Dividends Matter

Slow and steady wins the race. Most fund managers know that well but few of them really put the philosophy into practice. In a world of growth investing, dividends fell out of style for a long time, but the reality is that dividends, reinvested, have provided over 40% of equity market returns over time. Investors have "re-discovered" that fact: through June 30. the 385 companies in the S&P 500 which pay dividends gained 4.9%, while the 115 non-payers rose only 1.1%. The fund managers at BB&T Equity Income Fund look for rising income and dividends to generate 8% or better return for the investors.

Q: ***What is the investment philosophy of the fund?***

A: We believe the tortoise won the race. To me, there are two basic classes of investors. Those that like to buy low and sell high, which is our style, and then those who like to buy high and sell higher. We're the tortoises and the latter style is the hare. We're trying to plow ahead every single day. We have a long-term view but take it one day at a time.

Dividends matter. In a low-return world, if we can capture a 3% or 4% dividend yield in high-quality companies, we're halfway to what we believe is a reasonable goal of making 8% a year. A side benefit is lower portfolio volatility. On the tough days, dividend-paying stocks tend to play good defense.

Our strategy and part of our research process is that we only buy companies whose dividends have grown. So it's not merely finding companies with above average yield, but also companies that have a history of raising their dividends for at least 3 years in a row or 5 out of the last 10. We're conservative, but we seek growth, too.

We are skewed toward large-cap value, because those companies tend to generate cash in excess of ongoing needs and thus pay dividends to reward their shareholders. Where we are from a style-box perspective is a result rather than a goal. Certainly we are free to buy other kinds of companies if they fit the basic dividend growth criteria.

Q: ***So if the company doesn't have a dividend, you will not look at it even if it has a free cash flow?***

A: That's correct. That limits us a little, but we have other portfolios where we can buy a more traditional growth stock that is attractive on valuation. Our team manages about $1 billion dollars, and close to half of that is in the Income-plus style I described.

Q: ***What are the key elements of your portfolio construction?***

A: We tend to have fairly concentrated portfolios of 25 to 27 stocks. If we do it right, it'll give us 92% or 95% of the diversification of a 500-stock

BB&T Equity Income

Fund Facts

Symbol	BAEIX
Website	www.bbtfunds.com
Address	BB&T Asset Management Inc. 434 Fayetteville Street Raleigh, NC 27626
Tel. No.	800-228-1872
Inception	9/7/2004

Portfolio

Total Net Assets *	$ 107
Avg Mkt Cap ($ Weighted)	$ 64,900
Average Price/Earnings Ratio	14.10
Average Price/Book Ratio	2.49
Turnover Ratio	40 %

Investment Information

New Investment	Open
Min Initial Investment	$ 1,000
Min Subsequent Investment	$ 0
Min Initial IRA Investment	$ 1,000

Risk (Against S&P 500 - 3 Years)

Alpha	N/A
Beta	0.80
R-Squared	N/A
Ann Std Deviation	N/A
Sharpe Ratio	N/A

Returns vs. S&P 500 Index

	BAEIX	Index
1 Year (Cum.)	13.76 %	5.38 %
3 Year (Ann.)	N/A	10.80 %
5 Year (Ann.)	N/A	2.82 %

Returns vs. Russel 1000 Value TR IX

	BAEIX	Index
1 Year (Cum.)	13.76 %	11.59 %
3 Year (Ann.)	N/A	16.06 %
5 Year (Ann.)	N/A	7.46 %

Fees and Expenses

Max Sales Charge - Front **	5.75 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.10 %

Portfolio Manager

George Shipp	6/04/2004

** millions* *** amount invested less than $50,000*

Data through: 7/31/2006

Source: Company Documents; Lipper

Q&A

TICKER's Choice

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portfolio. So we should disclose that as a modest risk, and we're cognizant that dividend-paying stocks are often concentrated in certain industries - financials, energy, etc. We look hard for companies that can diversify us, like healthcare and technology.

There aren't enough tech companies that pay dividends, but we have a couple of strong technology companies in the portfolio that meet the criteria. We're happy to scoop up a solid company after it runs into a bad quarter because we tend to be more patient than most investors. For example, we bought Nokia a couple of summers ago when it got down into the $11 to $12 range. At the time they were losing market share to Motorola but we thought the 3.5% yield on a no-debt, highly profitable technology company like Nokia was a good deal. More recently, investors have become skittish on semiconductor inventories, so we've taken the other side of that trade and added Taiwan Semiconductor, the world's leading foundry. We call it our nanotechnology stock - one that happened to make $2.9 billion in profit last year.

We've got traditional REITs, banks, utilities and other growth companies. What we want is not just income, but growing income. The idea of being fairly concentrated is that if we are fortunate and pick a stock that works, we would like for it to make a difference. We don't want our favorite ideas to be diluted by 400 other stocks in a portfolio, so we tend to take positions in the 3.5% to 4% range. This could be perceived as a more risky strategy, but so far it's worked out very well.

General Motors is the perfect example of what we can't own, and don't want to own. The fact that it hasn't raised its dividend in 13 years might tell us that the management has not been confident enough about the future to allocate more to its shareholders. A company with a high yield but not a rising yield does not get considered. Ford's another example and of course it just slashed its payout by 50%.

Q: *How do you look at companies like Microsoft with enormous cash flow that occasionally comes out, with one-time dividend that may or may not be sustained, yet the cash flow is stable, healthy and growing?*

A: We'd prefer regular dividends to special dividends. Dividends are a commitment. I'm not going to say we would never make an exception if a company started to "regularly" pay out special dividends, but the downside protection has to be there. If the payout to shareholders goes up over time, we would consider that stock. If it's just a one-time event we don't try to trade around a special dividend. We're going to look at the underlying regular dividend.

Q: *What are the most important things in a company that you are looking for?*

A: It's pretty basic – if we can find a company that has higher than average growth, a stronger than average balance sheet, below average valuation and above average yield, that stacks the odds in our favor. What kicks out of that core screen is a lot of banks and financials, and the traditional consumer staples like Altria. We don't want an entire portfolio of banks and financials so we do our best to sprinkle in a couple of smaller companies like Natural Resource Partners, which collects royalties on coal properties. It came public four years ago but has increased the payout almost every quarter since then. We think that's attractive and supplements our other energy holdings.

Q: *I think that's linked in some ways with the rise in oil price, which correspondingly brings a rise in coal price. Do you worry about inflation as at some point the energy prices may correct and you'll be caught holding it for 2 or 3 quarters?*

A: I'm one of these guys who's constantly paranoid so sure, we worry. We're focused on the inventory situation in oil worldwide and natural gas domestically, which is difficult right now. Coal tends to be on a longer cycle. A lot of the product is sold under contract to utilities. Natural Resource Partners just collects a royalty from the Peabody's and the Arch's and a lot of private companies that mine the coal. It doesn't have the operational and union issues. It collects a royalty of the tons of coal produced from its properties, and its reserves total over 2 billion tons, with a "b". The company does participate in the pricing on the upside and the downside, but in a less leveraged way.

We are believers in the "higher for longer" secular case for energy. I believe the shocking reality is that 71% of the world's known crude oil reserves are in Islamic countries, and another 20% or so is owned by less friendly socialists such as Russia and Venezuela. The oil that's out there is in tougher and tougher places to find – Siberia, the Caspian Sea, offshore Brazil, and in Venezuelan and Canadian muds. Governments all over the world, not just in Russia, Venezuela, and Ecuador but also in the UK and the U.S., are raising taxes, so the supply remains tight. Gaz guzzlers in the U.S., and of course China and India are driving the demand. The good news is the U.S. is the Saudi Arabia of coal. We've got it in abundance and it's cheap. So, anywhere near these prices, there's tremendous incentive from the energy economics, but also almost from a national security point of view, to produce more coal in this country.

Q: *What kind of research do you do to turn an investment idea into a portfolio holding?*

A: We have four professionals who average 20+ years in the investment business or real world. Like everybody else we do a lot of research. I was a sell-side securities analyst for 17 years, one of the other portfolio managers, Farley Shiner, was a telecom analyst on the sell side, and before that the CFO of a public telecom company, so perhaps we have some de-

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gree of expertise at reading Wall Street research because we've written it. We don't conduct as many management interviews as some others, but maybe that's because we don't care as much as others about whether the June quarter is going to beat the estimate by a penny. That's unknowable, so why is so much effort invested in trying to guess the last penny?

Q: *What is the fund's turnover?*

A: Our historical turnover has been pretty low, about 35-40%, and we believe that philosophical orientation gives us an advantage over some competitors.

Q: *How would you describe your sell discipline?*

A: We do not have a formulaic sell-discipline. We believe our shareholders are paying us to make judgements, and we want to retain the flexibility to buy or sell at a moment in time. Because we run a concentrated portfolio, roughly half our sells are driven simply by our need to come up with our least-favorite idea, to fund a new purchase. Every now and then we get lucky – Kinder Morgan was our largest position when management recently proposed taking it private. We hated to see it go, but thank you very much.

Q: *How do you build the positions in your portfolio?*

A: If consumer staples are 10% of the S&P 500 index, we don't have a rule that says we ought to be between 9.5% and 10.5%. We will attempt appropriate diversification, but we will always run a fairly concentrated portfolio.

If you want to achieve above average results, you have to dare to be different. For example, our consumer staples position is 15% of the portfolio instead of 10% of the S&P. Some portfolio managers might not be comfortable with that kind of overweight; we are. The last thing the public needs is another closet index fund.

Q: *What is the average position in a stock in the portfolio?*

A: It tends to be 3.5% to 4%. At the moment our biggest position is 4.2%. As far as the smallest position, we're getting our feet wet in a new idea at this moment and it's in the 1.5% area. We've got a couple of positions at 2% and 2.5%, one of which we are building and one, frankly, that's in the "penalty box." But those are the exceptions.

> "In a low-return world, if we can earn 3% or 4% in cash dividend yield upfront in high-quality companies, that is a good start to making 8% a year and a reasonable amount to expect in the stock market."

about **George Shipp**

George Shipp has been the Chief Investment Officer of Scott & Stringfellow's Choice Asset Management unit since its formation in 1999, and has led its growth to current assets under management exceeding $1 billion. In June 2003 he became lead portfolio manager of the newly created BB&T Special Opportunities Equity mutual fund. His team launched the BB&T Equity Income Fund in June 2004.

George graduated from the University of Virginia (1979) with an undergraduate degree in biology, and was awarded an MBA (1982) from its Darden School of Business. He is a Chartered Financial Analyst and member of the Richmond Society of Financial Analysts.

Q: *What kind of risks do you monitor and how do you control them?*

A: We try to know the pressure points. We're over-weighted in financials and real estate companies. We dare to be different, but there's a limit. We're never going to be 100% energy or 100% banks and financials,and by the way even within REITs we own industrial, retail, office, and hotel properties to mitigate concentration.

We have tended to carry more cash than the average mutual fund. We are willing to hold 10% to 14% cash. Right now cash is only 5% of assets but in the past we've touched 15%. The good and bad news is that returns on cash are competitive. The sad fact is that cash has beaten the S&P500 over the last 7 years. So while we fully realize that we're being paid to pick stocks, we are willing to raise cash if we don't feel good about the market for whatever reason, or if we have taken a profit in something, or maybe taken a loss and don't have that new idea right now. That is a risk dampening measure at the margin.

We prefer to buy low and sell high. We get hit by surprises just like everyone else, so the risk management comes from the purchase price of our companies, that proverbial margin of safety. We try hard to buy in the lower third, or at least the lower half of a company's historical valuation range, because we believe strongly in reversion to the mean. That way we have a chance to receive P/E expansion on top of any underlying growth or up-front yield.

The managers who are looking at the more exciting companies that have to figure out what they might earn in 2012 and beyond, and what the appropriate discount rate to value those earnings in today's dollars – whew, to me that's harder than what we do. We look at price-to-book values and P/Es and how are the companies doing now. Are they performing in line, or better than expectations, and is the valuation fair relative to the underlying performance. It's a good formula and a good niche. ▮

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