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INVESTMENT PERSPECTIVES

An In Depth Look at the HCM Research Process

Success in any endeavor involves a great deal of deliberate and consistent thought as well as a fair dose of good fortune. In this Investment Perspectives we hope to convey to our clients and others the essence of how we arrive at making our investment decisions. We have followed this approach to making our decisions since Hutchinson Capital Management started over eleven years ago. Prior to that, Bill developed and fine-tuned this process while he was a partner at Shuman, Schneider and Hutchinson.

A common problem associated with all research activities is the enormous amount of data available to any serious researcher. This is a problem because of the time and effort involved in wading through enormous volumes of material in order to arrive at an intelligent investment decision. Time is a scarce resource for our team just as it is for all of us. This research process helps us maximize the efficient use of our time in this area.

A final, core part of our research process is our strong belief that all good new investments need time (two to five years usually) to produce satisfactory investment results. In summary, our research process is the engine that delivers the results that we desire.

The Research Process – The Buy Decision

Our overall policy is to purchase high quality stocks based on a value approach to investing. Each new research endeavor involves identifying a stock that seems to fit our style (we call this an Idea) and researching the Idea through three levels prior to deciding whether or not we will buy the stock. Each sell decision also involves these three levels of research but generally the third level is where most of the additional work is done.

- **Preliminary Ideas**

The first step of the process is to find a stock that meets the specific parameters of our value approach to investing – this is a “Preliminary Idea”. The price of the stock usually needs to be down significantly over the past one to three years, the company

must be of high quality, and management must be intelligently addressing problems associated with the decline in price. These ideas are culled from various sources including current financial publications, ‘expert’ contacts in the industry (e.g. non-Wall Street), contacts in the investment community, breaking news about a company, analysts’ reports, etc. The preliminary ideas are reviewed by our Research Committee each week, and if they appear promising to at least a majority of the members, we proceed to Level I Research. Several Preliminary Ideas that are on our list right now are Gannett, St. Joe Company, and USG.

- Initial Research (Level 1)

Level I Research is intended to find out more basic information about the company. From the Preliminary Ideas List each week, one or more stocks may be selected for review. A Lead Researcher is assigned who completes a Peer Review worksheet comparing key parameters of the company to others in the industry to determine why the stock price declined. If basic parameters are met, the Research committee will approve moving to Level II Research. If the parameters are not met, the Committee may set a lower target price and review the stock at a later date if it meets that price, or the committee may decide to discard the idea entirely. Currently, we have two companies we are researching at Level I – Quiksilver Inc. and SLM Corp.

- Continuing Research (Level 2)

At this level, we strive to identify the one problem that caused the stock price of the company to decline. It is relatively easy to find ten or more problems but it is exceptionally difficult to identify the key problem in a company. Until that is done it is quite difficult to determine if the company is taking the correct steps to resolve their problem that will get their earnings back on track.

We typically perform most of the following tasks at this level:

- Prepare an in-depth Cash Flow Analysis.
- Review the information we have collected on this company and its industry.
- Review our ‘experts in all industries’ contact data base for people who possibly could be of assistance to us in our research on this company.
- Print and review the current company filings with the Securities and Exchange Commission.
- Print and review current research reports from industry analysts.
- Review the company’s website to identify significant events or initiatives.

- Final Research (Level 3)

At this level the decision will be taken whether or not to buy a position in the company.

We dig deeper into the quantitative information available about the company to seek more information about the results of the company's management decisions over the years as well as with their efforts at solving their unique current problem. We also spend a considerable amount of effort in determining what the quality of the management team is. We do our best to really understand the company's real strengths and weaknesses during this level of our research process.

The conclusions of the Lead Researcher will be based on the results of conducting the research identified below:

- Call appropriate research contacts.
- Perform segment analysis to determine the key drivers of earnings and cash flow, and how these drivers could change in the future.
- Call analysts that may have special insight into the company.
- Call the company with a list of appropriate questions, specifically to determine if they are able to correct the problem.
- Call local newspapers or local Chambers of Commerce to determine acceptance of the company in the community.
- Identify the "catalysts" that will cause earnings to increase.
- Calculate the upside and downside potential of the company.

The Lead Researcher will present his conclusions to the Committee including the following:

- What the company is doing to resolve its problem.
- Why this is a high quality company
- The reasons why the stock might double in price in five years
- The specific strengths and weaknesses of the company

A good example of Level 3 Research is the work that we performed prior to buying Lifepoint Hospitals. We contacted the Chambers of Commerce and several business writers in towns where Lifepoint had recently bought hospitals. These contacts validated our research that Lifepoint was doing all of the right things from modernizing hospitals, working with the local government to improve quality of care, and finding competent new physicians. Furthermore, they supported our conclusion that Lifepoint's problems at the time (postponement of non-mandatory health care) were transitory.

The Research Process – The Sell Decision

Perhaps more important than knowing when to buy a stock is knowing when to sell it. Each Committee Member is assigned a group of stocks that they monitor on a daily basis. Specific events or newsworthy items, and weekly stock declines of 2% or more, are reviewed by the Committee at its weekly meetings, or more often on an ad hoc basis as warranted. The Chair may request that additional research be performed, similar to Level

3 for a Buy decision. As warranted, the Committee may decide to either sell part of the position or all of the position.

A recent example of a sell decision was for BRE Properties. We believed that BRE and the other apartment REITs (Real Estate Investment Trusts) face significant problems from the addition of single family homes and condominiums to the rental pool market. Based on conversations we had with several REIT apartment managers, we believe this is especially true in several of the markets that BRE serves. A significant portion of this glut was caused by speculation in housing that is now starting to unwind. Owners of many homes and condos that cannot be sold for near their purchase prices will rent them at below market rates just to keep them occupied and to generate some cash flow while they wait for a better time to sell. In this environment, we believe that it will be difficult for BRE to raise rents for its apartments.

Our focus on following a defined research process enables us to maintain the necessary due diligence and keeps us on track. We do not deviate from our style, regardless of the pressures in the marketplace. We strive to buy high quality companies including small, mid-size, and large capitalization stocks that meet all of our qualifications. We always focus on capital preservation and the achievement of sound performance results over the long term. This, in essence, is our process for 'buying low' and 'selling high'!