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MONEY MANAGER INTERVIEW

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Finding Consistent Performance in Dividend-Paying Stocks

GEORGE S. FARRA, WOODLEY FARRA MANION PORTFOLIO MANAGEMENT



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SECTOR — GENERAL INVESTING

(AGU510) **TWST: Could you please identify yourself?**

Mr. Farra: George Farra with Woodley Farra Manion Portfolio Management.

TWST: What's your title there?

Mr. Farra: I'm Principal and Co-Founder.

TWST: Could you tell me a little bit about the firm?

Mr. Farra: The firm was founded in 1995 by Don Woodley and me here in Indianapolis, Indiana. At that time, we felt the Indy market, which had seen a considerable amount of bank consolidation, especially in the trust and investment areas, had room for a firm that performed traditional research. We invest in individual securities that we perform all the research on ourselves and have a strong focus on client relationships. Since our founding — we are now just over 21 years old — our assets under management have grown to nearly \$900 million.

TWST: Does the firm have a unique philosophy?

Mr. Farra: Well, we have always had a focus on investing in dividend-paying stocks. So therefore we tend to be larger-value-oriented investors, and in the last half of the 1990s, dividends were viewed as kind of quaint and old fashioned, but we stuck to our guns, and after the tech bubble burst in early 2000, our philosophy was validated, and clients enjoyed very solid performance during that three-year bear market.

Performance has been strong and consistent throughout the 21-year period we've been in business. We have six portfolio managers and analysts, of which five are CFAs, and we continue to do all of our own research internally. And we're looking for relative undervaluation or absolute undervaluation, and our goal is to have a concentrated portfolio of anywhere between 25 and 30 individual stocks. Turnover is low and has averaged 22% per year since 1995. So we have a very long-term

approach to investing in any particular stock. In fact, we've had one stock in the portfolio almost continuously for 21 years.

TWST: Is there more interest in dividend-paying stocks because interest rates have been low?

Mr. Farra: That's certainly been helpful. But I think what a lot of investors have realized since the two very significant bear markets is that the dividend payers don't go down nearly as much, and they perform very well when the market is heading higher. So your total return over an entire investment cycle is very competitive.

TWST: Is there also interest in dividend-paying stocks among those folks who are nearing retirement or retired, the Baby Boomers and those who are older?

Mr. Farra: Absolutely, yes. Dividends provide steady cash flow into a portfolio year in and year out, which retirees need, and good-paying companies that have an outstanding track record of increasing their dividend every year provide retirees with an increase in their income as well as some inflation protection.

TWST: So even if interest rates start to edge up a bit, there still will be interest in the dividend-paying stocks from what you're saying?

Mr. Farra: Sure, there would probably be some near-term volatility as some of the bond proxy sectors like utilities, consumer staples and real estate are sold off in anticipation that more cyclically sensitive companies like industrials, financials, energy and technology will start to witness better topline growth, and therefore better earnings

growth and ultimately better dividend growth.

TWST: Did you want to talk about some sectors that you find interesting?

Mr. Farra: Sure. We definitely feel that after a decade of underperformance, bank stocks are starting to show signs of life. In fact, if you look at a price chart of most any regional and large

Highlights

George Farra's his firm invests in dividend-paying stocks, and has seen strong and consistent performance since the firm's inception. Mr. Farra talks in-depth about the banking, industrial and energy sectors. He says that rather than trying to predict what's going to happen in 2017, he is focusing on trends currently in place in businesses as well as the stock market. He says a current trend is higher stock demand, which means investors want to buy. He believes that for the near term the market is on good footing. Companies discussed: JPMorgan Chase & Co. (NYSE:JPM)

commercial bank in the United States post election, it's been a rocket ship, with gains 25%, 30% from where they were prior to the election. They have since leveled off and are consolidating some of those gains.

“The anticipation that the economy will grow a little bit faster, that there will be higher confidence levels among individuals and businesses and therefore a greater demand for loans are the signals investors have been waiting for to begin buying bank stocks again.”

But years of the pressure from both ultra-low interest rates hurting their gross profit margins and a very heavy hand of regulation, they've been lagging behind the overall market. And so now that those conditions are becoming more favorable, we'll see if consistent outperformance becomes reality. The anticipation that the economy will grow a little bit faster, that there will be higher confidence levels among individuals and businesses and therefore a greater demand for loans are the signals investors have been waiting for to begin buying bank stocks again.

TWST: Do you think that that suggests that the banks that have more exposure to domestic loans and business will do better, or is it also positive for those that have a more global perspective?

Mr. Farra: I think it's both. If you look at the performance say of **JPMorgan** (NYSE:JPM), which is a global bank that has significant commercial, retail and investment bank operations, their shares are up about 18% since the election, and they are up 55% compared to their low of about a year ago. That would imply that this rising tide is going to lift all boats, especially the domestically focused banks, but also those that have operations overseas.

TWST: For the individual investor, what kind of precautions should they take when they're looking at banks, because at times they've gone up and times they've gone down. So what kind of precautions might they want to take?

Mr. Farra: It's been a very competitive landscape the last several years with loan demand being relatively muted. So banks have been competing fiercely for the high-quality borrower and finding that their margins are probably below where they would like them to be on those particular loans. But at the same time, as new loan demand picks up, that competition will remain fierce, and you have to be careful not to make an underwriting mistake just to get the business.

So as an investor, you want to monitor loan growth; extremely rapid loan growth relative to the growth of the economy would suggest any one bank is buying the business and perhaps structuring the loan more advantageously to the borrower's benefit rather than to the bank. And if that borrower were to run into some trouble, that bank may not have the cushion, both in terms of collateral or spread, to weather the storm. So it's likely going to be the same cycle we've seen for decades — increased loan demand, increased desire to gain market share, but hopefully not a lot of sloppiness in the underwriting side to make sure that good loans are

booked and bad loans are turned down.

TWST: And do you think banks as a sector would benefit if the Dodd-Frank laws were changed a bit if not totally repealed?

Mr. Farra: For sure, yes. Measured by the number of pages in the law and the regulations that have been written since the law has been passed — it's the biggest law ever written, and it's extremely complicated — I don't think very many banks can claim that they have understood every single page of it. It's been an ominous law, a law that's designed to prevent the financial crisis of 2008 from happening again.

I don't know if any law could ever prevent a financial crisis from happening again anyway. But when you have an action like the financial crisis, the reaction tends to be as bad and as overboard, and this law certainly has been the case. So if it's repealed or if it's softened considerably, which is more likely, then bankers can breathe a sigh of relief and feel like they can operate their business again in a more traditional manner.

TWST: From what I understand, especially with the regional banks, it's been difficult to comply with the law?

Mr. Farra: Yes, compliance has become a major line item for every bank, and some bankers are throwing their hands up and saying, “I might as well just merge with whoever knocks on the door first.” And there have not been very many bank mergers in the last few years; part of it is the approval process takes a considerable amount of time and is uncertain, and the other is that business wasn't that good.

We think most mergers will focus on cost savings rather than topline growth. As a result, we do anticipate that there will be a pickup in bank mergers. We don't think that premiums are going to be very high and that mergers will focus more on gaining market share, gaining efficiencies, leveraging your compliance area. I do think that while Dodd-Frank will be softened, it will still remain relatively intact, though some areas will not be enforced as rigorously.

TWST: A lot of those mergers — would they involve the regional banks more than the global banks?

Mr. Farra: Yes, the largest banks will not be active players given their size. Too big to fail is still an issue.

1-Year Daily Chart of JPMorgan Chase & Co.



Chart provided by www.BigCharts.com

TWST: Did you want to talk about industrials a bit?

Mr. Farra: Sure, yes. Industrials are in some ways

feeling the same kind of pressures as banks did, not from a regulatory point of view but from a business opportunity perspective. The lack of loan growth in the commercial banking sector does reflect the much slower pace of capital spending that industrial companies have undergone in the last 10 years. So if there are more incentives to spend money in terms of tax reform, then the ability to take on a new project, whatever that might be, is enhanced, and so capital spending will go up.

“We have seen a lot of consolidation on the industrial side, but I do think with lower corporate tax rates, a repatriation of overseas cash that has been building for over a decade now, that we’ll see more corporate activity such as capital spending, higher dividends, share buybacks and particularly in mergers and acquisitions.”

So with a lot of corporations — you’ve seen more mergers in the industrial side than you have on the banking side — it was more economical to buy a competitor or buy into a new industry than to enter that business on your own. So we have seen a lot of consolidation on the industrial side, but I do think with lower corporate tax rates, a repatriation of overseas cash that has been building for over a decade now, that we’ll see more corporate activity such as capital spending, higher dividends, share buybacks and particularly in mergers and acquisitions.

TWST: Where do you think there might be the most promising opportunities in the industrial goods sector? Things like construction, manufacturing?

Mr. Farra: There is talk about a massive infrastructure spending bill that would be spread out over several years, and construction-related equipment makers have already reacted accordingly. The incoming administration is much more energy investment friendly than the outgoing administration, so energy service firms and the companies that make the equipment that those service firms use should see a resumption of demand.

It’s going to be interesting if the emphasis on domestic drilling will increase with the intent of further solidifying the United States as an energy powerhouse that, along with Canada and Mexico combined, will make North America energy independent, eliminating the need to import any oil from outside the region. And if that’s the case, that could be a significant source of new jobs here, countered by the risk that there will be an oversupply of oil, and thus prices won’t be high enough to compensate for the increased amount of investment here in the United States. As a result, it’s more likely going to be like previous energy cycles.

In the tug of war between supply and demand, supply has the upper hand at the moment and may have the upper hand for a long time since the U.S. is now capable of producing around 10 million barrels per day, which puts us in the same league as Saudi Arabia and Russia. So if the goal is more energy independence for a national security purpose, then we should see an increased amount of drilling here in the United States simply for that fact.

TWST: When we talk about some of the manufacturing and construction that can take place, do you think that if things work out and the job market improves, that more Millennials will be buying homes and that in turn will help that whole sector?

Mr. Farra: It should. Millennials have delayed forming households. They are marrying at a later age, and therefore the economic push that comes from a marriage — buying a home, buying the furniture, appliances, etc. — and then starting a family, that might finally start to pick up.

TWST: And do you think too that this Millennial generation might be interested in a lot of the do-it-yourself kind of approach, so that the places that sell various home improvement supplies could do well in that kind of economy?

Mr. Farra: Possibly. I do know a lot of Millennials, because our three kids are Millennials. They’re on the younger end of the Millennial age cycle, so they’ve come out of college the last three years or so. They’re currently renters, they have not gotten married, and they haven’t gone through the cycle that I described above. But depending upon budgets, depending upon personal interests, if they want to take on some of those do-it-yourself projects, then yes, that there would be that kind of boost to those sectors. However, I do think that more Millennial marriages will likely remain two-earner families once they have kids. And so therefore they may not have the time to take on those kinds of projects and prefer to hire some other people to do it for them.

TWST: Is one of the things you’re following the home construction companies just to see if there is a demand in housing starts and what their involvement might be?

Mr. Farra: Yes, we haven’t really found them interesting at the moment. If you look at the homebuilder stocks, they haven’t really done much the last two, three years. They obviously got crushed during the financial crisis and rebounded nicely, but the last couple years, they actually had been trending downward. So if you look at single-family home starts, they’re only now at a level that is barely above what used to be a very bad year historically for housing starts.

Apartment construction on the other hand is going gangbusters. So the real question will be if Millennials view buying a home as both a significant personal achievement and as an investment compared to renting. This trend has not really begun to take off just yet. You are seeing so many Millennials preferring to live in the downtown of a city. Indianapolis is a great example of that. Once all the apartment developments currently being built are completed, there will have been close to \$1 billion of apartment construction the past 10 years, and that’s being repeated across the country. So if they prefer to remain urban dwellers then housing will probably just be bumping along at the current levels, and if mortgage rates pop up too high then they’ll wait for the next cycle for rates to drop before they might consider buying or building.

The housing stock is getting old, and the amount of available land in most cities is starting to dry up. Builders are looking further and further away from downtowns, which may not be a good fit for Millennials. The younger generation currently prefers to live downtown, have a short commute and the freedom to walk to all of their entertainment.

TWST: And we talked a little bit about the energy sector. Did you want to highlight what you think might be going on with that in the coming year?

Mr. Farra: We do think natural gas has probably bottomed. The number of drilling rigs devoted to natural gas dropped significantly over the last few years. We have an abundance of it. Natural gas is an important industrial raw material, and we'll start seeing greater demand if we do experience a pickup in capital spending. An increase in home construction will boost demand as well, since most homes use natural gas for heat.

The real excitement is the prospect of the U.S. becoming an exporter of natural gas, which seems to be becoming a reality. Ten years ago, we thought the U.S. would have to import natural gas, so we were building facilities on the coasts that would take liquefied natural gas shipped from somewhere else and convert it back to a gas and then pipe it to various different end users. Now those ports are being converted to export facilities.

It's quite possible that by the middle of the next decade, say 2025, that the U.S. could be a net exporter of energy, principally due to natural gas exports. It's a remarkable turnaround from a few years ago when we thought we were running out of natural gas, and its price was exceptionally volatile. There are many regions that are natural gas-poor like Western Europe and Japan who are eager buyers of U.S. natural gas because we are a reliable partner, and they would also like to diversify away from coal and possibly nuclear. So the future for natural gas is pretty bright.

TWST: Do you also get a sense of confidence from the likely priorities of the Trump administration in terms of natural gas production?

Mr. Farra: Yes, though we haven't seen too many specifics. Trump's attitude is: Let's make all of our goods here. You've seen that with his comments about the domestic automakers and his desire that all of the vehicles they want to sell in the U.S. are made in the U.S. So he wants to build them here and consume them here, and the same is true with energy. It's definitely a marked

change of course as compared to the outgoing administration.

TWST: When you talk with investors, do they have any concerns that you're hearing more than others for 2017?

Mr. Farra: No, it's been remarkably quiet. We heard a lot of questions going into the election, namely what could happen if Trump won. There were more concerns over a Trump victory than a Clinton victory. And just like we saw with Brexit, the unexpected happened, and the market unexpectedly rose. And so as we've been telling clients, trying to make a big call on a portfolio is a waste of time; it's a fool's errand. This is the time of year that market predictions are a dime a dozen. That's all well and good, but last year nobody predicted the British would vote to leave the European Union. Very few people expected the Chicago Cubs to ever win a World Series, and nobody expected Trump to win. Last year began with the market's worst start to any year, and we ended up having a solid year.

So rather than trying to predict what's going to happen in 2017, we focus on trends currently in place both in terms of the business trends and trends in the stock market. We try to determine if supply or demand is dominant in the stock market. Supply indicates investors are selling, and demand reflects investors want to buy. And currently the trend is for higher stock demand. But that can change over the course of a few months. So I don't know where we're going to be in the spring, but at least for the near term we feel like the market is on pretty good footing.

TWST: Thank you. (ES)

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