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MONEY MANAGER INTERVIEW

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Using Free Cash Flow Yield to Determine Valuation

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MATTHEW NORRIS, CFA, is a Senior Vice President of Waddell & Reed, Inc., and Ivy Investment Management Company. He earned an MBA from the University of Nebraska-Omaha. Before joining Waddell & Reed, Mr. Norris was affiliated with Advantus Capital Management, Inc., in St. Paul, Minnesota, from 1997 to 2003. He joined Advantus as an equity analyst and was appointed a large-cap value portfolio manager in 2000. Before joining Advantus, he was an equity analyst and portfolio

manager for Norwest Investment Management, Inc., from 1994 to 1997. Mr. Norris joined Waddell & Reed as a Senior Vice President and Portfolio Manager in July 2003. He served as Director of Equity Research from June 2005 to April 2010. He is Portfolio Manager of large-cap value institutional accounts, Waddell & Reed Advisors Value Fund, Ivy Funds VIP Value — formerly W&R Target Funds Value Portfolio — and Ivy Value Fund. He has managed the value funds since July 2003. Mr. Norris is a member of the Kansas City CFA Society. He also serves as a member of the finance advisory board for The University of Kansas School of Business.

SECTOR — GENERAL INVESTING

(AGW501) TWST: We interviewed you in 2012. Tell us what's changed since then and what's new.

Mr. Norris: Over the last three years, the company has grown. We've added some portfolio managers. We've added some analysts. We've added some fund products, such as global real estate, emerging market debt and midcap income, among others. Our company still focuses on trying to make money for the fund shareholders.

TWST: You still manage the Ivy Value Fund, what has changed in this fund since 2012 in terms of weighting, geographic coverage, risk mitigation, etc.?

Mr. Norris: Since 2012, about one-third of the holdings are still the same. There is maybe a little more or little less of a certain name. As far as geographic coverage, we're global but primarily domestic; however, I always take a look at the many larger companies in Europe or Asia. I always look around for ideas outside the U.S., but I tend to have very few of those and usually concentrate just in the U.S.

The risk-mitigation question is interesting. I use the same approach as I've always used. I chop the universe up into about 13 to 15 segments of stocks that have similar characteristics or have high correlation among them. For example, like retailers, media, cruise lines and automakers, those stocks tend to move together because they are based on consumer spending. Energy stocks tend

to move together because they are based on price of oil and natural gas, etc. Financial stocks, insurance tend to move together.

I cut the universe up into a number of these sectors, and then, I monitor that to make sure I don't get really too overweighted or underweighted in any one of those specific sectors so as to draw out and take macro risk out of the portfolio. I don't want to bet on interest rates or the price of oil and GDP growth; I'm not good at that. I want to bet on an individual company's success. So by diversifying the investments over various groups, I hope to minimize the effect of the macro factors and let the individual companies shine through.

TWST: How many holdings does the Ivy Value Fund currently have, and has this changed since 2012?

Mr. Norris: Today, we're at about 36 holdings. That's less than the last time we spoke, and there's really two things behind that. One is an active decision to have a more concentrated portfolio, and analysis of my performance historically has shown a decent ability to pick stocks. But there's only so many in the world, and you need to concentrate in your best ideas, and since I've been preferring a lower number of stocks, the portfolio performance has improved.

The other problem is, it's not easy to find a lot of good value names today. The market is expensive. Since 2009, there's just not a huge amount of really compelling ideas to own. We typically concentrate down into fewer names, and each one has a larger weight in the portfolio.

TWST: Previously, you listed as your top holdings, Target, Aetna and ACE. I see these have been replaced by Citigroup, AIG, Microsoft, Capital One and JPMorgan Chase. Why is this? What do you like about these names? What makes you buy or sell?

Mr. Norris: On some of the previous names, Aetna (NYSE:AET) is still in the portfolio. It's not as much of a value as it was; it's just a lower weight now. ACE (NYSE:ACE) and Target (NYSE:TGT) both reached full valuation. Whenever I buy a company, we think about what it's truly worth, what's that stock worth. If it's trading at a big enough discount — for me, that should be usually 30% discount to what I think its true intrinsic value is — then it's a buy. Hopefully, if you are correct over time, the issues that are causing it to be cheap disappear, and the stock appreciates to full valuation, and it's time to go. That was true for both Target and ACE.

Some of the other names, I mean, looking at Citigroup (NYSE:C) and AIG (NYSE:AIG), here's two companies that have subpar ROE and are trading well-below book value, but the reasons for poor performance are imminently fixable. It will take time, but as ROE goes from, say, 6% or 7% or 8% up to 10% or 11%, for both those companies, they shouldn't trade below book value anymore. They'll trade at about a 10% premium to book value.

Really, anytime the market is trading below book value, they're implying it's not going to be around in the future because any financial has a book value that they can generate at least some ROE off of. Therefore, those just became compelling names over time. I've owned both of those for a while now. They're some of the more interesting names, and that's why they have large weights.

Microsoft (NASDAQ:MSFT) was below \$50 only about nine months ago or so. I think Microsoft is viewed really as an old-school-type stock that isn't very exciting the way Facebook (NASDAQ:FB) and Amazon (NASDAQ:AMZN) and Google (NASDAQ:GOOG) are, but they are competing very well with cloud computing. When you think of cloud computing, everyone thinks of Amazon Web Services; that's the big winner.

A lot of people don't realize it, but Microsoft's cloud-computing service is somewhat hidden inside such a large company but growing very rapidly. They are a major player. The stock started to move up recently because I think as each quarter comes and they announce how they are doing, that's becoming more and more apparent to people. That is a name that was cheap because people thought it was being left behind, and that wasn't really accurate.

There's two other financials listed there. Again, financials are one of the cheaper areas of the market with interest rates at decade lows. It's hard for banks and certain types of lenders to make much profit by either spread lending or retained portfolios, as you are investing at such low interest rates. So these stocks are very inexpensive.

Highlights

Matthew Norris discusses Waddell & Reed, Inc., and the Ivy Value Fund. The Ivy Value Fund is a global fund but is primarily invested in domestic names, and it holds about 36 large-cap positions. When Mr. Norris is looking at the investment universe, he divides the stocks into segments that share similar characteristics or have high correlations. By diversifying his investments across these segments, Mr. Norris is able to minimize the effect of macro factors. This allows the fund to center on the successes of the individual stocks. Mr. Norris' basic valuation metric is free cash flow yield. In addition, when identifying investment opportunities, he looks at what is causing a stock to be inexpensive and decides if it is a situation that can be resolved.

Companies discussed: Aetna (NYSE:AET); ACE Limited (NYSE:ACE); Target Corporation (NYSE:TGT); Citigroup (NYSE:C); American International Group (NYSE:AIG); Microsoft Corporation (NASDAQ:MSFT); Facebook (NASDAQ:FB); Amazon.com (NASDAQ:AMZN); Alphabet (NASDAQ:GOOG); Capital One Financial Corp. (NYSE:COF); ING Groep NV (NYSE:ING); HSBC Holdings plc (NYSE:HSBC); JPMorgan Chase & Co. (NYSE:JPM); Chipotle Mexican Grill (NYSE:CMG); Sears Holdings Corp. (NASDAQ:SHLD); Lam Research Corporation (NASDAQ:LRCX); Time Warner Cable (NYSE:TWC); Charter Communications (NASDAQ:CHTR); Macy's (NYSE:M) and Amgen (NASDAQ:AMGN).

Capital One (NYSE:COF) made a few acquisitions and got beaten up when they bought ING (NYSE:ING) and HSBC (NYSE:HSBC) portfolios a couple of years ago. That was a good opportunity to buy the stock cheap. JPMorgan (NYSE:JPM) is in the same boat. They had the London Whale event, which was about three years ago. The stock dropped tremendously just in the space of a couple of days, and yet, it's a great franchise. So this is why we bought these names. I think you've still got more to go out of financials, especially if we do get an interest rate hike here; it seems pretty likely in the near term.

TWST: What are the key metrics you assess when making valuations?

Mr. Norris: My basic valuation metric is free cash flow yield. Every value guy in the world has some metric they use to

decide a value, whether it's p/e or price to market, price to sales or EBITDA, or any one of all kinds of things. Mine happens to be free cash flow because I think, in my mind, if I had enough money and could buy every single share, just own the whole company, free cash flow would be my annual salary, which I can just take home and spend on myself. How much am I paying for how much salary?

That allows me to put a value on any company, and then as I said before, I add a 30% discount to that. Yet, that's really rare today. It's really pretty hard to find names trading that cheaply. You'll find a lot of maybe 10% to 15% discounts today, but we need a little market stress to have more value opportunities.

TWST: Drilling down into your buy discipline, how

can we identify opportunities in the current market?

Mr. Norris: I have a computer at work with 20 years of financial data from all these companies. I can run how companies have done over time, how much free cash flow they've generated and compare that to today's stock price to see companies that may or may not be cheap. It doesn't take very long to run that stream, but the computer is dumb. It doesn't know whether a company just made an acquisition or if it issued a bunch of shares or if it doubled its dividend or something of the like. So these could be reasons why the company looks cheap.

“If everything is going right in a company, it's not going to be cheap. There's got to be an issue that people are worried about. If you can't figure out what's wrong, then I would just stay away, because if you do not know what's wrong, you can't really have conviction.”

Because of this, there are a couple of rules of thumb. If you see a stock that's down and seems inexpensive, you need to ask, “Why is it cheap?” If everything is going right in a company, it's not going to be cheap. There's got to be an issue that people are worried about. If you can't figure out what's wrong, then I would just stay away, because if you do not know what's wrong, you can't really have conviction.

If you figure out what's wrong, then the next step is to question whether this will be resolved. For example, the company **Chipotle** (NYSE:CMG), the Mexican restaurant chain, has had problems as people have been getting sick after eating at the chain from E. coli bacterial infections. That's definitely knocked the stock down. It may not be cheap enough for me, but it might be cheap enough for some people. Can that be fixed? You have to assume yes. Other companies can deliver uninfected food to people.

However, on the other hand, look at a company like **Sears** (NASDAQ:SHLD), which isn't making money as a retailer. They're closing stores; they're losing business to Amazon and other better-positioned retailers. Can that be fixed? My opinion is that it probably can't because they're secularly challenged.

TWST: Tell us about your sell discipline.

Mr. Norris: Selling is fairly straightforward. The best sell is when the stock reaches your price target, and you think, “My thesis worked out. My company went up. It's now fully valued.” Sometimes I'll sell a name if it's close to fully valued, just for a better name that seems like it has more upside. The third reason you sell, which is the worst, is a change in fundamentals.

That's when you bought a company cheap, thinking what was wrong could get fixed, and then you realize later, no, I was wrong. Either what's wrong, I didn't get that right, or it can't be fixed, or it's not getting fixed anytime soon. Then, it's hard for human beings to look in the mirror and say, “I made a mistake. I was wrong.” To be a good investor, you have to do that. You just go ahead and you sell it, and you get back to work. It's just against human nature. Nobody ever likes to admit they're wrong, but it does happen.

TWST: You favor financials, consumer discretionary and IT as your top three sector holdings. Explain to us the reasoning behind this.

Mr. Norris: Sector overweights come from the bottom up. If I run that screen I talked about, I get 20 or 30 ideas to look at, and then, I see if there is an actual place to put money. There's just been more in these areas recently. Financials have a lot of ideas due to low interest rates and a challenged regulatory environment. Slow GDP growth has made financials cheap. If you think rates may go up or the regulatory environment will stop getting worse, then some companies like **JPMorgan** and **Capital One** will prove to be successful. They produce a lot of free cash flow, they can buy back their stock and pay dividends, and if you're buying cheap enough, you will make money.

A lot of the hardware technology is cheap. For example, a company I like called **Lam Research** (NASDAQ:LRCX) makes the machines to produce semiconductors and memory sticks, and there are many other companies that do similar things. Most tech investors have gravitated to the higher growth names in the space at a time when really PC, cellphone, and tablet sales have been disappointing and not growing as fast as they used to. The people searching for growth elsewhere left these other tech stocks I mentioned behind, yet the demand for data storage grows about 30% a year.

Facebook has made statements that they get over 300 million new photos posted every day. They have got to put those on hard drives and on flash memory. The companies that make such storage, their earnings slowed down last year and this year, but I don't think that's permanent. Therefore, you are able to buy these at really nice valuations.

1-Year Daily Chart of Microsoft Corporation



Chart provided by www.BigCharts.com

The last sector you mentioned is consumer discretionary. So as an example there, I've owned **Time Warner Cable** (NYSE:TWC) for a number of years. It got purchased or is in the process of getting purchased by **Charter** (NASDAQ:CHTR) so that name may disappear, but that was very cheap a few years ago. **Macy's** (NYSE:M) is a department store that's very inexpensive because they're struggling along. Yet, if they just spent maintenance capex, they are a company that would produce almost \$3 billion of

free cash flow in a year, \$2.8-ish billion or something like that on a \$13 billion-market-cap company. Things don't have to go that well for that stock to go up from here.

Conversely, in the fund, there's no real estate. There's no telecom. There's only one utility. These are areas where I look and I just really don't find any good value ideas, and so those spaces have no exposure.

TWST: The Ivy Fund is large-cap only. What, in your opinion, is the current environment for large-cap stocks right now?

Mr. Norris: Growth has outperformed value over the last few years. Everything was valued the same a few years ago. If that's the case, well, you'd want to buy the fastest-growing company if I'm paying the same valuation. However, over the last few years, when growth was outperforming, valuation spreads widened out at the end. Now, there are truly overpriced growth names and underpriced value names.

There are some ideas in large cap now, even if nobody can really predict GDP, interest rates and next year's stock market performance. But if interest rates rise and the yield curve flattens, that may be accompanied by a slowdown in economic growth, in which case you want to own more stable, defensive large companies with good balance sheets than you would small-cap companies in that environment.

Rising rates and a slowing economy typically favors large cap. I think with the outperformance of growth over value, we're setting ourselves up for value to have a really good run as it catches up. This is what happens: One style or the other wins for a couple of years, then the other one wins for a couple of years. We've kind of stretched our rubber band out into growth's favor, but predicting the time span of when that rubber band will snap back, that's near impossible, but it will happen eventually.

TWST: Over the years, what have you noted to be the biggest strengths of the Ivy Value Fund, and what are the elements that you think have contributed to that over the long term?

Mr. Norris: Stability and stubbornness. I mean those in the most positive ways. Stability is a proper process; it is about a strong philosophy that allows you to consistently find good investment ideas. This should never change. You don't want your fund manager altering the way he manages money every six months based on either an outside influence or just his own

desire to follow different themes.

Looking for value has been proven over the years to be a successful way to approach investing, and that's where the stubbornness comes in. Sometimes you buy a stock, and you know it's cheap. I bought **Amgen** (NASDAQ:AMGN) a couple of years ago when they were down in the \$40-ish range and nobody liked it. Many people said they didn't have a pipeline. I analyzed the numbers and asserted that they had a lot in their pipeline. My argument was that it was just going to take a little while for them to get going.

I owned that stock for a year and a half. It didn't move a dollar in either direction. People started to warn me I was wrong, but I kept saying no. Suddenly, some of **Amgen's** new products started to come to market and the degradation of the older, existing portfolio wasn't as bad, and then another two years went past and it grew to be an \$160 stock.

Stubbornness has paid off for me. You have to stick to your process, and if you're right, you're right. Of course, you have to be able to admit when you are wrong and move on, but as long as you have faith in your process, I'd say stability, stubbornness and patience have been the key strengths.

TWST: Do you see any challenges ahead that investors should consider in the large-cap space? What would your advice be?

Mr. Norris: If interest rates do begin to rise, and I do believe they will — a lot of investors have chased high-dividend-yielding stocks because they wanted the income, and you couldn't get it from the bond market anymore. Generally higher interest rates hurt dividend-yielding stocks, and they also hurt high p/e stocks the most. I would say, just be aware that high-dividend-yielding stocks or very high p/e stocks are usually challenged in rising rate environments. Make sure you're not all or nothing in those areas.

TWST: Thank you. (KK)

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