

MUTUAL FUND SNAPSHOT

Today's Top 5 Stock Picks: Quality Dividend Payers

The Nicholas Equity Income fund looks for companies whose growth rate plus dividend yield equals 10%.

By Crystal Kim

In a market with no earnings growth, rock-bottom interest rates, and Brexit uncertainty, investors have poured so much money into dividend-paying “quality” stocks that a Citigroup analyst suggested the GARP, or “growth at the right price,” trade has become QAAP, or “quality at any price.”

Albert “Ab” Nicholas, 84, and Mike Shelton, 44, don’t buy that. Or, more to the point, the managers of the \$525 million Nicholas Equity Income fund (ticker: NSEIX) are still buying. They look for companies with clean-balance sheets, dividends competitive with the S&P 500, and the earnings growth to support those payouts. But they don’t pull the trigger until a stock is out of favor, says Shelton. The portfolio’s average price-to-earnings ratio, at 14, is lower than the S&P 500’s 16, while the fund yields nearly 3%, compared to the index’s 2.2%.

Recently, the formula has not been a winner. The fund has lagged the market over the past 3 and 5 years, held back largely by one sector. “In a word: oil,” says Shelton. The fund has 7% of its assets in the energy sector, half of what it accounted for early last year. Shelton chose to stay invested in what he still considers “best operators” in the space. He expects the price of

crude to recover eventually, and likes the yields — some as high as 10% — in the meantime. As with many dividend portfolios, the fund tends to hold up better in bear markets; in 2008 when the market declined 37%, the fund was down 24%. Losing less helps over the long-term — its 10-year annualized return of nearly 10% beats the S&P 500 and 96% of fund peers.

Shelton looks for companies with a combined growth rate and dividend yield of 10% or better. “Compare that with S&P 500 earnings growth, which is essentially zero, and its 2% yield,” he says. They also have to have “reasonable” payout ratios and debt-to-capital ratios of less than 50% for Shelton to consider them. Of the 50 names in the fund, Shelton highlighted toolmaker Snap-on (SNA), drug wholesaler Cardinal Health (CAH), amusement park master limited partnership Cedar Fair (FUN), defense radio and communications device maker Harris (HRS) and Time Warner (TWX). Yields range from 2% to 6%.

Barrons.com spoke with Shelton to get his take on his top 5 picks.

Snap-on: The \$9 billion automotive tool maker stands to benefit from the aging fleet of cars on the road as well as technology-heavy vehicles now coming to market. The company derives a

significant portion of its \$3.4 billion in sales from its 3,500 tool-stocked mobile vans, a larger footprint than that of competitors Stanley Black & Decker and Danaher subsidiary Matco Tools combined. From December to February, shares fell more than 20% to \$133, when investors became overly concerned about the company’s credit division, says Shelton. What the average investor doesn’t understand is that people aren’t likely to default on tools they need to continue working, he says. At a recent \$152, the stock is trading at 15 times next year’s earnings estimates, below its 10-year high of 22 times. Meanwhile profit margins and return on capital haven’t been better. Its dividend yield is 1.6%, and it has paid one since 1939, uninterrupted. Barron’s listed it as a stock that Berkshire Hathaway CEO Warren Buffett could buy.

Cardinal Health: Shelton blames “generic deflation” — the phenomenon of off-label drugs getting cheaper every year — for the stock’s 13% decline over the past 12 months. It’s not alone; the company’s two biggest competitors, McKesson (MCK) and Amerisource-Bergen (ABC), have also felt the hurt since the summer of 2015. How much generic drug pricing will weigh on fiscal 2017 earnings is still in question and

(over please)

Cardinal's management has remained mum. The company, however, recently told analysts it would wrap up the fiscal year ending in June with 18%-20% earnings-per-share growth, impressive considering its single-digit growth rate of the past couple years. Shelton also sees growth potential from its recent acquisition of Johnson & Johnson's heart-product business and the company's efforts to bone up its medical division, which chips in about 20% of Ebitda (earnings before itemization, taxes, depreciation and amortization); its pharmaceutical division makes up the rest. At a recent \$77, shares trade at 12 times his estimate of 2017 earnings; he thinks it can get up to 14 times. Meanwhile, collect a yield of 2.3%.

Cedar Fair: As a master limited partnership, Cedar distributes most of its income to shareholders. It owns and operates 11 amusement parks, including Knott's Berry Farm and Cedar Point. The company should benefit from the secular trend of customers seeking to spend on experiences rather than material goods, says Shelton. Cedar Fair is attractively valued: Its estimated 2017 enterprise value to Ebitda ratio is under 10 compared to Six Flags'

14. Cedar is growing comparatively slowly; analysts expect the company to deliver 5% free cash flow in 2017, Six Flags' 16%. Additional growth, however, could come from its new water park, new rides and investments in digital technology coming online this year. At a recent \$58, its dividend yield is a whopping 5.7%.

Time Warner: The death of the set-top box has been greatly exaggerated. "Quality content has value," says Shelton. Time Warner owns TNT, TBS, Turner Classic Movies, HBO, Adult Swim and Cartoon Network – not to mention NCAA coverage. The company's first quarter revenue rose 7% year-over-year to \$2.9 billion driven by subscriptions and ads. Warner Bros. fared less well, but Shelton expects the 11 superhero movies planned for the next five years to give it a lift. Time Warner has a steadfast leader in Jeff Bewkes, who rejected 21st Century Fox's \$85-per-share bid in 2014 "for reasons that included price," according to The Wall Street Journal. Bewkes plans to win back cord cutters with value by offering "skinny bundles" and has been aggressively selling stacking rights, allowing networks to offer all episodes

of current season shows on-demand. Binge-watchers, rejoice. The stock, at a recent \$73, trades at around 13 times 2017 earnings estimates, far below its 10-year high of 20. Meanwhile its net profit margin has been getting fatter. Shares yield 2.2%.

Harris: The Melbourne, Fla., maker of military radio and air traffic control equipment recently acquired former ITT defense unit Exelis in a transformative \$4.75 billion merger, the largest defense deal in nearly 20 years. The bigger Harris is expected to pull in \$7.5 billion in revenue this year, half of which will come from the Pentagon. The company recently scored a \$1.7 billion contract with the department of defense for radio equipment. Management guided earnings per share lower to about \$5.70 for its June-end fiscal year, the bottom end of its previous outlook range, in part due to reduced demand from oil and gas companies. Shelton, however, sees "acceleration in earnings growth" ahead and believes Harris will benefit from cost synergies as it tucks in Exelis. Harris' stock, at \$83, trades for 14 times consensus 2017 EPS estimates, below its 10-year high of 17. It yields 2.4%.



Nicholas Equity Income Fund (NSEIX)

June 30, 2016

Please read the information below along with the included article from Barron's.

Co-Portfolio Managers: Albert (Ab) O. Nicholas, CFA & Michael L. Shelton, CFA, CPA

Investment Philosophy:

The advisor invests in high quality companies that meet our investment criteria, which includes

- Attractive dividend yield
- A strategic position within their industry
- An enduring franchise, product or brand
- Consistent, or improving, earnings growth and free cash flow
- Low debt levels
- Reputable management with meaningful stock ownership
- Out-of-favor or undiscovered companies
- Stock price below long-term potential value

Investment Approach:

Nicholas Equity Income Fund seeks to provide investors with a reasonable stream of income along with long-term capital growth through a diversified portfolio of stocks with attractive dividend yields. The Fund will invest in small- to large-sized companies with capitalizations generally between \$1 to \$100 billion. The Fund is typically benchmarked against the Standard & Poor's 500 Index over a market cycle.

Portfolio Information:

Date of Inception:	11/23/1993
Net Assets:	\$522.6 million
Number of Holdings:	48
Weighted Avg. Forward P/E Capped:	14.17x
Weighted Avg. Trailing P/E Capped:	15.00x
Weighted Avg. Market Capitalization:	\$64,367.4 million
Weighted Median Market Capitalization:	\$10,386.7 million
Weighted Harmonic Avg. Price/Book:	2.54x
Turnover Rate:	24.92% (03/31/16) ⁽¹⁾

⁽¹⁾ Annualized

The Fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The statutory and summary prospectuses contain this and other important information about the Fund, and they may be obtained by visiting www.nicholasfunds.com. Read carefully before investing.

Opinions expressed are subject to change at any time, are not guaranteed and should not be considered investment advice.

The Standard & Poor's (S&P) 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. You cannot invest directly in an index.

Fund holdings and/or sector weightings are subject to change at any time and are not recommendations to buy or sell any security.

Glossary of Terms:

Debt to Capital	The long-term debt of a company divided by the company's total capital. Total capital equals long-term debt plus preferred stock plus common stock.
Earnings Per Share	(EPS) is calculated by taking the total earnings divided by the number of shares outstanding.
EBITDA	Earnings Before Interest, Taxes, Depreciation and Amortization.
Enterprise Value	Market capitalization plus all debt (preferred stock, minority interest, etc.) less cash.
EPS Growth	Represents the annualized rate of net-income-per-share growth over the trailing one-year period. Earnings-per-share growth gives a good picture of the rate at which a company has grown its profitability per unit of equity. EPS Growth and Earnings Growth are not measures of the Fund's future performance.
Free Cash Flow	Measures the cash flow available for distribution among all the securities holders of an organization.
Harmonic Price/Book	Price per share divided by book value per share. The harmonic function reduces the impact of outliers in the denominator on the aggregate calculation.
Market Capitalization	The market price of an entire company, calculated by multiplying common shares outstanding by the current market price per common share.
Payout	The dividends paid by a company divided by its net earnings for the period.
Price/Earning Capped	P/E is a valuation ratio of a company's current share price compared to its per-share earnings or in the case of REITs (real estate investment trusts), their funds from operations. These weighted average values are limited (capped) in a range between 0 and 60.
Profit Margin	A measure of how well a company controls its costs. It is calculated by dividing a company's profit by its revenues.
Return on Capital	A company's net income over invested capital.
Turnover	A measure of a fund's trading activity, which is computed by taking the lesser of purchases or sales (excluding all securities with maturities of less than one year) and dividing by average monthly net assets.
Weighted Avg. Market Capitalization	The average market capitalization of all companies in a fund—with each company weighted according to its percent held in the fund.

Performance History: as of June 30, 2016

	<u>Quarter</u>	<u>1 Year</u>	<u>3 Year</u>	<u>5 Year</u>	<u>10 Year</u>
Nicholas Equity Income	3.62%	0.34%	8.75%	9.97%	9.65%
Standard & Poor's 500 Index	2.46%	3.99%	11.66%	12.10%	7.42%

Expense Ratio: 0.72%

30-Day SEC Yield: 3.01%

Performance data quoted represents past performance and is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance of the Fund may be lower or higher than the performance quoted. Performance data current to the most recent month end may be obtained by calling 1-800-544-6547 or visiting www.nicholasfunds.com/returns.html.

Top Ten Holdings:

% of Net Assets

Pfizer Inc.	3.60%
Walgreens Boots Alliance, Inc.	3.43%
Cardinal Health, Inc.	3.02%
W.P. Carey Inc.	3.01%
Nielsen Holdings plc	2.96%
Chubb Limited	2.94%
AbbVie Inc.	2.87%
Time Warner Inc.	2.85%
Apple Inc.	2.64%
TEGNA, Inc.	2.49%
	<u>29.81%</u>