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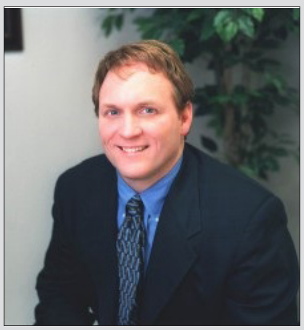
THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Investing in Biotech Companies with Free Cash Flow and a Research Focus



J. JEFFREY AUXIER is President of Auxier Asset Management LLC and Founder of the Auxier Focus Fund. Prior to forming Auxier Asset Management in 1998, Mr. Auxier spent 16 years at Smith Barney — formerly Foster Marshall-American Express, then Shearson — where he was on the Portfolio Management Advisory Board and the Chairman's Council, and was Senior Vice President of Investments and Senior Portfolio Management Director. In 1997 and 1998, he was named one of the top-10 brokers in the country by *Money* magazine, winning two consecutive stock-picking contests.

SECTOR — GENERAL INVESTING

TWST: Could you tell me a little bit about the firm?

Mr. Auxier: We're a smaller research-driven boutique firm and running close to $800 million in client assets. We've got one mutual fund that I started at the top of the market in 1999, and then, we have separate accounts for the balance. Basically, I've been in the business since 1983. I started with Foster Marshall, which ultimately became Smith Barney.

TWST: Does the fund have a unique investment philosophy?

Mr. Auxier: It is unique. Compounding is our primary focus, and so we have a very broad latitude to protect on the downside. I've got 100% of my retirement committed in the fund, with continual monthly investments. We have more of a principal mentality than an agent. In other words, we believe in investing full on with our clients. So we believe, as a steward, it is important to have major skin in the game. We also have a wide latitude and flexibility to protect in down markets just to keep that phenomenal power of compounding going.

TWST: Did you want to highlight a company you find interesting right now?

Mr. Auxier: We routinely go through 1,500 companies annually, so we're constantly digging through individual businesses for compelling opportunities. So one we like right now that might take a while to work out is **AIG** (NYSE:AIG), and basically, we've had real good experience with the new manager Brian Duperreault, and he just recently came into **AIG**, and they actually pulled him out of retirement. So we right now — in a high market — we're looking for exceptional managers with a history of strong capital allocation, and with current disasters, from the hurricanes in Florida to the fires in California and earthquakes, etc., down in Mexico, the glut of reinsurance capacity is starting to be worked off, and that should bode well for some moderate improvement in pricing going forward.

So the reinsurance business has really been glutted with too much supply, too much capacity. But **AIG** has been horribly mismanaged really since 2008. So right now, the stock is trading about 12 times earnings at $59, about 80% of book. But now, you finally have, we think, a really good insurance underwriter. The problem with **AIG** has been just very poor underwriting the last several years, and so we like it when you can actually bring in a focused operator who knows the business. And he actually was taught under Hank Greenberg before all of the folly in terms of the derivatives and what have you that sunk **AIG**. And ultimately, they were leveraged back in 2008, but now, they're getting back to becoming a plain-vanilla insurer with a focus on underwriting discipline.

So we think in time that price discount will diminish as they improve returns on invested capital. And they're very much single-digit subpar returns on invested capital, but they have over, I think, a $230 billion investment portfolio. So the new discipline together with the discount, we again look for that double, triple play, and we think with this new management it will take some time, but we're taking a time risk on this one, but that's just really a price risk in our view.

TWST: I believe AIG recently got Berkshire Hathaway's Tom Bolt to come in for its chief underwriting post. Does that sort of illustrate what they've been working on?

Mr. Auxier: We really watch these managers, and that's what happens. They start to be attracted to other good managers, and then, you're looking at something that's been horribly mismanaged, and all of a sudden, you're bringing in some new discipline. You know it's a fixable problem. But we would rather buy the assets cheap and endure a little longer turnaround then take a big price risk.

TWST: For 2018, do you expect to see much in the way of changes at AIG, or might it take a couple years before things start to really change there?

Mr. Auxier: I think — he just came in — it's going to take a while, but the good news is we had **Marsh & McLennan** (NYSE:MMC) in a similar meltdown. But he came in and he kind of took a while. We're patient as long as we've got the right person in there, and that's the most important thing. **Unum** (NYSE:UNM), years ago, dropped from, I think, $60 down to $12 and then same kind of thing. They lacked discipline in underwriting, and so that stock now has come back from $12 to $53. But a same kind of deal, it just traded at huge discount to book, discount to their intrinsic value, but they got the right operator.

It's kind of like **GEICO** and Jack Byrne. Warren Buffett brought Jack Byrne into **GEICO**, same kind of thing. It was really just about to go bankrupt, but he instituted some hard-nosed disciplined underwriting, and we see that now again with **AIG**.

TWST: Did you want to mention a second company?

Mr. Auxier: In general, we really like valuations of several leading biotech companies, like **Amgen** (NASDAQ:AMGN), which is going to earn close to $14 this next year and trades at $169. **Amgen** has $38 billion in cash, and 40% of their sales are free cash. They've got just staggering amounts of free cash, and we like what's going on in terms of the innovation and then some of the deregulation, where these companies can finally get safe compounds out to the market, but it's been a laggard, but 13 times earnings and an attractive free cash flow yield. As we get into a potential tightening as we run down to 4.1% unemployment and then with the new tax code, we'd see actually the potential for quite a boom in new business formations.

Highlights

J. Jeffrey Auxier discusses Auxier Asset Management LLC and the Auxier Focus Fund. When it comes to the fund's investment philosophy, Mr. Auxier's primary focus is compounding. He has a wide latitude and flexibility in order to protect in down markets. Mr. Auxier also believes it is important to invest in the fund alongside his clients. In the current market, he particularly likes the valuations in the biotech sector. Mr. Auxier looks for biotech companies with free cash flow and research as one of their core values.

Companies discussed: American International Group (NYSE:AIG); Marsh & McLennan Companies (NYSE:MMC); Unum Group (NYSE:UNM); Amgen (NASDAQ:AMGN); Biogen (NASDAQ:BIIB); Costco Wholesale Corporation (NASDAQ:COST); Valeant Pharmaceuticals Intl (NYSE:VRX); UnitedHealth Group (NYSE:UNH); Medtronic PLC (NYSE:MDT); Covidien Ltd. (NYSE:COV) and Philip Morris International (NYSE:PM).

So we like companies that have a lot of free cash that, in the event of higher rates, can still do well. **Amgen** is the world's largest independent biotech company. If you can buy an industry leader or experience 13 times earnings, there's a lot going on in utilizing the immune system and a lot of cures from cancer all the way to Alzheimer's.

We have a fairly large stake in **Biogen** (NASDAQ:BIIB) as a bet. **Biogen** is a leader in basically diseases of the brain: MS, ALS, Parkinson's and Alzheimer's. So we think, in time, those businesses that are most focused on research will win in the end.

We like this group that's really benefiting from data analytics and dramatic advances in research. We're generating more data in one day now than we have going back from the beginning of man. This exponential explosion of data is really creating exciting new innovation and a better understanding of the chemistry of the body and what have you. So we like that area; it's extremely volatile, but we like businesses with free cash flow, with research a core value.

TWST: Does the company have some stuff in their pipeline that's promising too?

Mr. Auxier: They've got Repatha and Prolia and KYPROLIS. So their pipeline looks pretty good, and we think with the new FDA will help to streamline some of these, if they are safe. Here's a company that probably has grown 8% to 10% earnings growth, not great, but together with their free cash flow yields and just a potential — they spent almost 17% of sales on R&D, $3.8 billion in 2016. So we like this kind of quality trading for 13 times earnings.

Back in 2002, the bottom of the market, the stock was at 35 times earnings. So you're not paying a huge premium, whereas a lot of technology stocks you're just paying an enormous amount for not a lot of free cash, and here's a company that is really working. They've got this ABP 215 for oncology, and the oncology side, it looks promising. At 13 times earnings, we're really paying up for much of that potential, and we are being compensated for the risk.

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TWST: Do you think that the concern that you saw maybe about a year and a half ago about the overpricing of certain drugs has settled down in the companies that were involved in it and that the sector is not going to see as much of those concerns in the public?

Mr. Auxier: I think **Amgen's** just really been pretty conservative. We're in a **Costco** (NASDAQ:COST) world, in a low market. We're not in a world of price gouging, and everyone knows it. So I think they're a magnet for news, but again, **Amgen**, it's not a roll-up. Some of these companies that blew up, like **Valeant** (NYSE:VRX), were making multiple acquisitions and cutting their research and then cranking on the drug prices. **Amgen** is spending 17%

of sales on R&D. I mean, this is not a roll-up model, but it's penalized the whole group.

But we've just found that you definitely want to look at those models. That's why a lot of these IPOs, the pre-public unicorns, they can't make it out because they are priced by a venture capitalist, and many of them are really mispriced, overpriced, and their models are suspect. But when you take a conservative model that values research, it is much more sustainable.

1-Year Daily Chart of American International Group

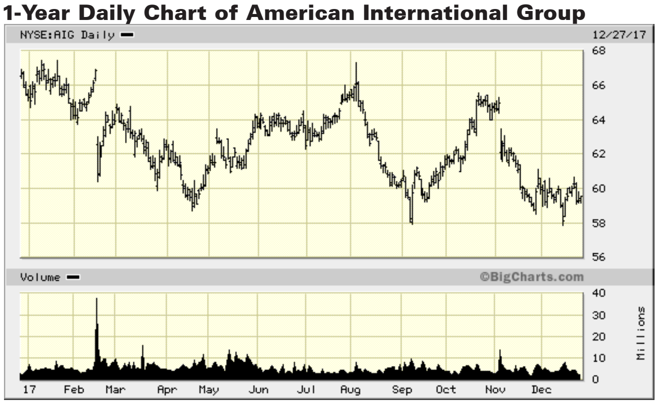

Chart provided by www.BigCharts.com

TWST: Did you want to mention a third company?

Mr. Auxier: Yes, another leader is **Medtronic** (NYSE:MDT). Again, they're not exciting when the economy looks like it's blistering, but again, this company will generate like $40 billion of free cash over the next five years, and not a lot of growth right now, but you're still looking at 10,000 Americans turning 65 each and every day, and this is an enormously high-quality company. It has been left behind in a momentum-driven market, where the focus is on quarter-to-quarter gains in sales and earnings. But when we look at, again, the total picture — balance sheet, enduring franchise, free cash flow, the quality — and even though it looks like we're late in the cycle, here's a company that, like I say, just generates enormous free cash flow, and it's trading like 13 times this next year's earnings for the world's largest manufacturer of implantable biomedical devices, 120 countries.

A consistent 15% return on invested capital, very strong balance sheet, high free cash flow yield add to the appeal. This is the kind of company that would be very attractive to private equity firms, which currently have $1 trillion in buying power. I'm surprised they haven't gone after **Medtronic** just to break it up with the stock at $78. At the bottom of that recession in 2002, the stock traded at 31 times earnings. So you've had kind of a multiple compression on this, but their R&D is, I think, 8% or 9% of sales, not quite like **AMGN's**.

"And these are out of favor, as the economy really looks strong, but we would argue there's still a lot of debt out there in the system, and these kinds of companies that generate enormous free cash flow and have strong leadership positions are a good value in today's market."

1-Year Daily Chart of Amgen

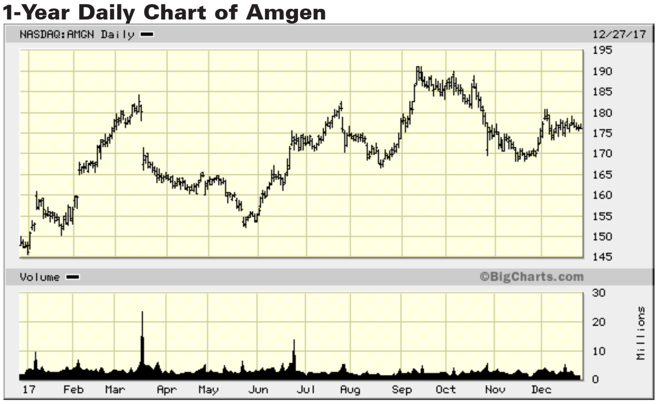

Chart provided by www.BigCharts.com

Biogen is also very focused on their research effort. In today's world, data is critical to driving value creation. Data and using data analytics are important in order to compete. We have a large position in **UnitedHealth** (NYSE:UNH). We bought **UNH** in the mid-$40s; that moved from $45 to $213 recently. A big part of their outperformance has been utilizing data with predictive analytics with their **Optum** group. So we like companies in today's world that can apply that data and utilize that as a competitive advantage.

And these are out of favor, as the economy really looks strong, but we would argue there's still a lot of debt out there in the system, and these kinds of companies that generate enormous free cash flow and have strong leadership positions are a good value in today's market. They have about half of the cardiac and the vascular market share in the country now, along with a strong position in spinal products.

TWST: I understand that they just purchased an Irish medical device company for about $45 million dollars. Do you think that they might be doing some more acquisitions in the year to come and maybe the following year?

Mr. Auxier: Yes, they do typically smaller tuck-in acquisitions, which is good. I mean, they're not betting the farm, and they do have quite a bit internationally, 120 countries, but in this kind of market where you've had enormous run in many companies — and there's still the **Covidien** (NYSE:COV) acquisition; they're still trying to blend that through — I think they're about 50% market share in that hard device area, and then also, they're the leader in spinal products as well. But again, with an aging population and just some of these basic products, this type of business can do well late in a business cycle if interest rates move up. So if we get into the high-3% unemployment rate and inflation picks up, this could lead to higher interest rates. We are in an environment kind of like the early 1960s, with zero inflation for years and years in the 1950s and early 1960s.

Once unemployment dropped below four, then the Vietnam War kicked in, bonds suffered huge losses. You could argue with the tax cut stimulus with a current 4.1% unemployment, you could really have a very strong economy going into 2018. Back in 1986 when we dropped tax rates, we had 5 million new business formations, and interest rates soared after that tax reform act in 1986. I mean, rates went from 7% to 8% and 9% to 10% by the fall of 1987. So the rates can go up if you get too low on the unemployment.

I mean, manufacturing unemployment right now is under 2.8%. So potentially, when you throw this pro-business tax act together with deregulation it could lead to stronger pricing. When you have those two combinations, you typically have a lot of business formations. In 1996, we deregulated the telecom industry, and that led to enormous new business starts, which led to a big boom then bust. We deregulated financial services in 1999, and that ultimately led to a boom and then a bust. And so that's the way we're looking at things going forward. We see that potential for the first time in 10 years for rates to actually move up.

TWST: Do you think that it would help some of these medical device companies if the medical device tax was repealed? I guess it's not on the table right now with some of the other things regarding the tax reform package.

Mr. Auxier: Yes, if you look at companies like **Philip Morris** (NYSE:PM), where they've raised taxes over the years, and that's actually with excise taxes, and that's actually helped their pricing. So in a way, regulation is not a bad thing if you're trying to keep a lock on the market. So we don't think the tax is as important as the demand for the product and the number of entrants in the industry. It is important to look hard at each company's competitive advantage.

So many models are being disrupted, turned upside down. Look at media and streaming, or you look at newspapers or what have you. It is important to be on the right side of the digital trend. Higher taxes and higher regulation, it's kind of an oxymoron, but it can actually lead to better investment results, because when you deregulate, you have a lot more competition.

So it's, again, we're looking kind of at the market position for these businesses and how strong of a market position they have, and a lot of times, like I say, if you look at it as a background, I think higher taxes have really kept out this competition. So just from that standpoint, from a competitive advantage, it's kind of counterintuitive, but that's why we're not really that focused on the taxes. We're more focused on execution and then market position and competitive advantages.

TWST: Changing gears a bit, why do you think that investors may want to consider going to a boutique firm such as yours, rather than one of the mega firms for their investments in the next few years?

Mr. Auxier: Well, there's a proliferation of all these pools, and we've dropped the number of publicly traded stocks from what 7,800 back in the late 1990s to 3,600. The key with investing is to know what you're in and what you're doing. So when interest rates drop to 5,000-year lows, and you've got $9.7 trillion negative in Europe still, there's going to be a corresponding upward boom in asset prices. We think it is important to look at the performance in the down years, like the PC bubble in 1983, the market crash of 1987 or the thrift crisis in 1989, the dot-com bubble in 2000 followed by the housing boom-bust then commodity boom-bust into 2011.

We have learned that there is great value in cumulative knowledge and tracking prices to understand where we are in a cycle. We price our securities by hand daily, and I have since 1983. We want to be with those operators that have a principal mentality and a lot of skin in the game. There is a plethora of investment pools but very few with heavy managerial ownership. According to Morningstar, half the domestic mutual funds have zero invested in their funds and less than 10% have a million dollars invested. We strive to be invested with the clients, so we feel the pain on the downside.

People are OK holding investments they don't really know as long as they're going up. But once they go down, the key organ to investing is the stomach, and it becomes difficult to stay in the game. Take the Japanese Nikkei index. In 1989, it reached 38,089, and it dropped to 28,000, then 18,000 and then 7,500 by 2009. Where do you buy? If you break out the businesses within that, you can figure it out.

Global Central Bank balance sheets have expanded from $3 trillion to $18 trillion since 2002. Easy money can lead to high prices and speculation like you are seeing with Bitcoin. I mean, you know there are always bubbles out there, but I would want to be with someone who has survived and endured through numerous declines. We like to see long track records through the most difficult economic times.

We have a documented track record going back to 1989 for separate accounts and back to 1999 for the Auxier Focus Fund. We started the fund close to the top of the market in 1999, and it's pretty much outperformed all of the major indexes since that time. We survived two 40% market declines in nine years. So normally, when the market gets tough, you'll find out who the real investors are.

Right now, I don't see this as a period of disciplined investing. This environment is one filled with great speculation. I mean, if people are going through each company, there's no way they would own a large swath of technology names. You can't defend or justify many of those valuations.

TWST: Thank you. (ES)

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