# Finding Balance

*Balancing consistent income and capital appreciation is not easy, but John Kornitzer, the manager of Buffalo Balanced Fund, believes that investors pay for a special edge, not for following an index or buying Treasuries. The fund covers a wide spectrum of securities, including equities and high-yield bonds, to create a one-stop investment for those who don't want to spread their money across different funds.*

**Q:** ***Why should investors consider a balanced fund and why should they consider your balanced fund?***

**A:** Not every investor has a lot of money to spread across a wide variety of funds. A balanced fund can take care of both their fixed needs and their equity needs in one investment. Our fund is designed to provide consistent income plus capital appreciation. If you are conservative or older and want to hedge against inflation, an investment in equities plus current income is a good investment.

We try to maintain consistent increasing income. We look for companies that increase their dividend at least every other year. They should have great cash flows, stock repurchases and rising earnings. We are looking for shareholder friendliness in some way.

We also invest in convertible bonds, convertible preferred and high-yield bonds. We buy mostly unsecured, high yield bonds with ratings of BBB or lower. We wouldn't be earning our keep if we were just buying Treasuries.

About 75% companies pay some dividend nowadays but they don't always increase yearly. We try to look for the companies that continuously increase their dividend – we don't invest if they don't – and we have 200-300 companies on that list. More and more companies are starting to pay dividends.

**Q:** ***Would you define yourself as a value investor or as a GARP investor?***

**A:** We use both processes. Most people don't have hundreds of thousands of dollars to spread across different funds.

**Q:** ***How do you implement the philosophy of balancing income and appreciation into an investment process and strategy?***

**A:** We start with a screen of about 10,000 securities. Then we keep refining it until we get it down to some companies that we can do research on. After we research them, if they fit the criteria we are looking for, we invest in them.

We use profitability and value screens. We do a relative value screen of performance within the industry, we use P/E, price per share, operating cash flow, EBITDA, P/E to growth, etc. Then we do vigorous fundamental research to identify the best ideas. We look at both historic and projected earnings and we normalize them to take out all the noise. That process narrows the universe down to a handful of 100 or 200 stocks.

Then we talk to the company, check who they compete against, check to see if there are any lawsuits outstanding, look at the balance sheet, capital expenditures, what they are going to need for

## Buffalo Balanced

### Fund Facts

| | |
|---|---|
| Symbol | BUFBX |
| Website | www.buffalofunds.com |
| Address | Buffalo Funds<br>c/o U.S. Bancorp Fund Services<br>P.O. Box 701<br>Milwaukee, WI 53201 |
| Tel. No. | 800-492-8332 |
| Inception | 8/12/94 |

### Portfolio

| | |
|---|---|
| Total Net Assets * | $ 150 |
| Avg Mkt Cap ($ Weighted) * | $ 38,584 |
| Average Price/Earnings Ratio | 15x |
| Average Price/Book Ratio | 3.2x |
| Turnover Ratio | 33 % |

### Investment Information

| | |
|---|---|
| New Investment | Open |
| Min Initial Investment | $ 2,500 |
| Min Subsequent Investment | $ 100 |
| Min Initial IRA Investment | $ 250 |

### Risk (Against S&P 500 - 3 Years)

| | |
|---|---|
| Alpha | 4.98 |
| Beta | 0.74 |
| R-Squared | 74 |
| Ann Std Deviation | 9.55 |
| Sharpe Ratio | 1.64 |

### Returns vs. Lipper Balanced Funds Index

| | BUFBX | Index |
|---|---|---|
| 1 Year (Cum.) | 11.67 % | 10.05 % |
| 3 Year (Ann.) | 18.36 % | 12.56 % |
| 5 Year (Ann.) | 5.03 % | 2.89 % |

### Returns vs. S&P 500

| | BUFBX | Index |
|---|---|---|
| 1 Year (Cum.) | 11.67 % | 12.25 % |
| 3 Year (Ann.) | 18.36 % | 16.96 % |
| 5 Year (Ann.) | 5.03 % | -1.49 % |

### Fees and Expenses

| | |
|---|---|
| Max Sales Charge - Front | 0.00 % |
| Max Sales Charge - Deferred | 0.00 % |
| Max Redemption Fee** | 2.00 % |
| Total Expense Ratio | 1.03 % |

### Portfolio Manager

Team Managed

** millions* *** within 60 days*

*Data through: 09/30/05*

*Source: Company Documents; Yahoo Finance*

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the future and if they generate enough cash to take care of that, their debt rating, etc.

**Q:** ***Do you rely mainly on bottom-up research and valuation?***

**A:** Yes, but if we have a top-down idea, we look at it. Flexibility is very important in research. Our primary purpose is to discover companies with rising dividends, cash flows and earnings, but we are also looking for companies that are improving their market share, their R&D, their technology or their leadership in the industry.

As far as the selection of convertible and high-yield bonds is concerned, it must be a public company or we wouldn't buy it. We go through it and tear it apart just like every company we invest in. We are interested more in their cash flow than in their earnings, because we need to know that they can pay us back. It is strictly a debt structure perspective.

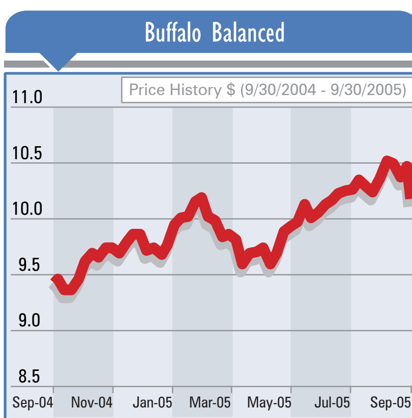
**Q:** ***Do the fund analysts specialize along sector lines?***

**A:** We have 6 analysts for the bond research and 18 to 24 analysts for the equity research. They are generalists, pretty broad based. But in certain areas, you definitely need people who understand the industry. Such areas are drugs, technology, and energy. In the drug field, we have an analyst who was a medical doctor for 9 years and also has an MBA.

There is no consistency across sectors. In the 80s, the food stocks were really hot. In the 70s, it was energy. In the 90s, it was technology, the dot-com boom, and the medical stocks. In 2000 it is a new group, the financials. Now energy is back. Trends keep changing because investors end up chasing a group and it gets overpriced. It is the greater fool theory. For example, today everyone is buying real estate in the US. At dinner parties people discuss how many homes they bought, how they are speculating and how much money they are making. The dot com has been replaced by the dot home, and no one expects to lose. I guess that happens with most sectors of the market when they are hot. Companies come and go but there are always new companies and there will always be rotation of trends.

**Q:** ***Would you explain your portfolio construction process? What are your views in terms of sector weighting or benchmarks?***

**A:** We try not to follow weightings and benchmarks in the Balanced Fund. If I wanted to be an index fund, I could become an index fund. The investors who want mediocre index returns don't need me. The market has to measure us against the other balanced funds, not against an index. We try to be the best among the balanced funds and to maintain our special edge in what we do.




We have up to 60 stocks and usually have 30 or 40 bonds. So we run either 60% in stocks and 40% in bonds or vice versa. We invest entirely in domestic stocks and bonds.

**Q:** ***Do you share the increasingly popular view that management meetings do not offer much value?***

**A:** I find them useful because I want to know the character of the manager. It is true that you can find the information anywhere, but can you know the person? For example, when you meet someone with an autocratic approach, you know that this company is less likely to succeed. We like to meet the management in their office, on site. We don't care much about industry conferences because we prefer one-on-one discussions.

**Q:** ***Can you give us some specific examples of companies that would fit your criteria?***

**A:**. We look at a company's ability to have excess cash flow to pay dividends or to do stock repurchases. We look at management succession, how they are viewed by the competitors. We look at absolute and relative valuation analysis and we monitor our investments continuously. Basically, we want companies that are very good at what they do. They are market leaders or are on their way to become market leaders.

Let's take Wrigley as an example. It is a great worldwide company, which constantly increases its dividend every year. They have solid and stable management. Stability and consistency are key words in our philosophy. Coca-Cola was such company for years, but then Pepsi became more of a leader and Coke is trying to come back as far as growth is concerned.

**Q:** ***In such a situation, how do you recognize the signals? Three years from now Pepsi could be ahead of Coke by a significant margin.***

**A:** Pepsi is not bigger than Coke, but they've been able to grow. A couple of years ago Coke was in the 50-dollar range and today it is $44, while Pepsi was in the $30s and now it is in the high $50s. Which stock would you prefer to own over this period? We first bought Pepsi in 1994.

There were trends you could spot three years ago. You could see where each of them was in the market place. Coke was having trouble with its distributors, Pepsi wasn't. Pepsi got into snacks, Coke didn't. Pepsi was looking into how the market was developing, while Coke was struggling. When Coke's stock fell into the low 40's last year, we took a new look at it and decided it was worth buying.

When we buy a stock, we hang on to it until it is performing. It may be 2 years,

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5 years, 10 years, or 15 years. It doesn't matter; we are here for the long haul.

**Q:** ***Since dividends are important to your philosophy, would you consider a company like Pepsi three years ago if it doesn't pay dividends?***

**A:** If a company is doing really well, it is probably generating a lot of cash flow they need for expansion. We are looking for companies with excess cash flow, so that they are able to pay dividend or buy back stock. We might occasionally buy a company before it pays its first dividend if we think it is coming up. Buying companies early, before others discover them, gives you the chance for a better ride.

**Q:** ***When the trends you identified earlier die out, obviously you have to take the profits and exit. How do you decide when to sell?***

**A:** We sell when the valuation is ahead of itself, which eventually always happens. If it doesn't, it just gives you a chance to buy more. If there are good stocks that are not moving, you just keep buying them. If we think that we bought it early, that is fine, we can hold it. If a stock is underperforming for some reason, we'll reconsider. If something has changed in the outlook, we are out of there immediately.

**Q:** ***The yield in the bond market is driven by government estimates on inflation. Do you believe that inflation measures are accurate and comprehensive enough?***

**A:** I don't think that the official inflation numbers are in line with what is happening today. If you go to your local restaurant or buy anything, you will see that prices are going up. Clothes are cheap because of imports from China, but food and service prices aren't going down. The measured inflation does not include the housing price inflation, which is going through the roof.

But even though real inflation may be higher than reported, there are ways to hedge yourself in the bond market. In junk bonds, I don't buy anything with less than 8% or 9% yield. If inflation is measured at 2%, while it is probably 4% or 5%, I am still getting 8% or 9%. I have a cushion and my bond maturity is less than 10 years.

> "You have to look at trends but you don't jump all over the place anytime something happens. It is the long-term trend that matters. I was buying a lot of gaming stocks, but now they are fully appreciated. Trends do change and you have to change with them."

**about John C. Kornitzer**

**John C. Kornitzer** is President of Kornitzer Capital Management (KCM), and founder of Buffalo Funds. Before founding KCM in 1989 Kornitzer worked for Employers Reinsurance Corp., Texaco and Getty Oil and was a managing partner for the General Electric Investment Corporation. Kornitzer also worked on Wall Street for 11 years; seven years for Merrill Lynch, Pierce, Fenner & Smith Inc. and four years as Vice President and manager of Butcher & Singer's New York region. Mr. Kornitzer is a former Principal of the New York Stock Exchange and a founding governor of the National Organization of Investment Professionals.

Mr. Kornitzer received his degree in Philosophy and Accounting from St. Francis College in Pennsylvania. Mr. Kornitzer sits on many philanthropic boards, and supports numerous civic and charitable causes, but he has a special, passionate belief in the strong values-based message of the NAIA's Champions of Character program, and is committed to bringing it to America's youth.

**Q:** ***Historically, which sector has been a big borrower and where have you been able to make money in the bond market?***

**A:** Historically, the gaming market. The gaming companies had tremendous cash flows, they borrowed a lot of money to build all the casinos and they paid us all back. In the energy sector, some of the refiners had bonds we bought. We have also bought cable, food, drug companies bonds.

We will look at these companies for bonds but they wouldn't fit our criteria for stocks. The cable companies, for example, need a lot of money for capital expansion and aren't dividend payers. The sectors that fit our stock profile include some of the big banks, insurance companies, energy, food, technology, consumer products companies, some of the Wrigley type of companies, trust companies.

**Q:** ***What kind of risk control measures do you have in place?***

**A:** A 10% drop in the stock automatically triggers a major re-examination. Continual drop of 5% would make the situation extremely serious and may mean the end of it. We try to avoid big volatility and the timing of the purchase is crucial.

**Q:** ***How do you handle situations of market crisis?***

**A:** In 2002 there was tremendous overall market panic and liquidation. We handled that situation very effectively. We had enough cash and we were able to buy more at the bottom. We came extremely well back in 2003 and 2004 and it worked out favorably for us. ■

**TICKER Staff**

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