

## Better Returns from Better Businesses

*Using the principles of value investing, the Matrix Advisors Value Fund aims at identifying better businesses in better industries across the entire economic spectrum, and at buying them below their intrinsic value. Investing in both dividend and non-dividend paying companies that are financially strong and meet specific valuation criteria, the portfolio manager David Katz seeks a total rate of return comprised of capital appreciation and current income.*

**Q: What is your investment philosophy?**

**A:** We believe that you can earn better-than-market returns with less-than-market risks by building a portfolio of high-quality businesses selling below their intrinsic value. That translates into buying lower price to earnings, lower price to book and lower price to sales companies.

We have a strong preference towards better businesses in better industries. We'd rather buy a medical technology company growing at 15% at thirteen times earnings than an industrial steel company that's selling at twelve times earnings but whose earnings don't grow over time.

**Q: Some investors look at deep value, other investors look at turnaround value, and still others look at relative or absolute value. What is your version of value?**

**A:** We fall into the core value or the relative value area rather than the deep value area. We are trying to buy leading businesses at good prices. We are looking at the company's earnings, growth and prospects, the company's dividends growth and prospects, their cash flows, their return on equity, and then we want to make sure that it's a superior business with a superior franchise. Then, based on those earnings prospects, we try to figure out what that business is worth and we want to buy it at a one-third discount.

We believe it is better to focus on good businesses that have short-term issues than to focus on inferior businesses that are given away at a fire sale price.

**Q: How do you define a superior business? Are companies paying dividends a must for you to buy?**

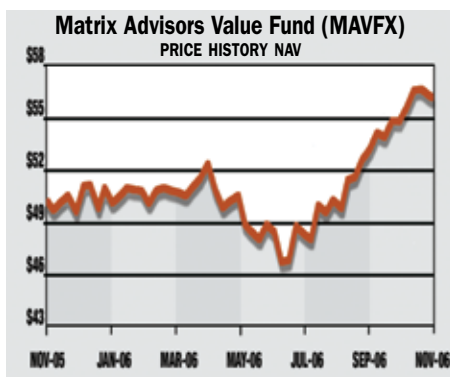
**A:** The company dividend rate and history of dividend are two of eight elements in our valuation models. However, some companies decide they can do better with your money than you can, and have not paid a dividend. As long as the company appears attractive on our other valuation models, we can and do buy and hold such stocks. There are several companies in the portfolio that were non-dividend paying when we originally bought them.

We like businesses that can grow over time through a business cycle. We like industries where sales are growing over time, where there's not a great deal of operating margin pressure, where there are barriers to entry for competitors, and where the companies have superior margins.

A few years ago we owned Guidant Corp., a company whose earnings over time were growing more than 15%. They had a dominant market share in the ICD market and a solid market share in the stent technologies, and there were a handful of competitors in these markets. Originally, we bought them at under fourteen times earnings. So, we had a good growth business, barriers



**DAVID KATZ** CFA is Matrix'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. After initially working at Management Asset Corporation (Westport, CT), 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.



to entry, wonderful cash flow, all at a very attractive price.

**Q: How is your research process organized? How do you find ideas and then how does an idea turn into a holding?**

**A:** Our research universe is the largest 1,500 companies in the Zacks company database. First, we look at the strength of the balance sheet, where we are trying to find companies that have low debt to capitalization ratio, high interest rate coverage and high current ratio. If a company violates our financial strength, it gets screened out. The first step is the balance sheet review. Thus we screen 1,500 companies down to about 1,000.

We then put every company through eight rigorous quantitative valuation models. Our models will look at a company on an absolute and relative basis. There are four absolute valuation models of earnings and earnings growth, dividends and dividend growth, return on equity to book value, and earnings rate to AAA Bond rate. We look at a ten-year operating history of the company along with the current year's earnings, next year's earnings, and the year after. We look at valuations based on those ten-year periods. The higher the earnings growth, the more we are willing to pay for a company, but within reason.

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Then we have four relative valuation models, which will look at how the company has sold vs. its own history over the last six to ten years. We'll look at a company on its P/E basis, its price to book value, its price to sale and its dividend yield. We require that a company appears attractive on any two or more of those eight valuation models. So the initial 1,500 companies are winnowed down to about 75 to 100 companies that appear statistically attractive.

**Q: How do you continue your research on these 75 to 100 companies?**

**A:** We do very detailed qualitative work. We go through the company's financial reports and their 10-K statements. We make sure that we are comfortable with everything they are doing. We look for understated or overstated assets, contingent liabilities and check the management strategy - are they running the business for shareholders, is there a conflict of interests. We'll then speak with Wall Street analysts, we'll try to pick an analyst that is negative on the company to make sure we understand all the reasons they don't like it. We'll then try to speak with two or three analysts that we think are the most insightful and have the best record on the company or an industry. We do not rely on the analysts for buy or sell recommendations but just to get an overview of the company and industry and current trends.

At the end of that three-pronged process, we'll try to do a catalyst assessment. Yes, the stock is cheap, we like the management, they are shareholder-oriented, it's undervalued, but what is going to help us achieve our value? If we can identify the catalyst, that's great. However, there are a number of cases where we can't, but if everything else is right for the company, we will still have a high level of interest. At the end of that process, those 75 or 100 companies are winnowed down to 30 or 40 most attractive stocks that we build a portfolio from.

**Q: Are your holdings all the same size, percentage wise, or do you employ a range?**

**A:** The latter. Generally, 2% would be a smaller position, and position at cost would be no more than 4%. So an average posi-

tion for us is about 3.3%. Then, beyond the rule of not buying more than 4% at cost, we will scale back a position even if we continue to like it, so that it would definitely be no more than 8% at market value of a portfolio as a rule, but generally a position will rarely be above 5% at market value of the portfolio.

**Q: Can you give us some historical examples?**

**A:** In the Guidant case, we had bought the company when it was at the \$23 to \$25 level. It was a full position, and over the eighteen or twenty-month hold period it traded from the \$23 to \$25 to the \$50 to \$55 level. It had become oversized. We scaled back on it a little. Even though we continued to like it, we did take some off the table into the strength simply because we didn't want to have too oversized of a position in the portfolio. Then the entire position was sold when they were acquired at the \$70 plus level.

In terms of things we've scaled back, a more recent one would be Merrill Lynch, a stock that we bought at the tail end of the research scandal, the Spitzer investigation, and the bear market of late 2002. We had bought Merrill Lynch in the sub-\$40 level, a full position of 3% to 3.5%, and that stock has subsequently reached the \$90 level, so it has been scaled back as it approaches fair value, and as it became oversized along the way.

**Q: How do you measure and mitigate risk?**

**A:** We control risk through portfolio diversification, through industry and stock diversification, by buying strong balance sheets, and by buying at a discount to its Fair Value.

Prior to looking at the company on a valuation basis, we are looking at it from a balance sheet perspective. We will buy companies with real or perceived business problems. We don't want one of those problems to be their balance sheet or financial risk. We are looking for companies with strong coverage ratios and very low debt so we don't have to worry about the financials as they work through the problem.

The second part of the process is by buying a business at a well below market multiple, at a well below its historic multiple, and what we perceive to be well below its private market value multiple.

By buying a business at one-third below what we think it's worth, we control the downside. If we were right that a business is worth \$40 and we are buying it at \$25, theoretically it should not go too much below that because it would become vulnerable to being acquired.

The third area of controlling risk is by buying no more than 4% at cost in any given company. We'll buy no more than 15% at cost in any given industry.

### Q: Do you follow any benchmark?

**A:** We are benchmark aware, not benchmark driven. We pay attention to the overall economy and where businesses and sectors lie within the economy. Within benchmarks, we pay most attention to the S&P 500, and we are cognizant of which industries have the greatest and the least representation in the index.

We don't build our portfolio by the industry concentrations or sectors. We do it on a bottom-up basis, but we don't like to be wildly out of sync with the economy. Whereas we have a 22% position in technology, and the S&P 500 has a 16% position there, we are comfortable with that because technology is a meaningful part of the economy.

### Q: Most value investors are longer term holders. What is your time horizon?

**A:** Our time horizon is eighteen to thirty months on average. For every company, we have a fair value or target sale price, and we would like to buy that stock at one-third below that target sale price. If we can do that, you'd generally get 50% or more upside.

Our mindset in terms of timing is that upside could take as much as anywhere from twelve to thirty six months. Our longest held position for the advisor was American Express that we bought in 1990 at about \$6 price. At the time we purchased it, our target price was about \$15 per share. Ultimately, that target price went up from \$15 to \$60, and in 2000 the lines crossed

in terms of stock price and targeted sale price as the stock traded above \$60.

### Q: Does your research work help you in deciding when to sell a stock?

**A:** Yes, most definitely. Our decision to sell is very much related to our decision to buy a stock: in both cases, it is based on the relationship of the company's business value to its stock price.

I said that ultimately we want to buy each of our holdings for at least one-third less than what we believe the business is worth. Conversely, we want to sell a stock when the stock price has risen to equal the updated business value of the company.


Happily, this is the outcome for the vast majority of our holdings. Of course, not everything works out as contemplated, and we certainly will sell stocks at a loss when we have lost confidence in management or the fundamentals of the business. However, the mere fact that a stock's price declines will not trigger a sale. In fact, it might make buying more of the stock compelling.

Ultimately, our disciplined approach to selling has been a key component in our long-term success.

### Q: In a world of thousands of funds, what is the "value-added" advantage that the Matrix Advisors Value Fund offers?

**A:** I think we offer several compelling features that investors should like: ours is a simple, one class of shares fund, with very reasonable costs. It benefits directly from the larger research efforts that we expend as a management firm.

The Fund's size is moderate, offering good diversification and yet not posing any difficulties for in terms of owning too much of a particular company or two.

Finally, Matrix partners and associates along with our friends and family have a significant portion of our net worth invested in the Fund. We have strong conviction about what we do, and that is something that our investors should find comforting and reassuring. 

## Matrix Advisors Value Fund

Symbol	<b>MAVFX</b>
Website	<a href="http://www.matrixadvisorsvaluefund.com">www.matrixadvisorsvaluefund.com</a>
Address	Matrix Advisors Value Fund 747 Third Avenue, 31st Floor New York, NY 10017
Tel. No.	800-366-6223
Inception	07/01/96

### PORTFOLIO

Total Net Assets*	\$192.1
Avg Mkt Cap (\$ Weighted)*	\$88,900
Average Price/Earnings Ratio	26.27
Average Price/Book Ratio	2.93
Turnover Ratio	18%

### INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$500

### RISK (S&P 500) - 10 YEAR

Alpha (Ann.)	2.74
Beta	0.99
R-Squared	0.83
Ann. Std Deviation	18.13
Ann. Sharpe Ratio	0.44

### RETURNS VS. S&P 500 INDEX

	MAVFX	Index
1 Year (Cum.)	14.16%	14.23%
3 Year (Ann.)	8.04%	11.82%
5 Year (Ann.)	6.78%	6.08%
10 Year (Ann.)	10.39%	8.05%

### RETURNS VS. LIPPER MLC-CAP CORE IX INDEX

	MAVFX	Index
1 Year (Cum.)	14.16%	14.20%
3 Year (Ann.)	8.04%	12.60%
5 Year (Ann.)	6.78%	7.62%
10 Year (Ann.)	10.39%	8.08%

### FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee **	1.00%
Total Expense Ratio	0.99%

### PORTFOLIO MANAGER

David A. Katz	07/01/96
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\*millions \*\*on shares held for 60 days or less

Data through: 11/30/06

Source: Company Documents; Lipper

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Our interview covers investment philosophy and strategy, research process, portfolio construction and risk control for funds. Through an interview we uncover long-term strategies and processes that help to generate long-term returns.

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