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W.P. Stewart Investment Update Conference Call for Q4 2009

THOMSON REUTERS

**Moderator: Tony Cook
January 27, 2010**

Tony Cook: Good morning and welcome, everyone, to W.P. Stewart's quarterly investment call covering the fourth quarter and full year of 2009.

This is the sixth in our ongoing series of quarterly investment update calls for both clients and prospective clients covering our stock views, portfolio views, and economic outlook and other matters that are affecting our client portfolios today and will also be in the future.

To remind you, our objective for these calls is to leave you with the knowledge of not only what we are thinking, but how we go about our analysis. My name is Tony Cook. I'm a senior client and marketing executive with the firm. And joining me are Bill Stewart and Mark Phelps.

Before turning the call over to Bill and Mark, we would like to remind you that at any time prior to any of these quarterly calls or indeed during the calls themselves, you can submit questions to us by email at questions@W.P.stewart.com. I'll be monitoring this account for your

incoming questions throughout the call. You can also always contact your W.P. Stewart representative if you don't have access to email at any time and have them forward your questions to me.

At the conclusion of Bill and Mark's comments, I'll summarize your questions and post them to our speakers. We estimate that this call will be about 20 or 30 minutes, but may exceed that time depending on the number of questions that we get.

Now I would like to turn the call over to Bill and Mark. Bill Stewart co-founded the firm in 1975 and continues to manage portfolios for clients today as a member of the firm's research and portfolio management team and he is also Chairman of W.P. Stewart. Mark Phelps, who will follow Bill, is the firm's Chief Executive Officer and head of Global Equities, managing the firm's EAFE, i.e. non-US and also global equity portfolio mandates, and is a member of the firm's research and portfolio management team.

Lastly, for the sake of good order, we must point out that both Bill and Mark have certified that the views that they will express during this call accurately reflect their personal views and no part of their compensation relates to the views expressed.

Bill, the call is yours.

Bill Stewart: Thank you and good morning. Fortunately we had a nice recovery in the value of our clients' portfolios last year and most of them being up in the low 30s (after fees) percentages and well ahead of the S&P for the second year in a row. And we're happy with that.

Fortunately, we've always tried to have our clients invested in a group of businesses that - as a group never have down earnings.

And last year's economy was so bad, we feared for quite a portion of the year that we might have had the first year ever in 35 years where what we call the look-through earning power behind your accounts actually went down.

But in fact we ended up with the 35th consecutive year of up earnings. So our companies did their bit as far as earning more money and more cash flow. Most of them are going to grow earnings considerably faster, probably in the area of 14% to 15% a year for the next five years. So hopefully those earnings will drive the performance in the years to come.

The performance of the market in '09 and our portfolios was - as I mentioned - very good. And that degree of appreciation approximated the advance you've had following the last couple of really big bear markets that we've tracked.

We put a letter out on that a few months ago. And it would be appropriate at this stage of the game for the market to consolidate, in other words for the market to wait for reality to catch up, perhaps even correct.

What we're really seeing is a small improvement in profits in the companies in your portfolio in the last nine months and a major improvement in price/earnings ratio. Price/earnings ratios for our companies got down to about 14, maybe slightly below at the very bottom last spring. And it's recently been at around 18 times 2010 estimates.

So we've had a nice improvement from 14 to 18. And where are we going to go from here taking the very, very big picture? I'll leave the details to Mark later on.

Why should anyone invest from this point forward? On average over the last 35 years, I believe our average P/E ratio for the portfolios has been about 22. And so if we went to an average P/E ratio over the next five years of 22 times, we'd get four multiples higher than the present 18, which is a little over a 20% improvement in price/earnings ratio.

At the same time, we expect earning power behind the portfolios to grow at 14% or 15% a year, basically doubling over five years. So, a doubling in earnings over the next five years, or something on that order of magnitude, plus another 20% multiple, that ends up nearly tripling the value of a portfolio. That's not a forecast – I'm just pointing out there is a lot of upside available if things work out right.

But a pause here in the 18 multiple range, after going down as low as 14, which by the way is the lowest we have seen in decades, is probably reasonable. And I feel that the longer we work out around this base and don't put another major leg on the upside, the better off - we're going to be. The market needs to build - do a little more base-building. And it's been in the process of doing that. So I feel okay about that.

The other thing is that the little weakness in the market we've been having lately is all about specific concerns. One hears people concerned about Obama, they're concerned about taxes, they're concerned about Bernanke getting reappointed. They're concerned that the unemployment level hasn't dropped yet. Everybody's got a concern and the market's going down a little bit reflecting those concerns.

Actually in my experience, when the market goes down on bad news, which is clear and understandable bad news, it's probably okay. We really get worried about the markets go down when you don't know what's driving them.

So I think we're going through a consolidation period. I don't know how long it's going to last, but I'm not of a mind that we're going to see a 10% to 15% break from here. I think we'll do some consolidation. The earning power will rebuild.

The economy is showing a number of signs of moving in the right direction. ISI, our economic consultants, says the leading economic indicators are good on balance. There are a number of very good ones and a couple of others that aren't so good.

Obviously the economy is still fragile, but moving upward in the right direction. And, again, we need a little more patience to see how things fall together, but things do not appear to be as bad as some of the politicians would have you believe.

So in summary, I think the economy is gradually improving from a fragile base. It's not a given that it's going to go ahead strongly, but it looks pretty good. If I had to make a guess, I would say the - this year's real GDP could grow 4%. Economists' estimates range from 2% to 5%, so we'd be a little toward the upper end of that range.

The stock market is by historical standards cheap. Our type of high quality growing companies are particularly cheap by historical standards. Last year everything was cheaper than we'd ever seen it before. We don't believe we're going back there. So we're constructive, positive in our long-term outlook.

I love the companies in our portfolio. I think our analysts are doing a great job. They're also doing a great job trying to ferret out new ideas for the portfolio going forward. Morale here is good. We feel we're heading in the right direction. And we're not at all concerned about a period of consolidation. We think this is good for us and our clients.

With that, I'll turn it over to Mark.

Mark Phelps: Bill, thank you very much. Good morning, ladies and gentlemen.

What I'd like to do is just drill down a little bit more into the details that sit behind the comments that Bill has just made. And I would point out that if any of you want to see the hard numbers, we have actually put out an investment review and outlook for 2010 on our Web site, www.W.P.stewart.com so you can read that at your leisure to go through the detail a little bit more on your own if you wish.

Certainly 2009 as Bill has mentioned was an extremely challenging year, although as it turned out a very good one for the stock market and our clients. I would remind us all that in March it didn't feel like a very good one with the markets continuing to move down and clearly the panic in the financial markets reflected a concern that there was something unwinding within the financial system that might not get fixed.

What turned the market, of course, was government action on a global basis to make sure that we would not see the financial circumstances that would take the economy into a depression.

It was a very clear and unambiguous statement by governments that this was not going to be allowed to happen that reminded investors that the underlying

companies in the main were still going to be trading and the vast majority of businesses would be able to survive and move ahead over a period of time. So we had that near-death experience. And as Paul Krugman, the Nobel Prize-winning economist said, 'the end of the world was postponed'.

Obviously the market having gone through that reacted strongly and has rallied to a point where the consolidation that Bill mentioned has to be reasonable. The easy gains – the liquidity driven phase of the market - have been made and from here we need to see real earnings coming through for the market and our client portfolios to move materially higher.

I would like to pick up on Bill's point about how the earnings in your portfolios have grown during the last few years and why that's been different to the way the market's earnings have grown.

As Bill says that we always look for that earnings power to continue to grow and we do believe that for 2009 that earnings growth will be around about 2%. We've obviously got companies reporting the fourth quarter as we speak, but that looks to us from our best estimates to be about the right number.

Let me put that into context. What that means is since the end of 2007, we saw 11% earnings growth in the portfolio in 2008 and we've probably seen about 2% in 2009. The market's earnings were significantly down in 2008 and up a bit in 2009.

And our estimates today for 2010 are for a gain of about 10%. That contrasts with the S&P down 35% in 2008, up a bit in '09, again, we're getting those numbers as we speak, and then we're probably looking at a much stronger rally because of the lows that were reached in '09 by the market of maybe 25% to 30%. Again, that's a very volatile number.

Mark Phelps: What we're trying to do at W.P. Stewart is find a concentrated portfolio of 20 companies where we can continue to see earnings grow. And we believe that over time the returns will follow that earnings growth.

Bill has mentioned on many occasions that there are only two things that matter, the P and the E, the price and the earnings. We spend most of our time focused on the earnings and we like to believe we've done a good job at finding those earnings over time. And certainly for us in 2009, managing positive EPS growth was a good thing.

That's what we do. In the short run, we can do nothing about the P. It moves entirely in line with expectations for the market. But in the long run, we genuinely believe that P will follow the E. So long as we get the E right over time we should make our clients good returns.

I think the other thing that we would point out at this moment in time is that we are looking at a number of themes in the portfolio that we think could continue to play for some time.

The first one is that within the portfolio we have companies with a lot of earnings coming from outside of North America. And clearly at this moment in time I think we're all aware that places like China, India and Brazil in particular are seeing a significant amount of economic growth and that is feeding through into your portfolio.

We have a number of companies like Yum Brands or Pepsi or Proctor & Gamble that see a significant amount of their earnings coming from that part of the world. And that from our perspective is a very positive thing.

The nice things about those businesses is they generate a lot of cash in their more mature markets, which they can use to fund that growth in the more emerging markets. So we like that background and we continue to see that as a positive.

Certainly for us, we think economic growth in the emerging markets will be in excess of 5% throughout 2010 and 2011. And interestingly of the overall world economic growth, over 50% will come from the emerging markets in the next few years.

They're not the biggest markets by any stretch of the imagination yet, but in terms of where the growth is coming from, they are a very big part of it, so that's a positive.

And there are a couple of other themes we continue to play in the portfolio. One is domestic US companies that can win market share in a more challenging environment. I'd highlight companies like Staples and Target in this area, which continue to do well in mature markets at the expense of weaker competitors.

And for us that's very important. Do our companies have the financial wherewithal to continue to grow their businesses even in difficult times and particularly take market share from weaker competitors? And they'd be two good examples of that.

And finally I'd highlight companies in the portfolio that we just generally believe are secular growth businesses. They just have real tailwinds behind them that can continue to go for some years.

And in particular here we looked at things like MasterCard and Visa, the credit card processing companies, which we continue to believe will do well as people move away from using checks and cash to using more plastic, both debit and credit cards.

As you may remember, these companies don't take any credit risk. That sits with the bank. They just do the processing. But as long as there are more transactions taking place on a global basis -- and these are very international businesses -- that continues to be an attractive area.

I'd also highlight companies such as Chipotle, the Mexican food business, which has seen very strong growth in North America, and Google, where we continue to see an improvement in their market over time as advertising continues to pick up and they continue to take a bigger amount of expenditure of the whole advertising market.

So, again, those are the three things - international exposure, domestic market share gains, and secular growth like MasterCard, Visa, Chipotle. And I'd add Ralph Lauren in that marketplace as well, which has been a very good stock for us in 2009 and we continue to think will be a strong performer again on the back of improving international exposure, certainly moving up over the next few years, probably from around 30% international to probably greater than 60%. So those are the sort of themes we see as exciting.

Now in that context, I'd like to also develop the theme that Bill mentioned in terms of relative valuation. If you went back ten years, it's fair to say that growth businesses were trading expensively relative to the value businesses in the marketplace. That premium as we all know over the last ten years has come down dramatically.

And actually in the early part of '09, if you look at the MSCI World broken out by earnings growth, the top quintile of growth was less expensive than the bottom quintile of growth. That's changed slightly as we moved through the year, but the modest premium you are paying for better growth at this point in time to us does look compelling.

To draw this to a conclusion, perhaps as Bill says we see a consolidation in the marketplace. I think it's fair to say that on a global scale, equity markets have moved up and are at fair value in the short run.

And certainly where you see growth, it tends to be priced more expensively than those areas not growing so rapidly. So if you look at China and India, those markets have run up a lot. They're expensive. If you look at the US, not quite so strong growth, trading more reasonably.

But what does seem the anomaly to us is you're not paying a premium for growth businesses within the United States relative to value businesses. And we think that's quite an attractive opportunity.

So with that I'll hand it back to Tony and we'll look to take any questions that you have.

Tony Cook: Great. Thank you, Mark. Thank you also, Bill. So we have a few questions coming in, but I think I'll lead off with a question that my colleague, (Kevin Crook), who pointed out in today's Wall Street Journal, there's a quote from Jeremy Grantham, who called the top of the market in late 2007, told his clients to get out -- and he's much more of a market timer -- and also in March 2009 told everybody to get back in.

He's saying today in The Wall Street Journal for the longer term, quote, the performance of high quality US blue chips compared with the rest of the US stock market is nearly certain, unquote. I'm curious how you both react to that.

Bill Stewart: Hope he's right.

Tony Cook: Why do you think he's saying that? Is it about earnings growth alone?

Bill Stewart: Mark?

Mark Phelps: One of the interesting things in the market obviously in 2010 is going to be this transition from companies that are seeing a rebound in economic activity on the back of government-sponsored programs to try and boost economies.

We're all aware that around the world, fiscal deficits in particular have shot up and they need to be addressed. So the amount of government stimulus that's available is going to be less than it has been.

As once that's taken away we need to be sure that economies have reached if you like this sort of escape velocity to move forward on their own without government stimulus. And we think we're about there.

So, you're going to see a very gradual reduction in fiscal and monetary stimulus over the next 12 to 18 months. But we think that's going to be okay. In some ways, I think that the world will be moving back to a degree of normality.

Let's face it. Fifty basis point interest rates are not normal. They need to be moved up over a period of time as we move into a more normal set of circumstances.

But as we go through 2010 into 2011, the strong rebound in earnings from some of the cyclical businesses and some of those boosted by economic activity from government expenditure will start to tail off. And so I think the point that Jeremy Grantham is making in that regard is the slack needs to be taken up by those companies that have sustainable growth over time.

And from our perspective as we move into 2011, Bill's already said we think we can find companies that can grow in the sort of 13% to 15% range. In 2011 it's more likely the S&P earnings aren't going to be plus 30%, which we'll see in '10, but move back to more like the long-term average, perhaps 7% or 8%, as we just realize that the world economy is having to come off the sort of steroids of government stimulus. And so that is really reflecting his point of view.

Bill, do you have anything to add?

Bill Stewart: Yeah, I think that probably it's sort of a natural progression. (Bob Kahn) used to always say things like the next stop on the train. And after - and right now, we hear that clients all over the world, investors all over the world, are still primarily looking for safety. They'd like - ideally they'd like a nice 5% yield from something that's very safe.

Of course, things that are very safe are yielding 1% or 2%, so they're not getting that. But they're willing to sit there anyway in very low yielding investments to be safe.

If they feel a little more comfortable, they might move - I'll give you a couple of examples of the more conservative stocks in our portfolio. And what you - what they might see over the next five years if they felt a little bit better, let's take Proctor & Gamble and PepsiCo, which have similar outlooks.

In each case, we think their earning power will grow about 11% a year, which means their earnings double in, oh, about 6-1/2 years, which is probably two times faster than the S&P average. That's not rapid growth, but they're good, solid businesses with global businesses running everywhere in the world.

These companies are - together trading around 15 times earnings. Pepsi's closer to 14 and Proctor's closer to 16. They each yield slightly less than 3% on the present dividend, looking backward probably about - give you a 3% yield over the next year, 18 months, and then more. Their dividends go up every year.

So we can buy for our clients companies like Pepsi and Proctor. These are the type of companies that Jeremy Grantham is talking about. And get a roughly 3% current yield that probably is growing at 10%, 12% a year, that dividend, which is yielding at 3% now, will be yielding you 6% on today's stock prices six years from now.

The P/E multiple on those earnings are historically low, so you have an overwhelmingly large opportunity to make money on the upside at a far faster rate than you make in a safe bond without actually taking an awful lot of risk.

Money will probably move in that direction. There are pension funds, for example, or other endowments and so on who need to invest money for a return. They can't stay invested in 1% or lower treasury bills.

And they're ready perhaps to go out and buy the latest technological growth stock. So - it makes sense that money could move toward these very high quality, steady growth companies. And as money moves into them, their price/earnings ratios go up, and our clients do well!!

(As I say here), just using Pepsi and Proctor as examples, their multiple could move from 15 to 18 let's say over the next three or four years just reflecting the fact that more money moves into them. That's a 20% improvement. In the same period of time, the earnings can go up 20%.

So you're going to have a - you could have a 40% to 50% improvement in the price of very conservative, solid stocks over two or three years. That's a very good reason to buy that kind of stock and with a lot of safety and a lot of comfort. (You can) sleep at night comfort in it.

So I would imagine slowly people will move toward that direction, away from the fixed income securities, which don't yield anything. So that would be reasonable to expect.

In the background, rapid growth companies have a world of their own and so on. There's lots of other places to invest. But that could be an interesting way to do it.

Tony Cook: Thank you, Bill. Thank you, Mark.

Here's a question -- you - Bill, you had mentioned in your comments that there were a number of things recently that people are worrying about. They're worrying about Obama. They're worrying about whether Bernanke's going to get reappointed. They're worried about the unemployment rate not coming down.

This individual is asking about China's tightening of their monetary policy. They've taken three or four steps in the last week or two to at least signal that

they're tightening their monetary policy and is that something we should worry about?

Bill Stewart: I would be very worried if they didn't.

Tony Cook: If they didn't!

Bill Stewart: Because it's a command economy, they get things done in that respect quicker than we do. They basically demanded their banks make loans, get things going, and they did six months ago, nine months ago, and it's worked. Their economy heated up to a rate of growth, which nobody can handle.

Now they're pulling it back. And it'll probably pull back very quickly. They are not going to crash their economy. They're trying to keep the growth rate let's say around 8% to 10%, which is a heck of a growth rate. So they're trying to maintain a rapid growth rate without a bust. Now I don't understand why anybody would not want them to do that.

Tony Cook: Right.

Bill Stewart: So I think what people are taking as a negative is actually a positive. Would you agree? You know more about that than I do, Mark.

Mark Phelps: Oh, I would absolutely agree with that. I think if we saw rampant inflation in those markets, we'd be much more concerned. They have had a good track record in the last five years of managing the economy.

And you're going to probably see an interest rate rise in India later this week. We've already seen interest rate rises in Australia reflecting stronger growth there.

And as I said, over a period of time with a return to normality, even in the mature markets, interest rates are actually going to be a sign of those markets' recoveries being self-sustaining. So we wouldn't be overly concerned about that.

Emerging markets had a fantastic run last year. And a pullback in those markets using the interest rate move as an excuse is extremely likely. We've already seen China come back between 10% and 15%. We were talking about India this morning.

We thought that could probably come back somewhere similar on an interest rate this week - rate rise this week. So that's a perfectly reasonable thing and that gives us a period of consolidation before the markets move ahead again.

Tony Cook: Great.

–We have a few more questions. One is that for our portfolios, consumer and tech outperformed last year (in 2009). This person notes that we still have a good amount of exposure in these areas. Do we expect these areas to continue to do well? Or are we going to be adjusting them up or down or do we have any sense of that?

Mark Phelps: Perhaps just a couple of points -- technology is one of those areas where people talk about, the sector, tech. And, of course, the reality is that the underlying within that can be very, different.

We look at our companies that are related to technology very much on an individual basis and they have very different characteristics. So, we have a company like ANSYS, which provides simulation software systems for

designers to build a new car or an airplane or a toaster in new and innovative ways.

For literally anything that's designed, you now use a 3D CAD/CAM to use your computer, design and then you simulate what it's going to do. That's an interesting business.

But it's very different to firms like McAfee, which provides security software for both companies and individuals. So lots of different individual themes there rather than just saying technology.

What I would say in technology is it is an area on a global basis that the US leads in. And we can find a lot of interesting businesses in this area that we think can grow sustainably over time. There are lots of areas of the market where the global competition is incredibly intense.

I'm not suggesting it's not in technology. But there are certainly things in the United States, the great schools, the ability for businesses to get started from the perspective of innovation and entrepreneurship, and that coupled together with, lots of private equity money that's available in those areas, it's not something you see elsewhere.

And then that leads to companies being able to grow and develop over a period of time, at which point we try to pick them up. So, that I think is a genuine competitive advantage that the US has.

On the consumer, I think I alluded to it before. We are not making a big bet on the US consumer coming back aggressively. What we do see is the global consumer continuing to consume more.

And as you see, you get to that point in the developing market where consumers really start to, want those brands, want those products just to reflect their greater incomes. And, I see India and China particularly in that sort of point in their cycle.

But in the US, as I mentioned, we're not banking on a big consumer recovery. What we do like is companies that can win market share even in mature markets.

Tony Cook: Great. One more stock-specific question. Thanks Mark.

It's noticed that MasterCard and Visa remain reasonably decent-size positions for us -- and I would call it large -- and that this person is noting - or asking if we're concerned about some of the regulatory issues that are cropping up?

Bill Stewart: I'm not an expert on those regulatory issues here, although we seem to talk about them every week at our research meetings.

The regulatory issues do not seem to be a concern. To the purveyor - or to the card processing companies.

Bill Stewart: They seem to be to the banks. For example, you can't raise rates on an existing balance after your trial period. You have to give certain periods of time of notice before raising rates, and so on.

So these all affect the banks and what the banks can charge. Their interchange fees and things like that do - could theoretically affect the card processors themselves, but we've seen a number of examples when this has happened that they've protected themselves quite well.

And if anything, the - at the moment, the card companies seem to be actually improving their profit margins because the amount of the total fee that the - that is charged to people with card accounts that goes to the banks is the majority by a wide margin. A very small portion goes to the processors.

There are only - there are two processors that have a - pretty much a lock on the market, so there's not a lot of things that the banks can do to knock their rates down. And it's so small, it doesn't really matter.

So far they've gotten by just fine and the managements of both companies do not seem to be concerned about it. And the analysts we have that cover it do not seem to be terribly concerned about it.

It - the constant discussion does keep the price/earnings ratios lower than they would - otherwise be for the type of growth and cash generation these companies have. So in that respect it's almost a positive.

You're not - you don't have a runaway price here. You've got quite reasonable prices. And if the earning power keeps coming through, as we believe it will. You're probably fine with these, which is why we continue to hold between the two of them our largest position.

Tony Cook: Great. Thanks Bill. That's it for the questions. Any last comments from anybody?

Mark?

Mark Phelps: I think as we've said, we are looking out over the next two or three years and we are confident that we'll see earnings continue to rise. And we think valuations as Bill mentioned (can rise) with that.

Can we see some short-term gyrations as we start to digest this period of movement from government stimulus leading underlying economic activity to it being taken forward by the underlying businesses? Yes. There clearly is going to be some volatility here.

But, I would just mention to people, there's a tremendous amount of cash sitting on the sidelines. A little bit of that cash came out at the beginning and the middle of last year and moved into bonds. People realizing that zero return on cash wasn't great. Let's see if we can get 2% or 3%.

I think as we go back to a more normal period, you will see some of that money start to move into the equity market. And that's what's going to be the driver over the next two or three years.

So we believe that a little bit of short-term, noise and fluctuation is very likely, but on balance that's more of an opportunity we think.

Bill Stewart: I just urge everyone to know what you own and why you own it. If you have any questions if you don't understand why we own it, please call your W.P. Stewart representative and talk to them or email us and, we believe very much that you ought to know what we know and we want to share that with you. So we're all available here for questions at any time. And fortunately the email works 24 hours a day.

Mark Phelps: Absolutely.

Bill Stewart: Thank you.

Tony Cook: Thanks Bill and Mark.

I would like to remind everybody that this call has been recorded and will be available for two weeks on an archived telephone call and also on the Web if you want to listen to it again or have somebody else listen.

Thank you all very much for listening today.

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