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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Building Portfolios with Dividend Growth and Diversification

DAVID A. KATZ, CFA, is Matrix Asset Advisors, Inc.'s President and Chief Investment Officer and has overall responsibility for the firm's investment efforts. He graduated summa cum laude from Union College with a Bachelor of Arts degree in economics. He received a Master of Business Administration degree, with a concentration in finance, from New York University Graduate School of Business in 1987, graduating with distinction. His numerous works on value investing have earned him various awards and distinctions at the undergraduate and graduate levels. Mr. Katz is a CFA charterholder. After initially working at Management Asset Corporation — Westport, Connecticut — Mr. Katz co-founded Value Matrix Management with the late John M. Gates in 1986. He served as the firm's Senior Vice President and Chief Investment Officer, and was Head of the Investment Policy Committee. In 1990, he merged Value Matrix Management organization into Matrix Asset Advisors. Mr. Katz chairs the investment policy committee and is a portfolio manager/analyst. He appears frequently as a guest on CNBC and Bloomberg Radio.

SECTOR — GENERAL INVESTING

TWST: Maybe we could start out with you telling me about your firm, and then, we'll move into your investment process, and how you build and manage your portfolio.

Mr. Katz: I co-founded Matrix in 1986, and our mandate from our inception was to manage money in the stock and the bond market using a value approach for individuals and institutions. The firm has had a 100% continuity of investment strategy and management since the get-go. We've had great continuity of our partners and of associates at all levels in the firm and have a nice business. We currently run about $763 million. And about six and a little years ago, we started a second value strategy, which tracks our initial discipline but focuses on higher-dividend stocks with the desire of getting good and growing income, appreciation over time and less-than-market volatility.

TWST: And so today, let's focus on that one, on that particular fund and strategy. Tell me about the universe of companies that you start with. What are your parameters when you take the big global view of companies that you want to drill down on?

Mr. Katz: We start with the large-cap universe, companies that are basically $10 billion cap and up, and trade on the United States stock exchanges. We focus on companies with very strong financial ratios and balance sheets and very strong cash flow. And we're looking for yield, as a starting point, of about 30% greater than the S&P 500 with those strong balance sheets, with a history maintaining and growing their dividend over time. And within the value school, we try to focus on companies that have a long runway for earnings and cash flow, and do not have a lot of perceived problems or uncertainty.

TWST: How large is that beginning universe?

Mr. Katz: The starting universe is 1,500 companies, and if you look through the criteria that I just outlined, that winnows down to about 100 to 125 companies that are statistically interesting. And then, from that work, we do very detailed qualitative analysis, where we go through the companies' financial statements, their 10-Ks and 10-Qs, speak with management, speak in great detail with analysts from the Street who cover those companies, and that list of 100 to 125 is then narrowed down to about 40 companies of significant interest. We will then further narrow that down to the 25 or 30 most attractive stocks in the market at any point in time, and that's where we build the portfolio from.

TWST: And at any given time, how many different issues do you have in your portfolio, the 25 to 30 number?

Mr. Katz: Yes, we build portfolios of 25 to 30 stocks generally spread over as many industries and sectors as possible. The starting point is, these companies have this significant premium to the S&P 500 in terms of their dividend yield. And we are comfortable buying any area as long as the company has this significant dividend history and the ability to continue to grow those dividends.

TWST: And what about sector balance in your portfolio?

Mr. Katz: So it's a bottom-up approach, but we do try to be as diversified as possible but have a bias toward those sectors that are dividend-paying and are lower volatility. So over time, we've had exposure in all areas. Four, five years ago, we had a very significant exposure in consumer staples and utilities. As those groups have done extraordinarily well over the last few years, we have been reducing those exposures simply because the stocks have been hitting their fair value.

The flip side of that is, certain groups that were less attractive a few years ago have started to become a lot more attractive. And last year, we built meaningful stakes in financials, industrials and in health care, and we think that balance has been very important for us doing well over time.

TWST: And taking a macroeconomic view, why don't you spend a few minutes talking about the current state of the U.S. and the global economy and markets?

Mr. Katz: OK. Basically, we go into this year feeling generally pretty good about the economy. Companies are talking about as upbeat as they've been in quite some time. But we do think there is a much higher level of political risk than we've had in some time. If you take the Trump agenda, three or four items are very positive for the economy. The tax repatriation holiday, lower corporate taxes, maybe lower taxes for consumers and fiscal spending and less regulation would all be significant positives for the economy and then ultimately for the stock market.

The negative — and at the moment, the market has been discounting this as not being a great possibility — would be Trump's protectionistic comments and adversarial comments toward Mexico and China. So if the good parts of the Trump policy come through for the year and the bad parts don't play out, we think that the economy and the markets are in very good shape. But we are more cautious than we've been in some time because we do worry about those overhangs; the protectionism and the possibility of an international trade war are definitely worrisome.

TWST: Are you concerned at this point about any political instability in the U.S. right now? Does that factor in at all as you look ahead?

Mr. Katz: That falls into our comment that the political uncertainty is higher than it's been in some time. We do think that the government and the Trump administration will work through a lot of the problems and roadblocks they are facing, but the one thing that we worry about most is the administration's actions toward international trade. We think that the U.S. economy will be able to withstand most of the political issues that have arisen. But if there were significant tariff issues, tariffs started by the United States and then China retaliated, or the same occurred with Mexico, that would be problematic.

TWST: Why don't we talk about some individual issues that you find particularly compelling and why you find them compelling?

Mr. Katz: Even though the higher-dividend stocks have had a very good run over the last few years, we still think that it's going to be a very good place to be, and we think the key to that is to diversify. For example, I mentioned earlier that we sold our utilities last year. We continue to be wary about utilities simply because we think they're selling at a pretty rich valuation.

So what do we find interesting? We'd spread that out over a number of different industries. On the consumer discretionary side, we like **Target** (NYSE:TGT). Basically, we're pretty wary about retail in aggregate, as we think the companies are fighting an uphill battle versus **Amazon** (NASDAQ:AMZN). So we don't have a lot of exposure there, but the one that we are comfortable with is **Target** because we do think that they have a place in the consumer's pocketbook, and they have a place in retail. We think they have a viable store strategy, where people want to go to their stores, and they also have developed and are rolling out an internet strategy. So we think they're a long-term survivor.

They are very committed to shareholder value. They pay an inordinate amount of their cash flow every year back to shareholders, either through stock buyback or dividends. The current dividend is about 3.65%, and that will continue to go up in the high-single-digit, low-double-digit area. If you look at consumers, where they shop on the internet, **Target** is something that people have on their phone, and for the very reason that they're used to shopping there, they get these discounts, and that's their go to place.

Beyond that, on the consumer staple side — and we think this is critical for investors in the upcoming year because it does provide a lot more stability to the portfolio — we like companies like **CVS** (NYSE:CVS), **General Mills** (NYSE:GIS) and **PepsiCo** (NYSE:PEP). We think all of them have good long-term earnings trajectories. **CVS** is actually a great business at a great price, as it sells at about 12 times earnings. We think they've got a very good management team, and we believe this is one of the few consumer staple companies that we easily could see 30% to 40% higher in the next 12 to 18 months, and you're getting a nice dividend while you're waiting.

Highlights

David A. Katz discusses Matrix Asset Advisors, Inc. The overall mandate of the firm is to use a value approach to manage money in the stock and bond market for individuals and institutions. One of his value strategies follows this same mandate but focuses on higher-dividend stocks. The aim of this strategy is to get good and growing income, appreciation over time and less-than-market volatility. Starting with a universe of large-cap companies that trade on U.S. stock exchanges, Mr. Katz looks for strong financial ratios, balance sheets and cash flow. He then performs a detailed qualitative analysis of companies that are statistically interesting. From this process, Mr. Katz builds portfolios of 25 to 30 stocks across as many industries and sectors as possible.

Companies discussed: Target Corporation (NYSE:TGT); Amazon.com (NASDAQ:AMZN); CVS Health Corp. (NYSE:CVS); General Mills (NYSE:GIS); PepsiCo (NYSE:PEP); Exxon Mobil Corporation (NYSE:XOM); Occidental Petroleum Corporation (NYSE:OXY); Royal Dutch Shell plc (NYSE:RDS.A); AbbVie (NYSE:ABBV); Gilead Sciences (NASDAQ:GILD); Eaton Corporation, PLC (NYSE:ETN); United Parcel Service (NYSE:UPS); AT&T (NYSE:T) and Verizon Communications (NYSE:VZ).

The second stock that we mentioned was **General Mills**. And in that case, we think the company is managing their business well, but they are in a very slow growth market. We think that left to their own devices, they will continue to pay a nice dividend, and the stock will gradually appreciate over time, but we also think there is a possibility that **General Mills** ultimately gets acquired. We do expect more consolidation there, and we think they are one of the prime candidates to some of the bigger players. We think an acquisition of **General Mills** would be a win for their shareholders and very accretive to the acquiring firm.

1-Year Daily Chart of CVS Health Corp. (NYSE)

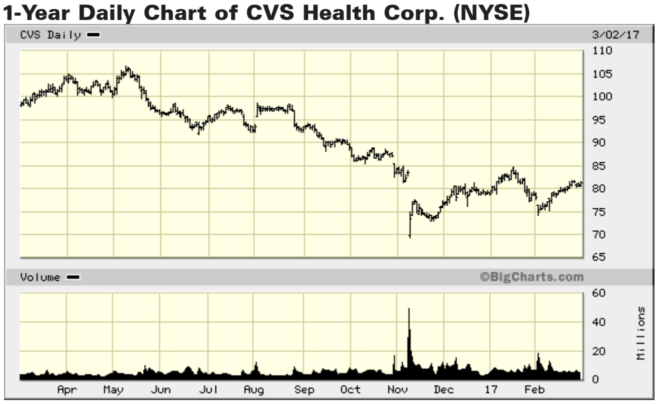

Chart provided by www.BigCharts.com

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TWST: And then you also mentioned, I believe, PepsiCo.

Mr. Katz: Right. So we've owned **PepsiCo** for some time. We like them. They have done an extraordinary job of meeting their earnings — meeting and beating their earnings expectations, returning a lot of cash to shareholders. They did that again in this past quarter where they had a good quarter and beat expectations.

One of the things that they highlight in their most recent call and in most of the analyst meetings is that while the name is **PepsiCo**, the **PepsiCo** flagship only represents about 12% or 13% of their total sales. So they are a lot more than just a soft drink company. They are a massive snack company, and they've got very good global presence, very good earnings growth and wonderful management that's very cost-sensitive. So we think that it's a very good position for a portfolio in terms of long-term appreciation potential and a lot of stability along the way.

They also recently raised the dividend about 7%. And one of the things that you see with a lot of the things that are in the Matrix dividend portfolio is this history of raising dividends very nicely. Since the strategy has been around, the dividend increases have been about 7.5% to 8% per year, and basically, what that does is, it increases your income stream over time, and it also protects you on the downside, because as these dividends go up, the stock prices generally will follow.

We also think there are opportunities in energy, but our key focus on energy are companies with the absolute best balance sheets, a management commitment to maintain and grow the dividend, even during tough times like the last few years, and are leaders in their respective markets. Our three favorites right now are **Exxon** (NYSE:XOM), **Occidental Petroleum** (NYSE:OXY) and **Royal Dutch** (NYSE:RDS.A), and each of those has yields that range from about 3.5% to about 6.5%.

TWST: Well, to finish up, do you want to talk about a couple of stocks in the health sector, which you said earlier has gotten more attention in your portfolio?

Mr. Katz: Sure. On the health side, this was one of the few groups that was actually negative in 2016. We think as a result of that, a lot of very good companies are at very attractive prices. Our two favorites there are **AbbVie** (NYSE:ABBV), which is a biotech company, sells at about 12.5 times earnings and pays a 4.2% yield. They are one of the few companies that's going to be growing earnings in the low teens next year. So if you look at a lot of the drug companies, they're growing earnings at low single digits. **AbbVie** is growing very nicely, yet you get it at a great price.

The other is a little bit off the beaten path for a dividend manager, and that's **Gilead Sciences** (NASDAQ:GILD). **Gilead** recently raised the dividend, so it's above 3%. They are a biotech company with great franchises in HIV and hepatitis C, and yet you're buying them at a single-digit multiple. We think something very good happens with **Gilead** this year, either in terms of new products, they make an

1-Year Daily Chart of PepsiCo Inc. (NYSE)

Chart provided by www.BigCharts.com

acquisition, or ultimately, if their stock stays too cheap for too long, they could attract an activist or be acquired.

The last two areas we like are industrials and telecom. In the industrial space, we like **Eaton Corp.** (NYSE:ETN) and **UPS** (NYSE:UPS). And then, in telecom, the more traditional dividend space, we like **AT&T** (NYSE:T) and **Verizon** (NYSE:VZ). We think that they are selling at reasonable valuations. Both pay a 4.8% yield, and we think, longer term, have good upside potential, very limited downside risk, and you're getting a very healthy income stream along the way.

1-Year Daily Chart of AbbVie Inc. (NYSE)

Chart provided by www.BigCharts.com

TWST: Is there anything else that you would like to add that we haven't talked about?

Mr. Katz: The dividend space has had a great run over the last few years. We think it's going to be tougher sledding in aggregate for areas and sectors that are your traditional dividend and interest rate plays, like the utilities or REITs, because we do believe that rates are going to be going up during 2017 and thereafter. So we think one of the keys to success in a dividend-focused strategy these days is the diversification that we talked earlier about.

At Matrix, we tried to position ourselves for a rising rate environment as 2016 moved on. Our early read is we were able to accomplish that because as rates moved up from last summer's 1.36% on the 10-year Treasury to 2.45%, typical interest rate areas like utilities went down, REITs went down, and our portfolio was up pretty nicely and a little bit better than the S&P 500. So we think that's going to be something that is with the market for the next few years, and we think that diversification and dividend growth are the keys to success here and feel we are positioned to continue to perform in that environment.

TWST: Thank you. (JM)

DAVID A. KATZ, CFA
President & Chief Investment Officer
Matrix Asset Advisors, Inc.
747 Third Ave.
31st Floor
New York, NY 10017
(800) 366-6223 — TOLL FREE
www.matrixassetadvisors.com
e-mail: matrix@matrixassetadvisors.com

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