THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

A Bottom-Up Approach to Large-Cap Growth Investing

NORMAN B. CONLEY III is the Chief Executive Officer and Chief Investment Officer of JAG Capital Management. Mr. Conley entered the investment industry in 1994 and joined JAG Capital Management in 1999. He oversees the firm's managed equity and fixed-income strategies, is one of four firm shareholders and is a member of JAG Capital Management's management committee. Prior to joining the firm, Mr. Conley spent three years as a Naval Officer and five years with a global investment firm. He earned his B.A. from the University of Notre Dame, which he attended on a Naval ROTC scholarship, and earned an MBA in finance from the Olin School of Business at Washington University in St. Louis. He serves on the Executive Committee of the board of Good Shepherd Children and Family Services and is a member of the St. Louis Chapter of Young Presidents Organization.

SECTOR — GENERAL INVESTING

TWST: Tell us about JAG Capital Management.

Mr. Conley: Our firm's roots go back to 1945. Our parent company was founded as a broker/dealer, and for many years we operated as a dually registered firm. In May of 2013, we concluded a corporate reorganization that separated our brokerage and advisory operations into two separate legal entities.

Our investment management business is named JAG Capital Management, LLC. We have approximately $1.1 billion in assets under management; roughly $400 million of that total is invested in our large-cap growth managed equity strategy. Most of the remaining $700 million is invested in our fixed-income strategies. The vast majority of our managed assets are invested in separate accounts for institutions and individuals, but we also manage an open-ended mutual fund called the JAG Large Cap Growth Fund. We launched the fund in December 2011, and it has approximately $22 million of assets.

TWST: How have your investment philosophy and the company evolved over time?

Mr. Conley: Interestingly, all of our strategies were developed over the decades to address the long-term challenges of religious institutional clients. Specifically, how do institutions fund their long-term missions and organizational goals over what will hopefully be a perpetual time frame? Accomplishing these objectives requires generating cash flow to fund current operations, combined with long-term growth of capital to fund future needs. Our core investment philosophy and all of our investment strategies were developed to address these objectives.

Our bond strategies seek to deliver long-term capital preservation, diversification and cash flow for our clients. Our large-cap growth strategy seeks to generate long-term growth of capital in excess of inflation. And all of our strategies embrace a focused portfolio structure by holding only 30 to 40 securities at all times. I should say right up front that we are unapologetically active managers. We think that properly constructed and intelligently managed securities portfolios can outperform passive indexes.

In each of our strategies, we're aiming to outperform our relevant benchmarks over rolling three- to five-year periods and beyond. In order to deliver outperformance, we have to be able to structure our holdings differently than the index. A key problem for many so-called "active" managers is that their portfolios mirror their benchmarks too closely, which greatly impairs the probability that they can generate excess returns after fees over long periods of time. I believe this is why most active managers fail in their goal of outperforming the broader market.

In any event, a happy benefit of our cultural history is that many secular institutions, individuals and families are faced with the same sorts of challenges as religious institutions have faced for decades. We have found that our message resonates with a wide array of clients. So in terms of the growth path of our firm, we think we're just getting started.

TWST: How would you describe your investment strategy? Are you top-down or bottom-up or a little bit of both?

Mr. Conley: We believe that stock prices are driven by earnings growth and earnings expectations, and we employ a primarily bottom-up, fundamentally driven investment process to identify stocks with strong growth characteristics, fundamental strength and compelling price-appreciation potential.

While we are always committed to maintaining a diversified portfolio across individual stocks, industries and sectors, we do think that there is such a thing as too much diversification. We do not want to be in a position where we are asking our clients to pay us for our 100th or 120th best idea. Holding only 30 to 40 names gives us the ability to diversify our portfolio away from many industry-specific risks, while at the same time ensuring that we have the ability to maintain enough exposure to our best ideas to move the performance needle.

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TWST: There are different ways to diversify within a portfolio. What does diversification mean to you?

Mr. Conley: To us, an optimal diversification approach should walk a knife's edge between risk mitigation and attractive performance potential. Risk control is clearly important to us and our clients. We don't want to have too much of any one sector, too much of any one industry, or too much of any single security in our portfolio, and we have portfolio composition rules in place to help us manage these risks.

At the same time, and I may have mentioned this earlier, there is definitely such a thing as too much diversification. At the extreme, overdiversification can limit a portfolio's upside potential. Again, it is sometimes a challenge to find the sweet spot between controlling risk and pursuing opportunities. But in my opinion, that's one of the ways we seek to add value as active managers. If it were easy, everyone could do it.

TWST: With your background of dealing primarily with religious institutions, do you screen out certain kinds of companies?

Mr. Conley: Yes. We have a cultural aversion to investing in certain types of companies and industries. Our baseline screen excludes companies that are in the tobacco, distilled spirits or gambling industries. We avoid companies that generate material revenue from the production of offensive weaponry or weapons of mass destruction. We also watch our portfolio companies closely and vote our proxies accordingly, when it comes to employee and labor relations policies, as well as policies related to pollution.

All of this being said, we think our process and long-term results have stacked up competitively versus our peer managers. We are not asking to be evaluated any differently than other large-cap growth managers in terms of our performance and our process.

TWST: Understanding that you are bottom-up, are there trends in the economy or in the market that you are watching right now that are impacting your decision-making process at all?

Mr. Conley: The domestic economy is locked in slow-growth purgatory. Real GDP is meandering along at a sub-2% rate, and inflation is nowhere in sight. The Fed's favorite measure of inflation is the Personal Consumption Expenditures price index, known as PCE, and it remains barely above the flat line on a year-over-year basis at about 1.15%.

Interest rates are up a lot from their lows, but are still very, very low relative to history. Overall corporate earnings growth rates have trended down since early 2012. Year-over-year growth in S&P 500 operating earnings has declined from a 12.9% clip in March of 2012 to 0.6% as of the second quarter of 2013. This means that most of the market's gains over the past 12 months to 18 months have come from multiple expansion.

The potential good news is that analysts expect corporate earnings to pick up as we head into 2014. Consensus is calling for earnings to be up more than 15% year over year by September of 2014. From a broader market perspective, we think that earnings growth is going to be very important to index returns over the next 12 months. Given the fact that profit margins have been very robust over the past several years, there may not be much room for margins to expand further. This means that companies will have to grow earnings the old-fashioned way, namely by growing their revenues by selling more stuff. In any event, if corporate earnings meet or beat expectations, there is probably plenty of room for stocks to continue to rally.

Conversely, if earnings disappoint, it might be tougher for the major indices to keep traction. Macroeconomic factors do not have a direct effect on our portfolio decision-making process, per se. Always and everywhere, we want to be positioned in companies that are growing faster than the broader market and their competitive peers. That being said, a slower-growth backdrop in the economy can make it more challenging for companies in certain industries to generate powerful earnings growth. For example, if inflation and commodity prices cannot get traction in the coming year, it might be more difficult for resource-based companies in the materials or energy sectors to generate strong earnings. All else being equal, that would make it less likely for us to maintain big portfolio weights in materials or energy companies.

TWST: What about the Fed? What is your opinion of the Fed's involvement in the economy?

Mr. Conley: Opinions are like noses: everyone has one. But our opinion is that Fed's QE policy is beginning to damage the engine of the economy. The Fed regards a steeper yield curve as a risk to economic growth, but we actually believe that economic and market history implies exactly the opposite.

Highlights

Norman B. Conley III discusses his firm's large-cap growth strategy, which seeks to generate long-term growth of capital in excess of inflation. Mr. Conley's process is bottom-up and fundamentally driven to identify stocks with strong growth characteristics, fundamental strength and compelling price appreciation potential. He currently sees growth potential in the information technology, industrials and consumer discretionary sectors, and shares his top stock positions.

Companies include: Starbucks Corporation (SBUX); Google (GOOG); NCR Corp. (NCR); Diebold (DBD) and Herbalife Ltd. (HLF).

Also, from the Fed's statement after their no-taper decision just a couple of weeks ago on September 18, it seems to us that the Fed is using a wider variety of economic indicators to feed their decision-making process. For example, the statement specifically cited rising mortgage rates as a justification to hold off on tapering their asset purchases. The danger is that the more data points the Fed feels necessary to consider in their tapering decision, the less likely it is that all of those data points will align perfectly to their satisfaction. Taken to an extreme, it could lead to mission creep at the Fed, which could trap them into QE indefinitely.

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Since Chairman Bernanke is now in the process of passing his baton to Vice Chairwoman Yellen, we think there's very, very little chance that the Fed is going to pull back or taper their QE policy until early or mid 2014. When and if they actually do taper, we think that will be a positive event for the market and for the economy later on in 2014. But since it seems to us that QE has passed the point of diminishing returns, we think an unexpected extension of the policy into the latter part of 2014 or beyond would not be received positively by the markets.

1-Year Daily Chart of Starbucks Corporation

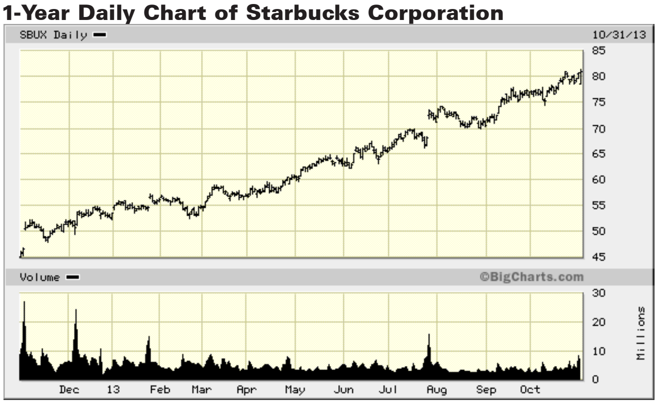

Chart provided by www.BigCharts.com

TWST: Where do you see the largest opportunities right now? What types of sectors are drawing your attention?

Mr. Conley: We see a lot of growth potential in the information technology, industrials and consumer discretionary sectors. We talked earlier about how the economy is in this slow-growth mode. Against that backdrop, we think that investors have penalized the valuations of companies which are perceived to be more economically sensitive. Meanwhile, capital has been chasing companies that are perceived to be less economically sensitive. In our opinion, this means that the market is overvaluing factors like quality and dividend yield, while undervaluing long-term earnings growth potential. So for example, we see lots of consumer staples sector companies trading at high-teen multiples with 2% to 4% revenue growth outlooks. From our perspective as growth investors, this makes little sense.

TWST: Can you give us some specific examples of stocks that are in your portfolio and explain why you like them?

Mr. Conley: Starbucks (SBUX) has been in our portfolio for several years and is one of our top five holdings. We like the company a lot. It's trading at a high-20s multiple on next year's earnings, but it's one of the world's premier brands and should be able to generate double-digit revenue growth and 20%-plus earnings growth for some time. We think **Starbucks** is a good example of an industry leader that is worth paying up for in terms of valuation.

Similarly, **Google** (GOOG) has been a large holding of ours for the last couple of years. Like **Starbucks**, they lead their industry globally. We think that leadership position is very secure, and they are even cheaper than **Starbucks** on forward earnings estimates.

NCR (NCR), which we bought in February 2013, is a more recent addition to the portfolio. **NCR** is the old National Cash Register. They represent one-half of a duopoly with **Diebold** (DBD) in the bank ATM industry, but they are also very involved in retail solutions like point-of-sale terminals and checkout kiosks. We think the stock is too cheap at 14 times next year's earnings, with a very compelling growth trajectory. We think they are being valued as a hardware company, but under everybody's noses they are quietly becoming more of a software company. More than 10% of their revenue this year is going to come from recurring, higher-margin software sales. I don't think the market is giving them credit for that in terms of their multiple.

1-Year Daily Chart of NCR Corp.

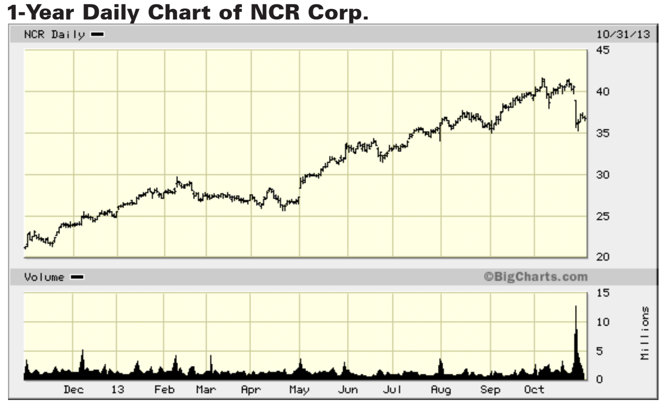

Chart provided by www.BigCharts.com

TWST: How often you turn over a portfolio then, and what is your sell discipline?

Mr. Conley: Our annual turnover has historically ranged between 75% and 100%. The vast majority of our turnover is driven by our sell discipline. We have a pretty rigorous sell discipline in the portfolio. I mentioned earlier that we don't hold a lot of names at any one time. Because we maintain such a relatively concentrated portfolio, we really need to be proactive in our sell decisions.

There are basically two types of reasons we will sell a security. The first is a happy one, that the security has increased in price so much that it is bumping up against our portfolio diversification rules. We will sell some of the position to rebalance it back to an appropriate weight. That's always a good problem to have. We will also sell a security due to a variety of negative developments. For example, we strongly favor companies with a history of upside earnings surprises which are growing their earnings more than expected year over year. Therefore, if a company significantly underperforms on the earnings or revenue front, or materially lowers their forward guidance, we will tend to reduce or eliminate our position.

Other developments that can lead to a sale would be an unexpected change in senior management, a significant SEC investigation or credible allegations of material accounting problems. We think we're really good portfolio managers and investment analysts, but we are not forensic accountants. So in instances in which the company's business model has come into question because of accounting problems, we will generally sell the security.

An example of a security that we simply would not own is **Herbalife** (HLF). **Herbalife** is a multilevel marketer. It is a fast-growing company, but their business model and their accounting treatment of their revenues and earnings is in serious question. We don't feel that we're qualified and/or interested in trying to decipher who's right in this debate. It's just too complicated and has too many nuances for our taste, and if the naysayers are proven correct, there will very likely be a catastrophic decline in the equity value of the company. So that's a great example of the type of company that we try to avoid, and it's also an example of the type of accounting situation that would result in a sale much more often than not.

TWST: You are an independent and employee-owned firm. In your opinion, why are those advantages?

Mr. Conley: Three other key employees and I own 100% of our company. Being independent has an awful lot of advantages. We don't have to answer to anyone but ourselves for what we're doing in our business for our clients. Our team and our owners are very significant investors in our large-cap growth strategy. In my case, as the lead portfolio manager, substantially all of my liquid assets are invested in the strategy alongside our clients. I don't think this sort of client-focused culture would be easy to replicate if we were owned by a much larger entity or were answering to a much larger corporate bureaucracy.

Another benefit to being a boutique, employee-owned firm is that we are very focused on doing a few things very well, as opposed to maybe some of our peers who operate as small cogs in very large machines. Our firm is aligned to benefit our clients and benefit our strategies, and we think that level of focus is a huge advantage.

TWST: What do you believe are the biggest mistakes investors make, and what advice you would give an investor?

Mr. Conley: I think that the biggest mistake investors make is tied to emotion. More specifically, investors read headlines, watch the news, look at the Web, read blogs on a daily basis, and the mistake they make is taking their long-term investment cues from really short-term noise in the media. This works both ways. I think we've seen in the past periods in which investors took cues that they picked up in the media and got too exuberant with their investments. The Internet bubble and the housing bubble are both good examples of irrational exuberance.

At the other end of the spectrum, particularly over the last several years, there has been an infatuation with what I call "recession pornography." By this I mean a continual and pervasive negativity in the media about the economy and the markets. As a group, investors remain pessimistic, apathetic and underinvested in stocks. For at least the last four years or five years, this has obviously not been the right stance. And for most of the past 100-plus years, investors have been rewarded by being optimistic about the long-term future. Overall, the biggest mistake investors make is letting their short-term emotions, either good or bad, tilt them into making significant long-term investment decisions.

My best advice for investors is to try to tune out the noise and avoid taking their cues from the media. Instead, they should build a long-term plan that includes an allowance for a variety of potential market outcomes. Then they should stick to their plan, no matter what happens day-to-day in the markets or the media. This is easy to say, and it is fairly common advice from financial professionals. Unfortunately, it is hard to do in practice. Regardless, that's my best advice.

TWST: Thank you. (LMR)

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Disclosures:
JAG Capital Management, LLC its affiliates, directors, officers, employees, employee benefit programs and discretionary client accounts had a long position in the common stock of Starbucks, Google, and NCR at the time of this interview on October 16, 2013.