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The Five V's

We are often asked to explain our Rising Dividend Investment strategy, and our response invariably surprises the questioner, "We do not have a rising dividend investment strategy, we have a relative valuation investment strategy." The next question is invariably, "Then why do you talk so much about the importance of dividends?" Our answer is, "Because over the last 20 years, our experience and research have proved to us that the dividend is the best indicator of value for many stocks." The reason is simple: Dividends are real money and, once distributed, cannot be reclaimed. Earnings, upon which most investors focus, are an exercise in financial engineering. Bloomberg, our primary source of earnings data, lists eight different kinds of earnings and only one of them is not subject to change, sometimes years after the fact.

Our actual investment strategy is this: **"We seek to buy the most valuable companies in the world when they are at the best values."**

To identify the companies that we believe best fit our investment strategy, we use a filtering process that has evolved into something we now call the **Five Vs**:

1. **Valuable**
2. **Viable**
3. **Valuation**
4. **Vexation or Variation**
5. **Validation**

1. Valuable

From the beginning, Donaldson Capital Management's investment selection process has always focused on high quality companies. That is, every company must possess a strong balance sheet; it must also be a leader in its industry and have a demonstrated commitment to its shareholders that manifests itself in dividend payments that are tied to the fortunes of the company.

We like to say that the first thing we do to find the companies with the best relative value is to consider only companies that can make it through the quality door. In this regard, we are aligning ourselves with a simple truth: Often the winner in any contest is the participant who can last. We only invest in companies that have stood the test of time and those that we are convinced will continue to do so. Finally, we invest in companies that are growing. **Growth is the surest sign of value, and as we have said before, there are few**

companies that achieve solid price growth without a growing dividend, and even fewer that possess a growing dividend that do not rise in price.

2. Viable

Many companies are valuable but are in industries that are facing increased competition or where new technologies are rendering their products obsolete. The best example of the viability issue may be a company like Sears. It easily passed the valuable filter. It was a quality company, a company with solid financial results who rewarded its shareholders with a steady stream of increasing dividends. However, it became clear to us in the early 1990s that Sears' viability was in question. Wal-mart, K-mart, and the malls were taking market share, and in many cities, Sears found itself in the slow growth parts of town, having been leap-frogged by the competition. It was still a valuable company, but its viability and growth prospects were in doubt.

The Viability filter in our investment approach asks what we call the "10-year" question. Would we loan this company money for 10 years with no recourse of getting our money back early and all of the interest coming at the end?

3. Valuation

Because a company is valuable and viable does not mean that it is a good value. The third V of our investment selection process seeks to find companies that are selling for less than their intrinsic value. In short, we are seeking bargains. We want to buy a dollar's worth of intrinsic value for 75 cents or less, if we can get it.

We use two proprietary valuation models in finding bargains, our Dividend Discount Model and our Dividend Valuation Model. We have designed and refined both models over the last 20 years, and while both borrow from classical investment valuation theories, each is uniquely calibrated to show us a different perspective of a company's relative value.

Dividend Discount Model: Our Dividend Discount Model has its roots in John Burr Williams' 1937 book, The Theory of Investment Value. It is a mathematical formula that computes the intrinsic value of a company by totaling the future dividends the company will pay during its lifetime and then discounts that total back to a present or intrinsic value. It may seem a bit far-fetched to think that it is possible to estimate a company's cumulative dividends, but there are extensive data on dividends for companies in the Dow Jones Industrial Average and the S&P 500 Index. In addition, there is a high correlation between the long-term rate of total dividend growth and the growth of the overall economy. Furthermore, while the economy and dividends are volatile on a year-by-year basis, their long-term averages are remarkably consistent, running near 6%.

For our discussion here, we will use a single stage valuation model known as the Gordon Constant Growth Dividend Discount Model. The formula for the model is:

Next year's dividend divided by the discount factor minus the constant growth rate.

Because we will be discussing the banking industry in our next topic, let's value Wells Fargo (WFC) under the constant growth dividend discount model.

We project that next year WFC will pay a dividend of \$1.25; the current discount factor is 9.25%, and WFC's long-term constant growth rate is 6%.

$$\$1.25 \div (.0925 - .06) = \$38.50$$

With WFC currently selling for \$34.50, the model is suggesting that the company may be nearly 11% undervalued.

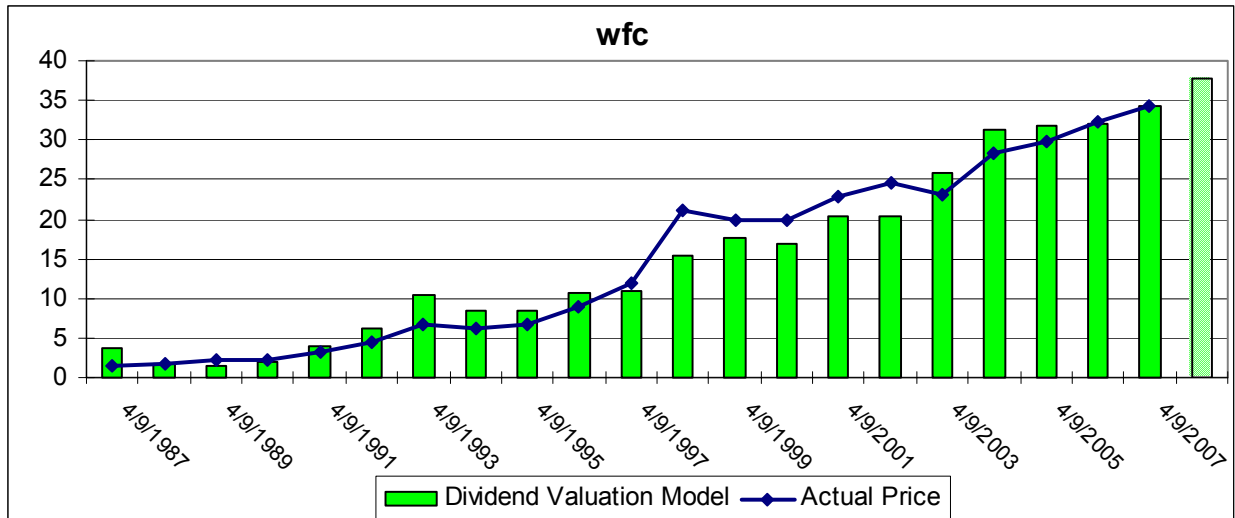
The dividend discount model we actually use is a bit more complex than the Gordon Constant Growth Model, but the principles are the same and our model is calculating that WFC is even more undervalued than the Gordon Model says.

Dividend Valuation Model: Our Dividend Valuation Model (DVM) is based on the work of Arnold Bernhard, founder of Value-Line. The easiest way to think of our Dividend Valuation Model is to think of it as calculating a formula that best describes the “normal relationship” among dividends, interest rates, and prices for a given stock over the last twenty years. After the computer determines the formula for a stock that best describes its long-term price movements, we then plug in our estimates for dividend growth and changes in interest rates for the coming year, and we arrive at the stock’s projected price twelve months into the future.

Below is a Dividend Valuation chart for Wells Fargo. The blue line is WFC’s actual price over the past 20 years, and the green bars are the DVM’s calculations of fair value. We like to think of the green bars as valuation steps. Notice that the valuation steps have risen more consistently over the past 20 years than have prices. This is the whole point of valuation investing. Prices and valuations are in range of each other most of the time, but periodically, they gap, offering a powerful buying or selling opportunity. The chart shows that WFC’s valuation was approximately \$10 per share in 1993, at a time when the stock was selling for only about \$7, a difference of nearly 40%. The stock remained undervalued or fairly valued until 1997, at which time it gapped nearly 40% above its value step. The stock then meandered sideways in an overvalued condition for four more years.

The model currently says that WFC’s current value is near \$38.00 (shown by the striped bar at the far right), which is very close to the value calculated by the DDM. With the stock selling for roughly \$34.50, the model is saying that WFC is currently selling at about a 10% discount from fair value. But there is more. Over the next twelve months, at today’s price, WFC will generate a 3.5% dividend yield. Thus, based on our estimates, the expected total return for WFC in the coming year is about 13.5%. Of course there is no guarantee that WFC will reach this level, but it is clear that, over the years, it has been very profitable to follow the leadings of WFC’s Dividend Valuation Model.

Wells Fargo Dividend Valuation Model



In the absence of “out of the blue” events, which no one can predict, we believe our dividend models can zero in on the best industries, stocks, and countries in which to invest.

4. Vexation and Variation

Our research has shown us that stock prices are in the ballpark of values about 80% of the time. We are convinced, however, that there are two circumstances under which the market is often wrong: 1. when a company or industry is vexed, or having problems of one sort or another; and 2. when a company is undergoing a variation in its strategy or the market for its products is undergoing a big change.

Vexation: Companies that are vexed often become mispriced because of one word, patience. Most investors lack the patience to endure difficult or uncertain times, so they cut and run, oftentimes irrespective of the value they are leaving behind. Most investors just cannot get their minds out of the status quo. They assume that whatever is happening today with a company or industry, or the entire market for that matter, will continue ad infinitum. We have found this kind of thinking to be not only faulty but at complete odds with reality. Indeed, we find that for companies or industries suffering from vexation, change becomes inevitable – new management or perhaps a takeover by a competitor, or a private equity group – especially for companies that the market considers valuable.

At present, housing is one of the biggest worries in the markets, particularly, the subprime housing market. Because banks are heavily involved in the mortgage business almost all banks have fallen in price.

Financial publications from Business Week to the Wall Street Journal have wrung their hands over the subprime loan issue’s impact on banks. CNBC has expert after expert tell us how bad things are going to get. In addition, Congress is gearing up to investigate the predatory lending practices of some banks. We would remind you that this is the same Congress that not long ago was criticizing banks because they did not make enough mortgage loans available to low income people or those with poor credit histories.

Banks are vexed and everybody knows it. Let’s sell all the banks. We have read that kind of recommendation from many corners of the financial media, and it is hogwash.

Subprime loans represent about 15% of the total mortgage loan market, and among the banks we own, the percentage is far less and in some cases zero. In addition, since most subprime loans are collateralized by a home, a loss to the bank will occur only in those cases where the value of the underlying home is less than the amount of the loan. In short, the bank may not get a 100% of their money back, but they will likely lose only a small amount by the time the subprime issue fades from the financial pages.

Wells Fargo is one of the largest mortgage originators in the country, and as such, their stock has fallen modestly in recent weeks, even though they have stated that subprime mortgages represent less than 5% of their total loans.

Earlier, the Dividend Valuation Model for Wells Fargo showed that it was selling at bargain prices. In addition, WFC is the only bank in the United States that earns Standard and Poors' top rating of AAA. In our minds, the market is extracting too much of a penalty from WFC for such a small part of their business.

Variation: The best example of variation that we can think of in recent years is the case of Toyota (TM). As you remember, we began buying TM after Hurricane Katrina struck the Gulf coast, sending gasoline prices soaring to \$4 per gallon. Prior to Katrina, TM was a AAA rated global automobile manufacturer that was gradually taking market share from Ford and GM. After Katrina, TM was the same company as before, but with a 10-year head start on hybrid technology and much less reliance on big gas guzzlers for their earnings. TM's market share and profitability soared. In this case, it was the market demand for high mileage automobiles that underwent a variation, but it resulted in TM's stock price running up 50% during 2006.

We believe that wherever there is vexation or a variation in a company or the markets is a good place to look for bargains. Looking does not mean buying, but using the filter of our 5 Vs, we can quickly size up each situation for profit potential.

5. Validation

We don't try to catch many falling knives. That is, we know that vexed companies and companies that are undergoing variations do not work through their uncertainties overnight. We can be patient and wait for one of two events to happen before we begin to buy: 1. management clearly articulates a list of milestones that we can and do verify, and 2. the price of the company's stock begins to react favorably to improving fundamentals of the company.

Validation is not waiting until Ford and GM are struggling for their lives before we buy TM. Validation is making the judgment that TM's product line and financial strength would likely force Ford and GM into a life and death struggle after Katrina, and then watching for TM's stock to begin to outpace Ford and GM. Validation is not waiting for the subprime mortgage crisis to pass before buying WFC. It was waiting until WFC made a public accounting of the level of their subprime mortgage risk. Sometimes validation takes years, sometimes it takes only weeks. There is no firm set of rules to know when to pull the trigger. It comes from having pulled the trigger on companies that have passed the 5 Vs in the past and knowing which of those decisions worked or did not work.

In the End

In the end, we work hard to fill our clients' portfolios with valuable and viable companies when the market offers them to us at good or great prices. Often, for truly great companies, those values only appear when the company faces some vexation or variation. If it becomes clear that they will emerge from those difficulties, and if the market is willing to honor that effort, we have enough validation to buy.

This approach, that begins with truly valuable companies, causes our portfolios to have less risk than the average stock, yet Capital Builder and Cornerstone (formerly Blue Chip Growth and Rising Income Equity), our two longest-running investment styles, have outperformed their benchmarks over the last 12 years. It would not seem possible to take less risk and yet outperform the market, but that is what has happened.

Blessings,

Greg Donaldson

Mike Hull

Important Announcements

Donaldson Capital Management is a Registered Investment Advisor with the U.S. Securities and Exchange Commission. Rule 204-3 of the Investment Advisers Act of 1940 requires that on an annual basis all Registered Investment Advisors offer to their clients the ADV, Part II Brochure. This Brochure describes our firm's background and business practices. If you would like us to mail a copy of the current Donaldson Capital Management Brochure, which serves as our ADV, Part II, please call Carol Stumpf, Director—Client Services, at 421-3203 or toll-free at 800-321-7442.

In addition, each year we must send you a copy of our Privacy Policy, explaining how we protect the privacy of the information you share with us. That policy is enclosed.

As always, we sincerely thank you for giving us the opportunity to be of service to you.