

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## Focusing on Quality and Financial Integrity to Mitigate Risk



**SCOT C. HOLLMANN, CFA, CIC**, is Principal, Vice President and Portfolio Manager for Luther King Capital Management. He has served as lead portfolio manager of the LKCM Balanced Fund since the inception of the fund in December 1997. Mr. Hollmann graduated with a Bachelor of Business Administration and a Master of Business Administration from Texas Christian University and joined Luther King Capital Management in 1983.

### SECTOR — GENERAL INVESTING

**TWST: Tell us about Luther King Capital Management and the history of LKCM.**

**Mr. Hollmann:** Luther King Capital Management is a Fort Worth, Texas-based independent registered investment adviser that was founded in 1979. Our client base primarily consists of high net worth individuals, endowments, foundations and retirement plans. In addition to separately managed portfolios, we manage a family of mutual funds called the LKCM Funds, which includes a core equity fund, a balanced fund, a small-cap fund, a small- and mid-cap fund, and a fixed income fund. We also manage the Aquinas Funds, which is a family of socially responsible mutual funds. Our investment process is extremely research-intensive, and our research team consists of sector analysts and a small-cap team, as well as some generalists, whose responsibilities are to find investment opportunities across the market spectrum.

**TWST: Can you detail LKCM's investment philosophy?**

**Mr. Hollmann:** In the equity markets, we look for companies that demonstrate several characteristics. Qualitatively, we like to invest in well-managed companies that are competitively advantaged. We dedicate a lot of resources to making sure we understand the strategic direction of the company and how management is pursuing its strategy. As long-term investors, getting to know companies not only helps us identify investment opportunities but also helps with our sell decision if management deviates from that strategy.

From a financial standpoint, we like companies that have solid balance sheets, consistently high return on shareholders'

equity, a high reinvestment rate and excess cash flow generation. Companies with these characteristics tend to be dominant or at least prominent within their industry and can be excellent long-term investments. In the fixed income area, our primary focus is on high-quality corporate bonds. Our sector analysts are responsible for credit work in their area and work closely with our fixed income team to minimize credit risk. The common thread that runs through our equity approach as well as our fixed income strategy is a focus on quality and financial integrity.

**TWST: You manage the LKCM Balanced Fund, can you tell us how that ties into the investment philosophy you were detailing?**

**Mr. Hollmann:** The LKCM Balanced Fund was formed in 1997, and its investment objective and approach has been consistent over the years. The goal of the fund is to generate capital appreciation as well as income, and we utilize a blend of equity and fixed income securities that meet our investment criteria to achieve that objective. As a balanced fund, we've maintained a weighting of at least 25% in fixed income securities. Over time, the equity portion of the portfolio has provided growth for investors, while the fixed income sector has generated income and smoothed out portfolio returns.

**TWST: What is the demographic that your fund targets, and how does it cover the needs of those customers?**

**Mr. Hollmann:** The fund's longstanding focus on diversification and quality as a means of managing risk is attractive to many investors. The fund is not managed for aggressive short-term investors or traders but rather patient long-term investors who want to build wealth over a long period of time.

**TWST: What are the key market and economic trends over the forthcoming six months to a year that you believe will influence the portfolio performance?**

**Mr. Hollmann:** It's certainly been an interesting year, and it will continue to be so in the next six to 12 months. 2016 is obviously an election year, so there will be a lot of political rhetoric to sort through regarding areas such as taxes, health care, and financial and environmental regulation. Also, it will be important to keep a close eye on global economic growth and its impact on corporate profits.

From a portfolio-strategy perspective, the direction of interest rates is especially important. In our view, both the equity as well as the fixed income sectors of the portfolio are well-positioned for a gradual lift in interest rates. As an example, the financial services sector has an emphasis on regional banks with asset-sensitive balance sheets, which means that spreads widen as interest rates rise, and wider spreads, everything else being equal, means better earnings, which usually translates into improving share prices. Also, we continue to de-emphasize interest-rate-sensitive areas like real estate investment trusts and master limited partnerships, as well as other areas likely to underperform in a rising interest rate environment. In the fixed income area, we've kept the portfolio duration relatively short as an additional way to manage interest rate risk.

**TWST: In general, what should investors be most concerned about in their portfolios over this time frame?**

**Mr. Hollmann:** I would say we are concerned that many investors are complacent about the amount of risk they are assuming, whether in the credit markets or in high-yield equities. The Federal Reserve's zero-interest-rate policy has driven many investors to a point of desperately reaching for yield with little understanding of the

investors during disruptive periods. A good example is during the financial crisis of 2008 and 2009 when our research effort led us to initiate positions in a number of high-quality companies whose share prices were under pressure during the bear market. This strategy benefited the fund as these companies not only survived but thrived as the economy and capital-market environment stabilized.

**TWST: Tell me more about how you mitigate risk and what your outlook is on that.**

**Mr. Hollmann:** In the equity portion of the portfolio, it's all about quality, financial integrity, and making sure that the investments that we make are in companies that have the financial strength and the market positions to survive difficult economic or capital-market environments like we saw during the financial crisis. In the fixed income sector of the portfolio, again, quality, financial integrity and keeping the duration relatively short are critical ways to manage risk levels. If interest rates gradually lift as we anticipate, the relatively low level of interest rate risk in the portfolio should help protect the fund, and ultimately, we'll have improving reinvestment rate opportunities in the fixed income sector.

From a big-picture standpoint, we have to monitor the strength of the global economy, particularly China and other emerging markets. A further slowdown in

these areas could make corporate profit growth difficult again in 2016. We like to own shares of companies that have the unique ability to grow their earnings despite a potentially challenging macro environment.

**TWST: Are most of your holdings based in the U.S., or is it a fund with an international reach?**

**Mr. Hollmann:** The focus of the fund is on domestic companies. Many of our holdings have significant international operations, but most are headquartered in the United States.

***"While there are many interesting businesses located around the globe, we find plenty of opportunities to invest in world-class companies in the United States. We like the transparency with regard to financial statements, disclosure requirements are high, and we have a much better opportunity to get to know management teams and understand corporate strategy."***

underlying assets generating the income. We believe that maintaining a high-quality focus and appropriate investment diversification will prove to be particularly important over the next year.

**TWST: How will some of your strategies take advantage of the trends that you foresee in the next six months to a year and create value whilst also protecting your investors?**

**Mr. Hollmann:** The balance between high-quality equities and short-duration fixed income securities should prove to be beneficial if we experience unexpectedly high interest rates or a shortfall in corporate profit growth. Historically, we have been opportunistic

### Highlights

*Scot C. Hollmann discusses Luther King Capital Management and the LKCM Balanced Fund. The fund aims to generate capital appreciation and income by blending equity and fixed income securities. In order to mitigate risk, Mr. Hollmann focuses on quality and financial integrity in the both the equity and fixed income sectors. In regard to choosing holdings for the equity portion of the portfolio, Mr. Hollmann looks for companies that are well-managed with a competitive advantage, a solid balance sheet, high returns on equity, a high level of reinvestment and cash flow generation. He feels these characteristics tend to be indicative of good long-term investments.*

**TWST: Why do you have a preference for U.S.-based companies?**

**Mr. Hollmann:** While there are many interesting businesses located around the globe, we find plenty of opportunities to invest in world-class companies in the United States. We like the transparency with regard to financial statements, disclosure requirements are high, and we have a much better opportunity to get to know management teams and understand corporate strategy. That's where we focus most of our research effort, and it's where we find most of our investment opportunities.

**TWST: Within the U.S., are there any sectors that you like to be overweight in or any that are currently captivating your attention?**

**Mr. Hollmann:** One of the sectors that the LKCM Balanced Fund currently has meaningful exposure to is the consumer-discretionary area. In our view, U.S. consumers are in better shape than they have been in several years. The employment situation, while not optimal, continues to improve. Additionally, energy prices are down, which is helpful for consumer spending. Finally, the housing market is significantly stronger than it has been in several years, which is important for consumer confidence levels. Based on these dynamics, we maintain significant holdings in areas such as e-commerce, media and branded apparel companies.

We are also excited about several sectors in addition to the consumer-discretionary sector. Since overall stock-market returns so far in 2015 have been below-average, a number of investment opportunities have presented themselves. For example, both the materials and industrial sectors of the market have been challenging in 2015 due to several factors, including commodity price weakness, the strengthening dollar and the overall slowing global economy. Investor expectations are modest for these sectors, but there are a number of companies that are well-positioned to weather the storm and should prove to be attractive long-term investments.

Finally, the energy sector will be important in 2016. As everyone knows, this sector was especially difficult in 2015 as prices for both oil and natural gas collapsed during the year. Many overleveraged companies are struggling to survive, which makes for a tough environment for anyone in this space. Ultimately, companies with the strongest balance sheets, best assets, positive cash flows, and experienced managements will successfully work their way through the valley and come out of the cycle with improved competitive positions.

In some ways, what is happening to the energy sector reminds us of what happened in the financial-services area in the 2007 to 2009 period. Shares of both high-quality companies as well as distressed companies in that sector came under intense pressure during those years. Companies with the financial strength to survive were ultimately rewarded by investors, while many others disappeared through bankruptcy, or were restructured with little or no value left for equity holders.

Since it's very difficult, if not impossible, to predict how long this down cycle for commodity prices will last, it's critical to avoid companies with weak financial positions. Ultimately, just as the case of the financial-services stocks, some terrific long-term investment opportunities will present themselves in the energy sector, and we are busy trying to identify those opportunities.

**TWST: Can you tell me about your sell discipline?**

**Mr. Hollmann:** We meet with several hundred company management teams during the course of a year either in our office or out in the field. We do, in our view, get a feel for overall strategic direction of the companies they are leading. If we sense that the strategic direction of a company is not consistent with what we understood it to be, that's a warning sign, and that can certainly mean that we should part ways with

a company and sell its shares. There are several other warning signs that we take into consideration, including unexpected management changes, or revenue, earnings or cash flow shortfalls relative to our expectations. Also, if valuation gets stretched, we may trim or eliminate a holding in order to manage stock-specific risk levels.

**TWST: How do you ascertain new opportunities?**

**Mr. Hollmann:** In general, we look for improving fundamental situations coupled with attractive entry points. Catalysts include management changes, market-share shifts, new product introductions or overall improvements to the revenue and profitability outlook for a company. As long-term investors, we are very selective regarding initiating new investments. Some of the equity positions in the fund were initiated 10 to 15 years ago, while other investments are more recent. As long as fundamentals remain strong and the strategic direction of the company remains intact, we will let management continue to build value for shareholders of the fund.

**TWST: Which benchmark do you use to track the LKCM Balanced Fund, and how well has the fund performed in relation to that?**

**Mr. Hollmann:** Since the fund is a blend of equity and fixed income securities, it's usually benchmarked against both equity and fixed income indices as well as compared to other balanced funds in its peer group. The Standard & Poor's 500 Index is an appropriate equity benchmark, and the Barclays Intermediate Government/Credit Bond Index is utilized as a fixed income benchmark.

Due to its relatively low duration, fixed income sector returns have tended to be slightly lower than the benchmark, although they are ahead of the benchmark over the last three years as well as year to date. The equity sector of the fund has generated strong returns relative to the Standard & Poor's 500 Index for most periods and since its inception almost 18 years ago. Blended together, the strategy has rewarded investors by achieving the objectives of long-term growth and income generation, while smoothing out returns over various market cycles.

That success is evidenced by the fund's 5-Star Morningstar rating, and being ranked in the top 4% of funds in its category by Morningstar over the last 15 years and top 1% during the last 10 years as of the date of this interview. While we are pleased with our long-term track record, our team works hard every day to continue to earn the confidence of each and every investor in the fund.

**TWST: Thank you. (KK)**

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	YTD	1Yr	3YR	5YR	10YR	Since Inception
<b>LKCM Balanced Fund</b>	8.74%	11.07%	7.16%	9.26%	6.92%	6.53%
<b>Lipper Mixed-Asset Target Allocation Growth Funds Index</b>	12.30%	13.30%	7.05%	9.45%	5.65%	6.32%
<b>S&amp;P 500 Index</b>	14.24%	18.61%	10.81%	14.22%	7.44%	6.94%

As of 09/30/17

Inception Date: 12/30/97

All periods over one year are annualized.

Net Expense Ratio: 0.81%\* Gross Expense Ratio: 1.04%

***Performance data quoted represents past performance and does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Fund performance current to the most recent month-end may be lower or higher than the performance quoted and can be obtained by calling 1-800-688-LKCM. The fund imposes a 1.00% redemption fee on shares held less than 30 days, and if reflected, the fee would reduce the performance shown.***

\*Luther King Capital Management has contractually agreed to waive all or a portion of its management fee and/or reimburse the Fund through May 1, 2018.

Cash flow measures the cash generating capability of a company by adding non-cash charges (e.g. depreciation) and interest expense to pretax income.

Duration is an approximate measure of a bond's price sensitivity to changes in interest rates

The Barclays U.S. Intermediate Government/Credit Bond Index is an unmanaged market value weighted index measuring both the principal price changes of, and income provided by, the underlying universe of securities that comprise the index. Securities included in the index must meet the following criteria: fixed as opposed to variable rate; remaining maturity of one to ten years; minimum outstanding par value of \$250 million; rated investment grade or higher by Moody's Investors Service or equivalent; must be dollar denominated and non-convertible; and must be publicly issued..

The S&P 500® Index is a capitalization weighted index designed to measure the performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The S&P 500 Index is one of the most widely used benchmarks of U.S. equity performance.

One cannot invest directly in an index.

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*The Funds' investment objectives, risks, charges, and expenses must be considered carefully before investing. The Funds' summary and statutory prospectuses contain this and other important information about the Funds. Please read the summary and statutory prospectuses carefully before investing. To obtain a hardcopy, please call 1-800-688-5526. Read carefully before investing.*

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**Diversification does not assure a profit not protect against loss in a declining market.**

For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating (based on a Morningstar risk-adjusted return measure that accounts for variation in a fund's monthly performance, including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star.

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