FIRM INVESTMENT STRATEGY

In analyzing an investment candidate, we break the purchasing decision into two principal questions: (i) Is the company under scrutiny a good business? (ii) Can we purchase this business at a cheap price in the marketplace? Delphi initially addresses the first question based upon a quantitative screening.

-On average, the company should earn a minimum 15% after-tax return on equity. For a cyclical business, the corporation must achieve the 15% target on its recovery earnings.

-We like companies that grow both revenues and earnings faster than inflation over a 3-to-5-year time horizon. While we accept that companies do not necessarily grow along a straight line, we want real growth, not just nominal growth, over time.

-For all non-financial companies, we perform a free cash flow analysis to determine if a firm can finance its growth through internally generated operating cash flow. We eliminate non-recurring items such as divisional spinoffs or divestiture of assets to obtain a true cash flow. Additionally, Delphi analyzes the areas of capital intensity such as inventory turns, days of receivables, and sales to fixed assets.

-We favor companies with low debt/equity ratios. Normally 10-15% of our portfolio holdings are virtually debt free (either zero debt, or cash and equivalents exceeding debt).

-As a disciple of Benjamin Graham, we insist that all purchases should be made at a substantial discount to a conservatively estimated liquidating valuation. For example, a media franchise must be acquired at a significant discount to its conservative breakup value.

-Delphi insists upon conservative accounting practices. Under-reserved banks have no place in our universe. High technology companies with rapidly deteriorating inventory turns are a sure sign of obsolesced product lines and overstated earnings and book value.

Once a candidate meets the quantitative criteria, Delphi has a rule that, in all cases, we must either telephone or visit with management. Most important, we like managements with a high degree of integrity; those who willingly communicate what the problem areas in the company are and who do not tout their stock with promotional literature or slide shows. Like the old Business Policy course at the Harvard Business School, we insist that companies have a well-defined business strategy and can articulate their strengths and weaknesses versus their competition. Finally, Delphi requires management to have a strategic plan and definable goals over a 3-to-5-year horizon. While a McKinsey or Booz Allen formal plan is not required, we expect management to have considered the four building blocks of any business--marketing, finance, production, and manpower.

After assessing the merits of the business, Delphi is ready to address the second question, "Can we purchase it cheaply in the marketplace?" I have divided the world of Graham & Dodd into two subcategories-earning power plays and asset plays. Earning power plays are companies with consistently high returns on equity every year with relatively few breaks in reported earnings. Under no circumstance does Delphi pay more than 13x the forthcoming year's conservatively estimated earnings. The multiple of the S&P 500 (whether it is 15x or 27x) does not influence our price/earnings ratio frontier. Hence, we are absolute value, not relative value investors. The second category, asset plays, are companies which may be currently depressed, which have earned 15% return on equity in the past with the likelihood of reaching that figure again, and which sell at significant discounts to liquidating value.

Portfolio Strategy

After committing the initial funds, Delphi remains fully invested (85 to 100% equity exposure) at all times. We do not think that anyone (including us) is smart enough to pick the turns in the stock market. Delphi has two main diversification criteria: (i) No one stock exceeds 5% of portfolio weighting at cost (in practicality, we usually follow a 3% limit); (ii) No one industry grouping surpasses 20% weighting at cost. In general, a typical Delphi portfolio comprises 60 to 85 names. On average, annual portfolio turnover of individual names is low, less than 35%.

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