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Matrix Asset Advisors, Inc.

Capital Markets Commentary and Quarterly Report: 4th Quarter 2016

The stock market made a new all-time high in the fourth quarter, with the S&P 500 rising by 3.82% and the Dow Jones Industrial Average nearing 20,000. The rally was driven by improving economic data and an enthusiastic response from investors to president-elect Donald Trump's pro-business platform of lower taxes, reduced regulation and fiscal stimulus. The President-elect's more problematic protectionist trade statements have not dampened the market's high spirits, for now. For the full year, the S&P 500 was up 11.95%, a remarkable comeback from the worst beginning to a year in market history.

Matrix's portfolios fully participated in the year-end rally. Both strategies, Large Cap Value and Dividend Income, out-performed the S&P 500 for the fourth quarter and full year.

There was a notable shift in sector leadership in the second half of the year from defensive sectors to those with more economic sensitivity. In the fourth quarter the leading market sectors were Financials, Energy and Industrials. The laggards were Real Estate, Healthcare and Consumer Staples, all posting a negative return in the quarter. For the full year the best performing sectors were Energy, Telecom, Financials and Industrials, in that order. The worst performing sector was Healthcare, the only sector showing a decline for the year.

Value strategies outperformed Growth in 2016 after a number of years of lagging performance. The high probability for Value's resurgence was something we discussed in last year's fourth quarter letter, following Large Cap Growth stocks trouncing of Large Cap Value stocks by 950 basis points in 2015. Looking at the Value/Growth performance style data as far back as it goes (1979), history suggests that Value is due for a multi-year period of outperformance.

Interest rates rose sharply during the quarter with the 10-year Treasury yield jumping from 1.60% to 2.45%, but were up only modestly from last year's ending level of 2.27%.

Gold dropped by $173, or -13%, in the quarter but was up 8.5% for the year.

U.S. crude-oil futures continued to rebound in Q4 after OPEC agreed in November to cut production for the first time in eight years. The oil price moved up by 45% in 2016 and more than doubled from its low of $26.21/barrel in February to close the year at $53.72. A sustained higher oil price above $50 has very positive economic benefits for the industry and broader economy, with the addition of good paying jobs and rebounding capital spending.

Matrix Portfolios and Outlook

As noted earlier, Matrix's Large Cap Value and Dividend Income portfolios posted strong returns in the fourth quarter and outperformed the benchmark for the quarter and full year.

We believe that both portfolios are well positioned for the economic environment we foresee in the year ahead. We think that 2017 has the potential to be a year of accelerating economic growth, breaking out of the sluggish sub-par GDP expansion that has characterized the eight year recovery since the Great Recession. The year ended with a long list of positive economic reports including a 4.7% unemployment rate (close to a nine year low), improving manufacturing and service sector growth in the U.S and Europe, rising home prices, auto sales at record levels, and the highest level of consumer confidence in 15 years.

We expect earnings estimates to rise this year, as energy companies show much improved earnings from a year ago on higher oil prices. We also anticipate that financial firms will benefit from rising interest rates, continued strong credit quality and an improving economy that creates demand for loans. High consumer confidence and a continuation of job growth are expected to lift consumer spending and industrial companies should benefit from an increase in business investment.

This projected profit improvement is before any benefit from a potential reduction in business and personal tax rates. The obvious brakes on profits for multinational companies are the relative strength of the U.S. dollar and the fallout from the possible enactment of any new protectionist trade policies. Consensus earnings estimates are for S&P 500 earnings to grow about 12% in 2017 versus 2016, according to FactSet. This would mark 2017 as having the strongest year over year profit growth in six years and a sharp improvement over the 1% earnings growth in 2015 and 2016.

This projected earnings improvement could provide a nice tail wind for Matrix portfolios as a study published in mid-December by Bank of America Merrill Lynch stock strategist Savita Subramanian (*Barron's, 1/2/2017)* suggests that Value outperforms Growth when earnings are picking up.

As we said for much of last year, we think the overall market is fairly valued at 16.9x estimated forward earnings versus the 20 year average of 17.2x.[1] It is important to note however that, there are a number of stocks in high quality, and higher yielding areas of the market that sell at substantial discounts to those levels.

Statistically, the most attractive sectors relative to the 20-year forward P/E averages are Technology, Healthcare and Telecom. Our portfolios have good representation in these areas. Financial stocks, our largest portfolio sector weighting, are not the bargain they were a year ago

[1] Source: FactSet, Russell Investment Group, Standard & Poor's, J.P. Morgan Asset Management.

but we believe they remain very attractive in an improving economy, with higher interest rates and a less adversarial regulatory environment.

In summary, we expect more volatility this year as a new administration in Washington legislates its agenda and the world confronts a changing political landscape in both the U.S. and Europe. We also believe however, that another positive year for the stock market is likely and high single digit returns are achievable. We expect interest rates to rise and remain cautious about fixed income investments, preferring high quality and short to intermediate term maturities.

Reviewing our Predictions for 2016

We appreciate the irony of reviewing last year's predictions and making new ones while writing an *Ideas* section highlighting the Nobel Prize winning work of two psychologists who have conclusively demonstrated the difficulty of making accurate predictions in a world of uncertainty. So with a lot of humility and accepting the advice given by the brilliant fictional chief homicide detective of the Surete du Quebec, Armand Gamache, to new detectives, "Don't believe everything you think", here goes:

At this time last year, we thought that the market would be volatile but provide mid-to high single digit returns. That return prediction did not look good after the worst start in market history, but in the end was actually conservative.

We thought China's economy would be a concern and it was at the beginning of the year but faded into the background as their economic data improved and other issues, like Brexit and the U.S. elections, took center stage.

Interest rates rose less than we thought but we were right in thinking that stocks would outperform bonds.

We were right in expecting that the price of oil would rise and that Energy, Industrials, Old Technology and Financials would have a good year and that Healthcare would be mixed as it became a focus for politicians.

We thought that after a nine year period of underperformance beginning in 2007, Value was due to begin a multi-year period of outperformance versus Growth. This seems to have started in 2016 as "Value" strategies significantly outpaced "Growth".

On balance, after an under-whelming forecast year versus outcomes in 2015, we were on the mark with much of our 2016 outlook.

Our 2017 Outlook

- As we look toward 2017, many areas of our outlook and the economy are more positive than they have been in some time. However this is partially overshadowed by uncertainty related to the changing geopolitical environment within the United States as well as Europe. The economy begins the New Year with momentum. We believe, along with the consensus, that interest rates will move higher this year, perhaps more than is currently expected, and that earnings, helped by easy comparisons for Energy and Financials, will grow by more than 10%.

- With the market near record highs, we expect more volatility as the market tries to handicap the successes and failures of the new administration's impact on the economy. While the volatility may be nerve wracking, we think stocks will provide positive returns in the upcoming year, approaching the historic market averages.

- We think tax reform will happen later in the year (surely on the corporate side) and provide a boost to after tax corporate earnings and consumer incomes, consumer confidence and business investment. Part of the tax reform will likely include some sort of tax holiday on repatriating foreign cash, which would be a nice positive for the U.S economy and companies.

- We expect continued job growth and higher inflation as wages increase.

- Among market sectors, we think, Technology, Industrials, and Financials will all perform well in an economy with accelerating momentum. And after a poor 2016, we believe that select Healthcare is poised to rebound in upcoming periods.

- We think bonds and Utility stocks will be difficult places to make money in 2017.

- We think the sharp reduction in 2016 oil & gas capital spending coupled with OPEC's first production cuts in eight years, are likely to result in oil trading in $45 to $60 per barrel range for the upcoming year.

- The biggest wildcard to our outlook is geopolitical risk. The global economy has growing momentum but could be slowed or derailed by protectionist trade policies from the new Administration, by the changing political landscape inside the Eurozone or by heightened tension from increase saber-rattling in a number of global hotspots.

Large Cap Value Strategy

Matrix's Large Cap Value portfolio had a very strong quarter and solid year, outperforming the S&P 500 over both time periods.

The greatest contributor by far to the portfolio's results in the quarter was Financials, the best performing group in the market and our largest sector weighting. High quality financial stocks have been out of favor with investors since the financial crisis and were trading at a 30% discount to the market earlier in the year, even as their businesses showed improving profits and increases in book value. Expectations for persistently low interest rates, fears of additional regulation (including ever escalating capital requirements) and sluggish economic growth all contributed to their undervaluation. The election of Donald Trump with his pro-business agenda renewed interest in the group because their profits should meaningfully accelerate with stronger economic growth, higher interest rates and a more benign regulatory environment.

We think Financials continue to offer good appreciation potential because we believe analysts are significantly underestimating their earnings potential and expect a multiple expansion on these improving earnings. Further, we think that institutional investors continue to be under-weighted in the group and the current changes in sentiment could lead to a large movement of capital towards the sector.

After Financials, the next best performing sector was Energy, where supply and demand were moving towards balance before receiving an added boost in November when OPEC agreed to its first production cuts in eight years. Other sectors contributing to Q4 performance were Technology, Industrials and Consumer Discretionary.

The worst performing sectors in the quarter were Healthcare and Consumer Staples. Healthcare suffered from increased political scrutiny of higher drug prices and Consumer Staples were a source of funds as investors favored more economically sensitive sectors over defensive names. Within Consumer Staples, CVS had a rare and unexpected business set back and lowered earnings expectations for 2017 after losing a large piece of business to a competitor. We are confident the company will make the necessary adjustments to return to its profit growth goals.

For the full year, our best performing portfolio sectors in Large Cap Value were, Financials, Technology, Energy and Industrials. Within these groups, the best performing stocks were Morgan Stanley J.P. Morgan Chase and Charles Schwab, Symantec, Devon Energy and Caterpillar.

Healthcare and Consumer Staples were the biggest detractors from performance for the year.

During the quarter, where funds were available, we added to positions in AbbVie, Alphabet (Google), Chubb, Harley Davidson, Johnson Controls, and Zimmer Biomet.

We sold our position in Caterpillar (CAT) after the shares reached our price target. CAT was the best performing stock in the Dow in 2016, surging on expectations of renewed demand for its equipment as oil prices recovered and interest in infrastructure projects made headlines. In the near term CAT's business remains challenged and we think the share price reflects an overly optimistic pace of recovery for the company. We also sold our remaining shares in HP Inc. after

the shares reached our price target and the small position we received in Adient, the spin-off from Johnson Controls.

We modestly trimmed positions in a number of our financial names after the election as the sector's already high weighting continued to rise due to the price appreciation of our holdings. Financials remain the largest sector weighting in the portfolio. We also trimmed our position in Symantec, a top performer in Technology this year, as the shares approached our target price.

We think the portfolio is well positioned to deliver solid results in the year ahead. For the first time in years, the global economy appears to have achieved some momentum. The United States and Europe are showing accelerating growth and Asia, including China, appears to be stable.

The biggest risks we see to the stock market are political, both domestically and abroad. While many areas of the Trump economic agenda are very favorable, the devil will be in the details and there is meaningful uncertainty related to the new administration's Trade and Immigration policies.

The Brexit vote in the U.K. and the recent U.S. elections reflect populist and nationalistic sentiments that are likely to be voiced again in elections in Europe in 2017 and cause further uncertainty over the fate of the Euro. As this plays out, the international markets might face more bumps along the road.

We expect inflation and interest rates to rise in 2017 beginning the long walk back to more normal levels.

Dividend Income Strategy

The Matrix Dividend Income portfolio (MDI) finished the year with very strong fourth quarter results, outperforming the S&P 500 and adding to its performance advantage over the benchmark for the full year. We are pleased to report that the portfolio was able to show solid gains even as interest rates rose, something we think will distinguish the strategy from its peer group.

For all of 2016, the strategy posted another solid year of positive returns, with less volatility than the market and very strong down market performance during the first part of the year, when the market got off to its worst start in history. Additionally, as in previous years, the portfolio's holdings showed good dividend growth during the year, up 6.18%, and ended the year with a current dividend yield of 3.3%. Since inception, the portfolio's holding have grown their

dividends by 7.76% per annum. We believe this combination of a high current dividend along with a favorable dividend growth places us in a very attractive area of the dividend space for upcoming periods.

In mid-October, the strategy became available through our new mutual fund to accommodate smaller investments.

The best performing sectors for MDI in Q4 2016 were Financials, led by J.P. Morgan Chase and Wells Fargo, and Energy, led by Royal Dutch Shell and Chevron. Other positive sector contributors to performance were Technology, Industrials, Telecom and Consumer Discretionary.

The two sectors detracting from performance in the quarter were Healthcare and Consumer Staples. Healthcare suffered from increased political scrutiny of higher drug prices, and Consumer Staples was a source of funds as investors favored more economically sensitive sectors over defensive names.

During the quarter, we started new positions in Coca Cola and Gilead Sciences and where funds were available, we added to positions in Kimberly-Clark, Occidental Petroleum, Verizon and Wells Fargo.

We modestly trimmed the position in Procter & Gamble to provide funds for some of our new positions.

The best performing sectors in the MDI portfolio for the full year were Financials, Industrials, Technology, Energy and Telecom. Notably, there were no portfolio sectors showing down performance for the year.

In 2017, we expect the MDI portfolio to continue to deliver good current income and capital appreciation, with less volatility than the market. Since inception, the MDI strategy has proven to be a solid performer in good markets and has provided added value in periods of market decline.

With more volatility expected this year, we believe the strategy is ideal for conservative, income oriented investors. Importantly, we think the highly diversified portfolio is also well positioned to have favorable performance in a rising rate environment, as demonstrated in Q4 2016. As of 12/31/2016 the current yield on the portfolio was 3.3%.

Bonds

At the beginning of the year, consensus expectations (which we shared) were that bond yields were likely to rise and their prices fall in response to evidence of accelerating domestic economic growth and the Federal Reserve's desire to begin the process of normalizing (raising) interest rates. Matrix bond portfolios were structured with that environment in mind, focusing on high quality Corporates, U.S. Treasuries, Agencies and Municipals (where appropriate) with nearer term maturities.

We were correct in our expectation that the Fed would eventually raise rates (though it took longer than expected to do so), and our Bond portfolio's performed well on a relative basis. The portfolio's absolute returns were slightly negative for the 4th quarter and modestly positive for the year. They remain positioned to provide greater protection in the likely event of increasing yields.

From its post-Brexit low yield of 1.36% in early July, the 10-year Treasury note yield rose by over 100 basis points to end the year at 2.45%. Over the next twelve months, we expect that continued growth in the U.S. and European economies will lead to further increases in interest rates. We have modest expectations for the bond market for 2017 and believe portfolios are well served by focusing on the shorter-term end and higher quality parts of the bond universe.

Balanced Accounts

Balanced account clients benefited from our significant overweighting to stocks during the quarter and full year.

Looking forward, we believe stocks offer more reward potential than bonds, but have higher levels of risk than they had a year ago. As a result, the risk-reward relationship for stocks vs. bonds is less compelling than it has been for some time and we expect to move from our meaningful overweight in equities to a more modest overweight in the upcoming quarter. We are constantly monitoring the many factors that go into this analysis and would look to increase or decrease this modest overweight depending on how the policies of the new administration are playing out.

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This quarter's *Ideas About Investing* looks at some of the reasons why the majority of investors do not get the market returns available. An interesting new book by Michael Lewis details the Nobel Prize winning work done by two psychologists about the biases people bring to decision making and how they often undermine rational thinking.

On an administrative note, over the years we have included our *Ideas About Investing* as a regular feature in each quarterly letter. As our investment product offerings have grown so has the length of our letter and we fear it might be informational overload. Going forward we will limit this section of our letter to our year-end review unless we have something especially timely to discuss.

On the corporate side, we are pleased to announce that effective January 1st, Conall Duffin became a partner of the firm, bringing the Matrix partnership to ten. Conall joined Matrix in 2001 and has worked in client relations, marketing, and mutual fund operations over the past 15 plus years. In December 2016, Conall became the firm's Chief Compliance Officer.

We would like to take this opportunity to wish each of you a happy, healthy, productive, peaceful and prosperous New Year. We are truly grateful for your confidence and trust, and are committed to keeping it, and earning it, every day and in everything that we do for you.

Please call any of us at (212) 486-2004 or (800) 366-6223 with any questions. Best regards.

Ideas About Investing

A Quest for Investment Enlightenment
December 31, 2016

Why is it that investors consistently do worse than the market averages among a wide variety of asset classes over long periods of time? In their most recent *Guide to the Markets* U.S. 1Q 2017, JP Morgan Asset Management provides 20-year annualized returns by asset classes (1996-2015) that shows consistent average investor underperformance versus REIT's, the S&P 500, a 60/40 and 40/60 allocation between Stocks and Bonds, 100% Bonds , Gold, Homes, Oil, etc. In not a single case do average investors match the annualized returns of these different asset classes. For example, the S&P 500 returned 8.2% annually, a 60/40 stock bond allocation returned 7.2% and the average investor's return was only 2.1% over that 20 year period.[2]

Much of the underperformance can be explained by poor market timing decisions. Missing the best days of market performance dramatically impacts long term performance. For example, between January 1996 and December 2015, the S&P 500 was up 8.18% annually. But if you missed the best 10 days over that time period the returns dropped to 4.49%. Missing the best 20 days lowered the return to 2.05% and so on. But this is not new news. Charts showing this data are now a staple of investment marketing presentations. So why in spite of this overwhelming well publicized evidence, do so many investors think they can successfully time the market?

A new book by Michael Lewis, *The Undoing Project*, sheds light on this subject. The book tells the story behind the Nobel Prize winning work of two Israeli psychologists who demonstrated how the unconscious biases people bring to decision making cause them to make systematic errors of judgement when dealing with uncertainty. Their work was the foundation for the field of behavioral economics and provides great insights about why the public keeps making the same mistakes when they should know better. Among their conclusions:

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[2] Source: J.P. Morgan Asset Management; (Top) Barclays, FactSet, Standard & Poor's; (Bottom) Dalbar Inc. Indexes used are as follows: REITS: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Barclays U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Gold: USD/troy oz., Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high quality U.S. fixed income, represented by the Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31 /15 to match Dalbar's most recent analysis. Guide to the Markets - U.S. Data are as of December 31, 2016.

- People tend to underestimate uncertainty, but after the fact create a story to explain how what happened was predicable in hindsight. The handwriting was on the wall but the ink was invisible.
- People have hindsight bias and misremember their predictions as being correct. After the fact they explain what happened with a great deal of confidence. It leads them to believe that there is a less uncertain world than there actually is. People predict very little and explain everything.
- People believe they can predict the future if they work hard enough.
- People accept any explanation as long as it fits the facts.
- People make decisions not to maximize utility but to minimize regret. The anticipation of regret affects decisions and they will pay dearly for certainty.
- Last impressions can be lasting impressions.[3]

How do these conclusions apply to investment decisions?

Think about how the market's crash in 2008/9 has impacted investor behavior. After the fact many people looked back and in hindsight said "the handwriting was on the wall" and regretted having too much money invested in the stock market. A common response was to sell some or all of their stock market holdings at the worst possible time, paying dearly for "safety".

More recently there were two periods of extreme uncertainty in the stock market this year, the Brexit vote in the U.K. in late June, and the U.S. Presidential election. If you had the results of the votes beforehand, would you have been positioned in your investments correctly? It's highly unlikely. Most experts predicted that Brexit would lose in a close election and that Donald Trump would not only lose but the margin of his loss could be historic. In the unlikely event that the experts were wrong, the experts also predicted that the unexpected results would be terrible for the stock market. Well, Brexit won and Donald Trump was elected and the markets defied the expert opinions and rallied dramatically to new highs.

The truth is, knowing the outcome in advance would not have helped, and in fact is more likely to have hurt your performance by causing you to raise cash, exactly the wrong thing to do. Recognizing our inability to predict the future is paramount to better decision making. Emotions can play havoc with our ability to make rational decisions.

So how can the average investor protect themselves from the biases we all bring to investment decision making and increase the odds of better investment performance?

- Review your goals and construct an asset allocation that will get you on a path to meeting your objective. Then stick to the plan. It makes sense to adjust an allocation to asset

[3] Michael Lewis, *The Undoing Project*, Page 197.

classes when they deviate outside agreed upon ranges but this should be done infrequently to minimize transaction costs and capital gains.

- Do not have more money in the market than you are comfortable investing to avoid panicked selling during market declines. Declines should be opportunities to buy from panicked sellers with the cash reserves you have for that purpose.
- We are cautiously optimistic in our outlook but always prefer looking at asset allocations at times of strength. With the stock market at new highs we believe this is an opportune time to review your overall financial plan and your current asset allocation. Please call us if we can be of assistance.