporate issues that are paying yields in excess of 9% with maturities under 10 years. It's a good time to consider what degree of exposure you want to have in the stock market. I find that more people are saying it's time to switch at least some of their money to fixed income.

TWST: Should I assume that you consider a corporate bond a separate asset class? You don't look at it as an equity?

Mr. Winans: Absolutely! To me, investing comes down to either owning or loaning, and when you own a corporate bond, you in fact have lent money to a corporation. It's a very different asset class with a different set of risk characteristics and, in most cases, it's far less volatile than stocks.

TWST: Will you do your shopping in the same growth sectors you outlined earlier?

Mr. Winans: Yes. If we were to have a correction to 8,000 on the DJIA, I would absolutely be looking in those areas to buy stocks, because I believe that will continue to be the leadership in the market.

I can find good deals on bonds right now. When you look at companies like **Kaufman & Broad** (KBH), which is one of the biggest homebuilders in the country, you have a bond that's a nine and three-eighths coupon due in 2003 with a yield to maturity of 8.4%. Again, **Kaufman & Broad** has weathered bad markets, especially in California, and made money in all those years.

RJR Nabisco (RN) has a BBB-bond with a 8 3/4%, due in 2007, and a yield to maturity of 7.7%. Needless to say, these could be nice additions to a portfolio wanting to better diversify itself.

TWST: Thank you.

KENNETH G. WINANS
Winans International
655 Redwood Highway, Suite 285
Mill Valley, CA 94941
(415) 381-4739

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100 WALL STREET, NEW YORK, NY 10005
TEL: (212) 952-7400, FAX: (212) 668-9842, E-MAIL: transcript@twst.com