

## **Capital Markets Commentary and Quarterly Report: 1st Quarter 2017**

The stock market continued its post-election rally in Q1 2017, with the S&P 500 rising by 6.07%. There was a brief stumble in late March when the market declined for eight consecutive days on questions about the Trump administration's ability to advance its policy goals, but stocks regained their footing after the release of the strongest consumer confidence data since December 2000. On balance, it was a quarter marked by good economic numbers, both in the U.S. and internationally.

Matrix's portfolios showed positive results in the quarter but lagged the S&P 500's return. As we discuss below, in many areas of both portfolios, the stocks, industries and sectors that were strong performers in the fourth quarter and the full year of 2016, took a temporary breather in the first quarter. While this was frustrating, it is a normal part of the investment process, and we believe this should be short lived and expect better things from the portfolio in upcoming periods. The companies we have invested in are delivering business results in line with or better than our expectations and sell at attractive valuations. Much of our relative underperformance last quarter is attributable to shifts in market sentiment rather than a change in business fundamentals.

Technology was the best performing sector in Q1 with a handful of names accounting for a disproportionate share of the benchmark's performance. According to data from J.P. Morgan Chase, Amazon, Apple, Facebook and Microsoft make up about 10% of the benchmark and contributed approximately 28% of the S&P 500's return.<sup>1</sup>

After Technology, the next best performing market sectors were Healthcare and Consumer Discretionary.

The worst performing sectors were Energy and Financials (two of the best performing sectors in 2016). The Energy sector showed a negative return in the quarter following lower oil prices. Financial sector underperformance was attributable to a modest pull back in longer term interest rates and slowing loan growth.

After a lackluster 2016, Growth strategies outperformed Value in the first quarter. The 10-year Treasury yield declined from 2.45% to 2.40%, a surprise to us following the improving economic data and rising inflation numbers reported during the quarter.

The Federal Reserve raised the Federal Funds rate by 0.25% in March; gold rose by 8.6% and crude oil declined by 5.8% in the quarter.

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<sup>1</sup> JP Morgan (data as of 3/31/17).

## **Matrix Portfolios and Outlook**

As noted earlier, Matrix's Large Cap Value and Dividend Income portfolios posted positive returns in the quarter but lagged the benchmark's performance. A large part of the Q1 underperformance was caused by sector rotation, as investors sold the sectors that performed well last year, and moved money to those sectors that had lagged.

We remain focused on the earnings, fundamentals, valuation and dividend-paying potential of the companies in our portfolios. We believe that both portfolio strategies hold companies that are well positioned for the economic environment we foresee over the next 12-18 months.

In general, we are confident that first quarter earnings and dividends for our holdings will show improvement and expect that the outlook provided by managements will project continued growth, in line with recent company presentations.

First quarter economic data were solid, confirming an acceleration of growth that began last year. As reported in the *Wall Street Journal* in mid-February, "...the upswing is global: In Europe, Japan, China and elsewhere, business surveys and markets have turned more optimistic." More recently, this month it was reported that growth in Europe is at a six-year high and unemployment at a nine-year low.

The U.S. economic expansion is now the third longest on record and is exhibiting continued strength. Part of the reason we believe that the cycle has been longer than normal and can still have legs is that we started from such a depressed base and the recovery has been among the slowest in the post-war era.

Recent data supporting further economic growth ahead includes:

- An index of manufacturing activity in March reported the seventh consecutive month of industrial expansion.
- The March employment report showed strong job growth, declining unemployment and rising wages.
- The Commerce Department reported on March 30 that fourth quarter 2016 after-tax corporate profit growth registered the highest year-over-year growth in five years.

The strong economic data convinced the Federal Reserve to raise short term interest rates in March (only the third increase since the Great Recession), with at least two more increases expected this year.

The risks to the stock market we see are mostly political. The Trump administration suffered a set-back in failing to pass its health care bill, and doubts are beginning to surface about its ability to enact tax reform. There was a lot of optimism about tax reform and a lack of progress in this area might result in more market volatility. In a positive sign, there is less rhetoric in Washington D.C. about trade wars, although this continues to be one of the market's biggest risks.

## **Large Cap Value Strategy**

Matrix's Large Cap Value portfolio showed a solid positive return in the quarter but lagged the S&P 500's return. Sector rotation was a large factor in the portfolio's underperformance this quarter. Some of last year's best performing sectors, Energy and Financials, detracted from this quarter's results. We expect both to rebound in the months ahead.

All sectors in the portfolio showed positive returns, except for Energy. Other sectors that negatively impacted relative performance were Technology, Healthcare, Consumer Discretionary and Financials.

Our stocks in the Technology and Healthcare sectors did well, just not as well as the benchmark sector returns.

We did have some strong stocks in the Technology sector including Apple, Cisco and Symantec, all up by double digit percentages. Gains were also aided by continued strength in Microsoft and TE Connectivity. However, the group's increase was slowed by the decline in Qualcomm. After a 35% gain in 2016, the stock price pulled back with the emergence of new legal challenges to its intellectual property. Ultimately, we think that Qualcomm's business model is sound and that they have strong defenses to these challenges. The company's operations are performing well, and it expects to complete a highly accretive acquisition of NXP (NXPI), a semiconductor company, by year end.

Healthcare was a mixed bag this quarter. Zimmer Biomet was up about 20%, and Thermo Fisher Scientific and AbbVie were solid contributors, up high and mid-single digits respectively. On the disappointing side, Gilead Sciences and Teva were poor performers.

We think Gilead has significant appreciation potential. It is rare to find a good biotech company with a strong balance sheet, excellent drugs and a 3% yield selling at 8.1 times earnings. GILD is a victim of its own success, as its best-selling drugs for Hepatitis C cures people and its patient population is declining (for a good reason). The company has also a strong position in the HIV market and has recently announced acquisitions of several promising drugs.

Teva, on the other hand, is a company we decided to exit after another unexplained high level management departure. Teva remains a company with great potential but our confidence in management and the Board has been shaken.

In the Consumer Discretionary sector, our relative results were hurt by both an underweight position in this top performing market sector and specifically the absence of Amazon (a top performing stock) in our portfolio. On the opposite side of the spectrum, media company Viacom was our best performing stock after a change in leadership. We think the company has valuable assets but has been poorly managed for years. In addition to a new CEO, Viacom recently announced a new head of its movie studio subsidiary, Paramount Pictures. We believe the stock is still significantly undervalued and these changes are for the better and should help realize that value.

Low single digit returns from Financials also hurt our comparative results this quarter. Financial stocks were great performers for us last year and we expect them to shine again this year, but the flattening yield curve and slowing loan growth weighed on investor's perceptions of their near-term profitability, pressuring their share prices. We believe that good quarterly profit reports, higher interest rates, a resumption in loan growth and a less adversarial regulatory environment will lead to strong stock price performance in the near future. We remain very enthusiastic about the sector's appreciation potential.

Other stocks that performed well in the quarter were Alphabet, American Express, Eaton, PepsiCo, and Procter & Gamble.

During the quarter, where funds were available, we added to positions in Alphabet, CVS Health, Chubb, Gilead, Johnson Controls, Occidental Petroleum and PepsiCo.

We sold our position in Teva (discussed above) and completed the sale of Schwab at a large profit when it reached our price objective. We also trimmed the position in Symantec and Morgan Stanley as they approached our estimates of fair value and TE Connectivity after it became an outsized position due to strong performance.

In summary, we think the portfolio is well positioned to deliver solid results for the balance of the year and beyond. The global economy has achieved some synchronized momentum, and we believe stocks returns can reach their historic averages, albeit with significant volatility along the way.

The biggest risks we see to the stock market are political, both domestically and abroad. We are encouraged that the election campaign rhetoric suggesting the possibility of trade wars has quieted down. We continue to 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) posted another positive quarter, but below the benchmark's return. After a solid finish to a very strong 2016, market rotation into Growth and Technology, along with sub-par performance from a handful of stocks, accounted for the majority of the strategy's comparative underperformance.

Starting on a positive note, the portfolio had solid returns in Consumer Staples, Healthcare, Producer Durables, and Technology. Consumer Staples was led by Kimberley-Clark, Procter & Gamble, and PepsiCo. Healthcare returns came from Johnson & Johnson, Merck, Pfizer, and AbbVie. Producer Durables' performance was led by Eaton, whose management sounded notably more optimistic on its most recent outlook call. The Technology sector's results were led by Cisco, IBM and Microsoft.

During the quarter, eight of our holdings raised their dividends by an average of 6.8%, and the portfolio ended the quarter with a 3.3% current yield.

On the negative side, Target surprised investors with a significant downward revision to its earnings guidance for the next few years after concluding that the competitive environment in retail required investing in new brands, adding more store level service, fixing the supply chain, remodeling stores, and sharper pricing. The retail environment has become ferociously competitive with retail bankruptcies heading towards their highest annual total since the Great Recession, according to CNBC and the consulting firm AlixPartners.

Target's CEO believes that the retail industry is at a generational inflection point and that Target will thrive and take market share, but that the company needs to make investments today to ensure a bright future. The market is intensely promotional as struggling retailers desperately try to clear out old inventory. We believe that Target is right in its assessment about its strong competitive position, and the actions it needs to take to prosper in the new retail environment. We are cautious overall about investing in retail stocks (TGT is our only retail investment), but we think Target is a solid value at 13.7X depressed earnings. The company has a 46-year history of raising their dividend and currently has a 4.3% dividend yield.

The Energy and Telecom sectors posted down returns in the quarter on lower oil prices and intense competition in the cellular phone business. We think both are likely to rebound on better industry news.

Oil prices declined as higher inventory data raised questions about OPEC's ability to reduce supply. We believe that this is a timing issue and that recent inventory data suggest that supply and demand are beginning to move towards balance. The companies we have investments in have dramatically lowered their breakeven points, shed less profitable assets, improved their balance sheets, and increased their free cash flow.

The Telecom industry has been engaged in a promotional price war to add customers, but now that both Verizon and AT&T have moved back to offering unlimited data plans, we expect that market shares will stabilize. Both are investing in media businesses to further cement customer loyalty. Both companies have dividend yields above 4% and remain solid dividend holdings providing portfolio stability during periods of market volatility.

Our Financial shares, which represent the largest sector weighting in the portfolio, were flat in the quarter on modestly lower long-term interest rates and slowing loan volume. We remain very optimistic about the appreciation potential of our holdings in this area. We expect their performance to rebound as the year unfolds. We continue to believe that investors are underestimating the earnings power of these high quality financial companies.

During the quarter, we started a position in CVS Health for the MDI portfolio. CVS is an exceptionally well-managed company operating in healthcare-related businesses, primarily pharmacy, which benefit from an aging population's increased utilization of prescription drugs (according to company data, the 65 and older population fills over 36 prescriptions a year, more than twice as many as the 19-64-year-old population). The company prides itself on lowering healthcare costs while improving outcomes. Late last year, the company had an uncharacteristic earnings miss when it lost a large piece of business to a competitor. As a result of the miss and lower earnings guidance for the year, the shares fell sharply and created a buying opportunity for MDI. The shares are trading at 13.5X estimated 2017 earnings with a 2.55% dividend yield. Over the past 5 years, CVS has grown its dividend at more than a 25% compound annual rate. Our target price is over \$100 per share.

We also added to the positions in Coca-Cola, General Mills, Occidental Petroleum, Royal Dutch Petroleum, UPS, and Verizon.

We trimmed positions in IBM and McDonald's as they neared their price targets and J.P. Morgan Chase when its position size became outsized due to price appreciation.

We look for our relative and absolute results to improve as the year unfolds. Last quarter's volatility was the lowest in decades, and we do not expect that to continue. Historically our Dividend Income strategy has added significant value for our investors by defending well when market volatility rises. For those who have an eye toward adding investments in this area, we think this quarter's recent slowdown creates a timely opportunity.

We believe the strategy is ideal for conservative, income-oriented equity investors. As of 3/31/2017, the current yield on the portfolio was 3.3%.

In October 2016, the strategy became available through our new mutual fund to accommodate smaller investments, and we are pleased to report that interest in the Fund is growing.

## **Bonds**

In our 2016 year-end letter, we said that "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".

For the first quarter this positioning was less than optimal as our combination of focusing on quality, staying short and having higher cash balances than normal resulted in us modestly lagging the relevant benchmarks.

So far in 2017 we have been right about the economy but wrong about the direction of interest rates, with the exception of short-term rates which have moved higher. Treasury bonds of five years and longer have seen their yields drift modestly lower this quarter in spite of stronger economic growth, higher inflation, and the Federal Reserve raising the Fed Funds rate by 0.25% and hinting that at least two more rate hikes were in store for 2017.

Based on healthy data on the world's economies, a modest pickup in global inflation, and uptick in International bond yields, a Federal Reserve that's in the early stages of a rate increase cycle, and a new administration that has a pro-growth agenda, we look for rates to return to their move higher that started last summer.

We continue to believe that we are well positioned by focusing on high quality short to intermediate term fixed income investments.

### **Balanced Accounts**

As we discussed at year end, we believe that 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 during the quarter we moved from our meaningful overweight in equities to a more modest overweight. 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 relationship between stock and bond values evolves.

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Based on client feedback, we are going to be making some changes to our quarterly client reports. We receive numerous positive comments about the thoroughness of our reporting, but many clients have asked if we could streamline it. In the upcoming quarters, we will be doing this. The goal will be to provide the same high level of information, but when possible tighten the report, reducing the number of pages and removing less essential data. One change this quarter is that we will be listing our portfolio in alphabetical order by company name rather than grouped by industry. While simple, this small change reduces the pages devoted to the portfolio appraisal almost in half.

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.