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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Finding Midcap Growth in Consumer Discretionary, Industrials and Health Care

SCOTT THOMPSON, Vice President, Co-Director of Research and Security Analyst, joined Montag & Caldwell in 1992 upon graduating from the University of the South with a degree in economics. He became Co-Director of Research in June 2009 and serves as Co-Chairman of the Mid Cap Growth Investment Policy Group. His professional affiliations include the CFA Institute and the Atlanta Society of Finance and Investment Professionals, former Trustee. He has a B.A. from the University of the South and an MBA from Emory University.

SECTOR — GENERAL INVESTING

TWST: Can you begin with an introduction to Montag & Caldwell, and tell us a bit about your role there?

Mr. Thompson: Montag & Caldwell is an investment management firm located in Atlanta, Georgia. We've been in business since 1945, and we manage primarily institutional long-only portfolios. We are focused on growth, both large-cap and midcap, high-quality growth strategies. We have roughly $13 billion in assets under management, and we have an investment team comprised of six dedicated research analysts, a team of 11 portfolio managers and three dedicated traders.

TWST: And what's your role?

Mr. Thompson: I've been here since 1992. I've been in equity research the whole time. I have long been an analyst supporting our large-cap growth strategy, following a variety of industries, including machinery, transports, telecom equipment, enterprise software and services, and media and entertainment. I became Co-Director of Research in 2009 along with my colleague Andy Jung.

In 2007, Andy and I spearheaded the launch of our midcap growth strategy, which effectively mirrors the philosophy and process of our large-cap strategy, which has been in existence for decades. Really, the main difference is that the midcap really just focuses on a much narrower slice of the market cap spectrum, that being between $2 billion and $10 billion in market cap, whereas the large-cap portfolio tends to concentrate its holdings at $10 billion and up.

Highlights

Scott Thompson talks about his role in managing his firm's midcap growth strategy. Mr. Thompson says that in the near term the outlook for the economy and the market is good; however, in the intermediate to long term he believes the market is vulnerable. Mr. Thompson's portfolio is most concentrated on the following three sectors: consumer discretionary, industrials and health care. He shares his top names within those spaces.

Companies discussed: Amphenol Corporation (APH); Fastenal Company (FAST); Dollar Tree (DLTR); Family Dollar Stores (FDO) and Dollar General Corporation (DG).

TWST: How would you describe your investment philosophy, and what makes it unique?

Mr. Thompson: Well, I would say we are clearly focused on investing in high-quality companies that have the ability to grow their earnings faster than the market and that are trading at a discount to what we believe their intrinsic value is. So the underpinning of that philosophy is, we believe that there are market inefficiencies that can arise in the near term that we look to exploit. In this case, the inefficiency we're looking to exploit is mispriced earnings growth, both overvalued earnings growth and undervalued earnings growth. And we apply a very disciplined process that is repeatable.

We have a dedicated team of analysts that have been here for long time, so we have a tremendous amount of continuity amongst the team that have been following the same stocks for a long period of time. We get to know our companies very well. We tend to focus our bets on our most compelling ideas. So we tend to operate fairly concentrated portfolios.

We also build our portfolios from the bottom up, and we are also benchmark-agnostic, so in essence, we're not afraid to look different than our benchmarks, knowing that that's really how

you tend to generate alpha. So like I said, it is a disciplined repeatable process that we look to apply consistently, and if we're doing our jobs correctly, hopefully we're identifying the right stocks at the right price at the right time.

1-Year Daily Chart of Amphenol Corporation

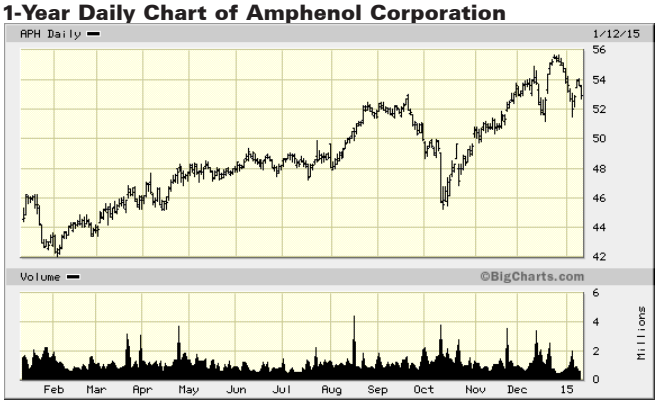

Chart provided by www.BigCharts.com

TWST: I know you said you take bottom-up approach, but are there any certain sectors that have emerged as being more likely than others to include the kinds of stocks you're looking for?

Mr. Thompson: I think right now if you look at how we're positioned in our midcap growth strategy, the three sectors where we are most concentrated or have the largest overweights relative to our benchmark and therefore see the greatest combination of both attractive value and compelling earnings growth would be, one, consumer discretionary, which is a sector which had really underperformed for most of this year until just recently, but that was after a period of several years of being a leadership group. We are particularly optimistic on discretionary now, not surprisingly given the steady improvement in jobs and early signs of perhaps some improvement in wage growth combined with the collapse in oil prices, which will provide bit of a tailwind for consumer spending as we go forward here.

The second sector where we see good prospects is the industrial sector. The group suffered some headwinds not too long ago on fears about global growth concerns particularly out of Europe and some of the emerging markets like China. We think this is another sector though that is likely to be a beneficiary of lower commodity prices and improved economic activity as we look out into 2015. There are also a good number of self-help stories in this sector that we tend to like, where companies are able to essentially make their own weather irrespective of the macro picture by reinvesting strong healthy cash flows at high returns.

Then the third sector that we are favorable on at the moment is health care. This has been a winning sector this year. Although admittedly, we haven't fully participated in our midcap strategy because we've been precluded from owning a number of the profitless biotechs that have been shooting higher this year, but it is a sector that we like because it offers a compelling combination of both value and earnings growth supported by demographic trends, broadening consumption brought about by the ACA, along with a number of really interesting drug discoveries and therapeutic advances.

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TWST: What's your outlook for the global economy, and how does that inform your approach to investing in the current environment?

Mr. Thompson: Yes, in the near term we would say the path of least resistance for the market is likely higher. The economy and corporate profits continue to grow slowly but steadily; there doesn't appear any immediate threat of recession and inflation remains subdued, which means that the Fed can be deliberate withdrawing accommodation.

At the same time, the market is also benefiting from favorable seasonality in the very near term — November and December tend to be very good months for the market — and then lastly, we've entered the third year of the presidential cycle which historically has been a very strong year for the market. In fact, since World War II you're batting 1,000; 17 out of 17 times the market has been up, and on average up 17.5% in that third year of the presidential cycle. So like I said, in the near term we think the outlook is good for the market and the economy.

In the intermediate to longer term, we think the market is vulnerable. One, valuations are full, at least on our work. Two, sentiment is overly bullish, reflecting worrisome investor complacency. It seems like lot of people are banking on the Fed put; i.e., the Fed has your back. Thirdly, quantitative easing has ended, which removes a powerful source of liquidity that has driven asset values higher, and so at a minimum we would expect volatility in the markets to increase, just as it did when QE1 and QE2 ended. In fact, we've already begun to see some of that volatility with the sharp pullback and rebound that we saw in October in the stock market. Bonds, especially high yield, currencies, commodities, have all shown an uptick in volatility here recently.

Then lastly, corporate profit margins are at peak levels and at some point are likely to mean revert, and that would create some near-term pressure on profit growth or threaten EPS growth for a period of time as that reversion takes place. So those factors make us a little bit more cautious on the outlook in the intermediate to longer term but like I said, in the near term it seems like the path of least resistance is probably higher still.

TWST: So let's talk about some specific names. Can you tell us three stocks that you think are really representative of your approach, and explain what attracted you to each of those names?

Mr. Thompson: Sure, absolutely. I think the three that I'll mention are all very illustrative of the types of companies that we like to invest in: high-quality, well-managed companies. The first is **Amphenol** (APH). They make connectors and sensors for a host of electronic devices. So think of your smartphone or tablet — you have a number of applications and functions like the need to recharge that device, cameras, volume controls, memory cards, battery, screen, microphones, speakers, all those require connectors. And so **Amphenol** is a leading supplier of those interconnects.

They enjoy broad geographic and product diversification. They've also been able to generate above-average organic growth relative to their peer group along with above-average profitability. They've been able to supplement that strong organic growth with additional M&A. And so the growth drivers for their business are one, the continued growth of mobility around the world, so the continued rapid global adoption of smartphones and tablets, and then two, the electronification of host of items like automobiles, airplanes, homes, factories. The more and more electronics, the more sensors that are put

in place in these environments, the more demand that is created for **Amphenol's** products.

And it's a stock that even though it's kind of near the upper end of its historical valuation range, we think it's justified based on its improving financial profile in terms of improving returns, improving profit margins and improving cash flow. And at the same time we think that their earnings outlook is quite good. **Amphenol** is expected to grow their earnings about 15% this year, and next year we expect earnings growth of another 12% to 15%, so pretty steady, stable earnings growth, and it's undervalued on our present value work.

The second stock I would mention to you is **Fastenal** (FAST). **Fastenal** is a leading distributor of fasteners and other industrial supplies. They operate in a highly fragmented market, but they've been able to grow faster than their peers through share gains with excellent profit margins and returns.

At the moment, we like **Fastenal** because they're experiencing accelerating monthly store sales growth, which is driving a commensurate acceleration in their earnings growth such that over the last 12 months, they've gone from sort of mid-to-upper single-digit kind of sales and earnings growth up to midteens and potentially better here over the next six to 12 months. While the stock at 24 times looks fairly rich, that's actually well below its historical valuation. If you back over the last 10 years, the stock has traded more in the upper 20 times range on average. So at 24 times, it's trading at a discount to that historical valuation level, and on our present value work, it's attractively priced at 75% of our present value target and again with accelerating top and bottom-line growth.

The third name I would mention to you is **Dollar Tree** (DLTR). It's in the dollar store category that competes with **Family Dollar** (FDO) and **Dollar General** (DG). They offer discount merchandise at fixed prices, including everyday products, seasonal products, closeout and promotional merchandise. We like the growth story here on organic basis because we see still a lot of runway for growth in terms of new store growth. We think square footage can continue to grow mid-to-upper single-digit on a standalone basis.

It's another well-managed company with industry-leading returns on invested capital. And this is a segment of retail that we think is likely to benefit the most from the recent collapse in gas prices. In another words, the decline in gas prices should have the most beneficial impact on their customer base.

And then the last sort of positive development here is the prospect of industry consolidation. **Dollar Tree** has announced its intention to acquire **Family Dollar**. There is a bit of a bidding war erupting here between both they and **Dollar General**; **Dollar General** has also made a bid for **Family Dollar**. We think it's created sort of a win-win scenario for **Dollar Tree**. One, we think it's quite attractive if **Dollar Tree** is successful in acquiring **Family Dollar** because there are significant opportunities for earnings accretion.

But if they don't win **Family Dollar**, if **Dollar General** is successful, then the breakup agreement requires **Family Dollar** to pay **Dollar Tree** $300 million. So **Dollar Tree** would get to walk away with $300 million plus the likely opportunity to cheaply purchase hundreds of stores that **Dollar General** may be forced to divest based on the terms of the agreement with regulators. So like I said, I think it's a bit of a win-win scenario potentially for **Dollar Tree**. Even if they don't win, on a standalone basis we like **Dollar Tree** very much. Again, one, where we expect earnings growth this year of midteens and same thing for next year, and the valuation is at about a 15% discount to our estimated fair value.

TWST: What do you see as the most significant risks for investors right now, and how does your midcap growth fund seek to protect against those risks?

Mr. Thompson: Terrific question. I'd say the most meaningful risk, which I kind of alluded to in the beginning, is that valuations in the market are full and sentiment is fairly complacent, and I think that's a function of the unprecedented monetary accommodation provided by the Federal Reserve. They created sort of an artificial environment, and we think as they seek to normalize policy — and the first step down this path was obviously ending QE3 — it will lead to repricing of risk in the marketplace and a return to more normal volatility.

As that happens, we believe the efficacy of our process should strengthen, and high-quality growth stocks should start to shine. Looking back over the last five-plus years, we've definitely faced some challenges against that backdrop of easy money policies. The types of high-quality growth companies that we favor have had a harder time keeping up with broader market averages.

But despite those headwinds, I'm proud to say that our midcap growth strategy has been able to outperform our peer group in three of the last five years — assuming the year ends where we stand today — and we've been able to do so with far less volatility of returns, or what some people would refer to as risk. We think the next five years are going to look a lot different than the last five years, and the big difference is this move to normalize monetary policy, which has rewarded higher-risk investments over the last five years. Going forward, we think that that as policy is normalized, it will lead to a return to fundamentals and higher-quality shares.

TWST: Thank you. (MES)

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