REPRINTED FROM MARCH 19, 2024

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

3 Companies That Check 9 Boxes for Quality

MICHAEL L. SHELTON, CFA, joined Nicholas Company, Inc. in 2006. He serves as lead Portfolio Manager of Nicholas Equity Income Fund, co-Portfolio Manager of Nicholas Fund, and is a senior research analyst. Mr. Shelton has a depth of knowledge following years of covering the health care, technology and industrial sectors. Prior to joining Nicholas Company, Mr. Shelton worked for the Department of Defense Financing & Accounting Service as a financial analyst. He spent three years with Robert W. Baird as a research analyst, and at McDonald Investments for one year focusing on health care companies. Before starting his investment career, he worked with Ernst & Young as an auditor and tax consultant earning his CPA designation in 1995. Mr. Shelton graduated magna cum laude from Miami University in Oxford, Ohio, and obtained his MBA from Ohio State University. He has earned the right to use the CFA designation and is a member of the CFA Society Milwaukee.

SECTOR — GENERAL INVESTING

(AHW511) TWST: Would you review for us your overall investment approach and philosophy? In particular, I know you focus on higher-quality companies and stocks. How do you define that?

Mr. Shelton: I'll walk through the objective, our investment philosophy, and then the selection process, which incorporates nine different characteristics that I look for, and to your question, how we would define a quality company.

To start, the Equity Income Fund's investment objective is to provide investors with a reasonable stream of income, with a secondary purpose of providing moderate long-term growth of capital and attractive total return potential.

The fund's investment philosophy is based on four elements. First, it's a traditional bottom-up process. We seek to invest in dividend-paying companies that have high-quality characteristics and sustainable business models.

We also focus on the long term, and to that end, the Equity Income Fund's turnover in 2023 was less than 10%.

We also seek to exploit short-term market fluctuations and extreme market valuations. Often, that's where the greatest sources of alpha will come from.

And then finally, we believe the combination of security selection, diversification, and risk management results in portfolios with greater price stability over time. As quoted by Morningstar, the Equity Income Fund's standard deviation, which is a measure of risk, does compare favorably to its peers over the past three, five and 10 years.

I think one unique difference of this Equity Income Fund is we're not bound by market cap, we'll own small-cap, mid-cap and large-cap stocks. We feel that gives us an advantage in finding the best dividend-paying stocks, because we're not bound by a certain market cap. And so, over the years and at any point in time, we'll have a diversification in market cap, and we think that differentiates us.

The selection process begins really by how we define a quality company, and we evaluate nine characteristics of the company. The first three are dividend specific. I try to buy a stock that has a dividend greater than the S&P 500. As of 12/31/23, the Equity Income Fund's SEC yield was 2.21%, and that compares favorably to the S&P 500, whose yield was 1.51%.

Secondly, I am looking for companies that consistently have raised their payout. The three-year CAGR of dividend increases for the Equity Income Fund is 8.8%, and that compares favorably versus the S&P 500's three-year CAGR dividend increases of 6.7%.

The third characteristic of the selection process is finding companies that have reasonable payout ratios. We target ratios below 60%. We feel that's ideal to provide dividend safety, but also potential for increases in the dividend payout, and enough free cash flow for the company to reinvest in the business, because growth is obviously key.

The underlying growth of the company is key for the company to continue to raise its payout. The Equity Income Fund's overall payout ratio is 45%.

The next step in the process, the fourth characteristic, is identifying an economic moat of the company. Possible moats can include intangible assets, cost advantage, switching costs, and a network effect.

The fifth characteristic focuses on historical earnings growth and free cash flow generation. Growth is crucial to sustaining and growing the company's dividend over time, as I mentioned before.

The sixth characteristic that we look for is selecting companies that generate returns on invested capital greater than their cost of capital. We find that's a very good measure of management's ability to make the right capital allocation decisions. Typically, if you don't have a moat, you're not going to earn your cost of capital over a sustainable period of time.

The next step and the seventh characteristic in the selection process is evaluating the company's balance sheet. A strong balance sheet provides optionality for the company, and safety for the investor.

The eighth characteristic focuses on owning companies with competent management teams and incentive structures that align with shareholders. A strong return on invested capital is one way to judge the management team, but we also want to see the incentive structure for management to be shareholder friendly, and often that is management's compensation, which is tied to performance metrics, and we find those by reviewing each company's proxy.

Finally, the last characteristic in the selection process is valuation. We incorporate a variety of traditional metrics — price-to-earnings multiple, enterprise value-to-EBITDA, and free cash flow yield.

"Free cash flow is important, because using the income statement and calculating valuation can be open to manipulation, as most firms report adjusted earnings. So, the free cash flow yield is one way to compare companies from a very pure measurement form."

Free cash flow is important, because using the income statement and calculating valuation can be open to manipulation, as most firms report adjusted earnings. So, the free cash flow yield is one way to compare companies from a very pure measurement form.

TWST: What is the importance of dividends in your view?

Mr. Shelton: There are several reasons why owning stocks that pay dividends is important and beneficial to long-term performance and stability. Historically, dividends have accounted for a significant percent of total return. Since 1930, dividends have accounted for over 40% of total returns earned by common stocks.

During high inflationary periods — which we are in now — in the 1940s and 1970s, dividends accounted for 67% and 73% of total return for those decades. Companies that offer attractive dividend yields and have grown the dividend offer the best risk-adjusted returns over the long run, especially in a lot of different markets.

And finally, a company that pays and raises the dividend can be seen as a good indicator of the company's health. Companies that pay dividends typically have a strong and consistent cash flow.

There are a lot of studies out there on dividend payers that have broken all the companies into different categories: growers, payers, companies that didn't pay any dividends, companies that cut their dividend, the equally weighted S&P 500. What they have found is, from 1973 to 2020, of all those categories, dividend growers had the best returns and the lowest standard deviation.

So, when we think about an overarching view on dividends, the optimal performance is really achieved through a balance of a growing dividend payout and earnings growth. And, to sustain the dividend growth, companies must have a reasonable payout ratio, because they need to have some free cash flow to reinvest in the business.

TWST: What is your outlook for 2024? And are there any particular areas of opportunity or concern that have led you to make changes to the portfolio in light of that?

Mr. Shelton: Before I discuss expectations for 2024, I want to provide some context about the macro environment and recent market returns, to give us a baseline.

During the bear market of 2022, there was a notable shift toward dividend-paying stocks among investors seeking protection from the Federal Reserve's significant interest rate hikes of 450 basis points. Traditionally seen as more reliable and steadier, firms that pay dividends have a history of outperforming their non-dividend-paying counterparts during periods of market instability, rising interest rates, and economic downturns.

Throughout much of 2023, the prevailing opinion was that the U.S. would face recession, prompted by the fastest pace of interest rate increases seen in over four decades by the Fed.

1-Year Daily Chart of Abbott Laboratories

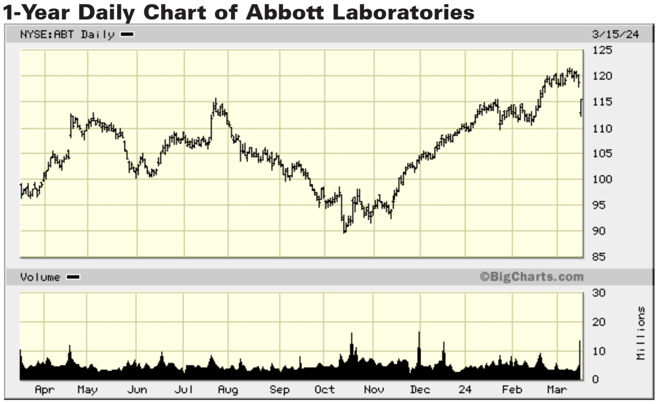

Chart provided by www.BigCharts.com

Contrary to these expectations, the U.S. did not fall into recession, as the U.S. government materially increased its spending, so much that it led to one of the largest deficits as a percent of GDP since 1948, surpassed only in years marked by unforeseen crises like COVID or the global financial crisis or by exceptionally high unemployment rates.

Based on the current historically low unemployment rate, the deficit theoretically should be about 1% of GDP, or $260 billion, not the $1.7 trillion that we see. This deficit spending led to government jobs making up an unprecedented 25% of all jobs created in 2023, and this compares to the long-term average of just 5%.

This fiscal expansion, along with the dominance of the Magnificent Seven stocks — which surged by 107% — fueled more than a 24% increase in the stock market over the year. The Magnificent Seven have undeniably demonstrated growth, innovation, and strong financial health. The real challenge for these companies moving forward is, can they sustain their current market valuations?

With the Federal Reserve shifting from a higher-for-longer stance to signaling potential rate cuts in 2024, the market has possibly overestimated future gains and overlooked several risks. Persistent inflation, potential downturns in consumer spending due to rising layoffs, and record high credit card amounts and rates could all affect economic stability.

Given these factors, dividend-paying stocks and funds present a compelling opportunity for investors, especially as they have lagged a broader market rally where valuations are now stretched. The S&P 500 trades at over 20 times forward earnings, which is above its 10-year average of 17.7.

In a large market selloff or a weakening economy, health care companies historically have outperformed.

As previously stated, the fund selection process focuses on assessing nine attributes. The first three address the dividend. We would argue that **Abbott's** dividend profile is very compelling. It has a 2% yield, and that compares to 1.4% for the S&P 500. It sports a 12% dividend growth CAGR over the past five years, and that compares favorably to the S&P 500 of 5%.

Abbott has increased its dividend for over 50 straight years, which qualifies them as a Dividend King. Additionally, its low payout ratio of 41% enables both growth potential in its dividend and free cash flow left over for future investments.

The fourth investment attribute I assess is determining, does **Abbott** have a moat and a competitive advantage? **Abbott** benefits from different moat sources depending on the product segment.

For example, in the nutritional sector, **Abbott** commands a leading market share position in a multi-billion-dollar market dominated by itself and **Reckitt Benckiser Group** (OTCMKTS:RBGLY), together holding over 80% of the market.

"Given these factors, dividend-paying stocks and funds present a compelling opportunity for investors, especially as they have lagged a broader market rally where valuations are now stretched. The S&P 500 trades at over 20 times forward earnings, which is above its 10-year average of 17.7."

Although market consensus might have shifted towards a soft-landing or no-landing scenario, ongoing inflationary pressures and a possible uptick in unemployment suggest that investing in dividend growers could offer a balanced risk/reward profile, particularly if market volatility emerges.

With the stock market's volatility index, or VIX, at the lowest point since the pandemic's onset, dividend focused investments stand out for their historical performance and risk-adjusted returns during uncertain times. And, the Nasdaq 100 had its best year since 1999 last year. So the market reflects a lot of good news.

From a portfolio positioning perspective, we still like health care given its growth and defensive characteristics. Health care is the largest weighting in the Equity Income Fund, and to that end, one of the stocks I want to cover that we own is **Abbott Laboratories** (NYSE:ABT). It's the third largest holding in the Equity Income Fund.

It's a $200 billion market cap company, and generates $40 billion in revenue. It's a globally diversified health care company that operates through four reportable segments: established pharmaceutical products, diagnostic products, nutritional products, and medical devices.

Abbott was founded in 1888, and offers a broad portfolio of market leading products that align with favorable long-term health care trends in both developed and developing markets. This diversity allows **Abbott** to weather the ups and downs of individual markets, as it is not overly reliant on any one product or market. What you get with **Abbott** is growth, but also a diversified health care company.

1-Year Daily Chart of TJX Companies Inc.

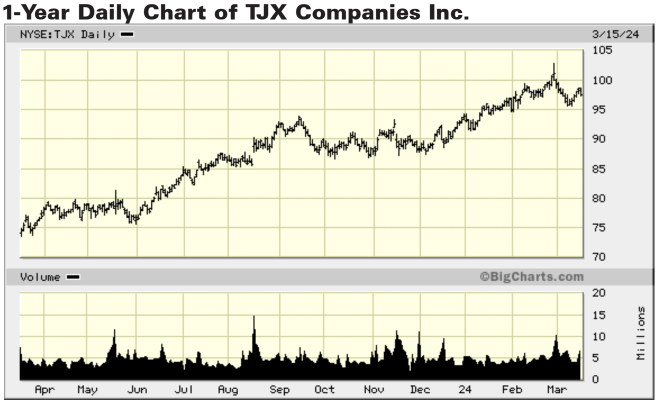

Chart provided by www.BigCharts.com

The company has successfully built intangible assets, notably earning the trust of new parents and pediatricians in creating unique and proprietary infant formula solutions for babies with specific dietary needs.

In the area of diagnostics, **Abbott** capitalizes on the substantial switching costs that hospitals face. Once **Abbott's** advanced testing systems are in place and staff are trained, the company secures steady income through the sale of high-margin consumable supplies and reagents. Usually, once a company selects a system, they almost never replace it unless the performance is awful.

The fifth selection criteria looks at historical growth, and to that end, **Abbott** has recorded excellent results. Its 10-year EPS CAGR is 8%, and that compares against the S&P 500 of 7%, and its 10-year free cash flow CAGR is over 10%. Furthermore, **Abbott** has generated double-digit returns on invested capital over the past five years.

The next attribute we consider is the quality of the balance sheet, and **Abbott** has an excellent balance sheet with leverage of just 1 times debt-to-EBITDA.

The eighth characteristic of the stock selection process is evaluating management, and if they are tied to shareholders. Ninety percent of CEO compensation is tied to performance. Metrics include sales, earnings per share, return on assets, and free cash flow.

The final item to consider is valuation. **Abbott** trades at 25 times next 12-month earnings, which is below its five-year high of 32 times. Moreover, **Abbott's** free cash flow yield of 4.8% is attractively priced compared to the S&P 500's free cash flow yield of 4.2%. Underpinning **Abbott's** current valuation is the expectation of **Abbott** growing earnings and free cash flow at low double-digits over the long run.

"TJX benefits from two strategic advantages: their intangible assets and cost advantage. Over decades, TJX has developed a unique procurement model and global vendor relationships that conventional retailers find difficult to replicate, serving as an economic intangible asset."

So, that's a stock that we like very much, and over the years and at different times have added to the position, either during large selloffs or due to specific issues at **Abbott** that we thought were short term in nature. Going back to our philosophy about taking a long-term approach, those are the situations that you hope to capitalize on.

TWST: Are there a couple of other favorite investment ideas that you can tell us about?

Mr. Shelton: Yes, this one is our fourth largest holding in the Equity Income Fund: **TJX Companies** (NYSE:TJX). It's a $115 billion market cap and does $54 billion in revenue. It was founded in 1962, and holds the leading position in the domestic off-price retail industry, via its TJ Maxx and Marshalls banners. It checks nearly all nine of the investment criteria characteristics that we look for.

Their dividend is 1.4%, which is the same as the S&P 500, however they do have a history of raising it at a much higher rate than the S&P 500. Over the last five years they have a 10% dividend CAGR versus 5% for the S&P 500, and their most recent increase was 13%. And, they still have a very low payout ratio of 43%.

TJX benefits from two strategic advantages: their intangible assets and cost advantage. Over decades, **TJX** has developed a unique procurement model and global vendor relationships that conventional retailers find difficult to replicate, serving as an economic intangible asset.

Additionally, its large scale grants it cost advantages over smaller competitors. The company's procurement expertise and network of over 21,000 global vendors create a competitive moat, making its go-to-market strategy and growth very difficult for others to copy.

TJX's approach to opportunistically purchasing excess inventory at significantly lower prices than conventional outlets, which could be 20% to 60% cheaper due to manufacturing overruns and retail closeouts, bankruptcies — they really have the scale and size to make those large purchases and then turn around and offer really attractive prices for their customers.

They have an excellent history of EPS growth and free cash generation. They've grown EPS and free cash flow over the past 10 years, at a 10% and 9% CAGR, respectively. They should continue to grow through new store expansion, consistent same-store sales growth, as well as expanding their international store base.

They have impressive return on investment capital metrics. They've averaged 17% over the past five years, and their balance sheet is pristine as they hold more cash than debt.

Their management, we would argue, is quite competent as measured by high returns on invested capital, and their compensation structures are shareholder friendly as well, given they're paid on EPS growth, return on invested capital and pre-tax net income.

1-Year Daily Chart of L3Harris Technologies Inc.

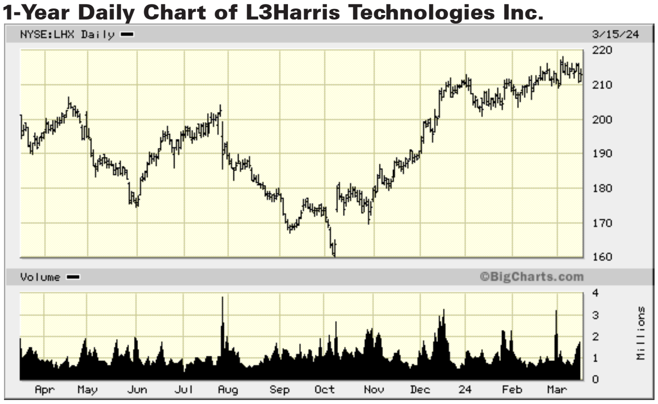

Chart provided by www.BigCharts.com

And we feel valuation is very attractive at only 23 times next 12 months, and that's with expectations of **TJX** growing earnings and free cash flow at low double digits over the long run.

The third stock I want to talk about is a stock that we just purchased this past fall, so it's a new idea in the portfolio: **L3Harris Technologies** (NYSE:LHX). It's a $41 billion market cap, generates $19 billion in revenue, and is the sixth largest U.S. defense contractor by sales. It was formed in 2019 from the merger of L3 Technologies and Harris Corporation.

The new company is a leading global aerospace and defense technology provider that focuses on delivering end-to-end solutions across networking, avionics, and space systems for both defense and commercial applications.

They have an excellent dividend, 2.15%, and they've grown their dividend over the past five years at a 15% CAGR, and have raised it for 21 straight years. And they, too, have a low payout ratio of 36%, which gives them the optionality to raise the dividend and to continue to make investments in its business.

They benefit from two moat sources: intangible assets and switching costs. **L3Harris'** market position is bolstered by intangible assets and significant barriers to switching. Primarily, the intricate complexity of the product serves as a deterrent to new market entrants, supported by mid- and long-term product cycles and contracts that mitigate risks for existing firms and prevent new suppliers from emerging.

Switching costs are also a significant source of the company's economic moat. The government and other prime defense companies that integrate **L3Harris'** products into their final deliverables would face substantial difficulties and risks if they attempted to switch products or suppliers.

For example, **L3Harris'** integrated core processor, or ICP, is integrated on **Lockheed Martin's** F35 fighter jet. The ICP acts as the brains of the F35, processing data for the aircraft's communications, sensors, electronic warfare guidance and control, cockpit and helmet displays — such a critical piece of the F35 and how it operates, so it would be very difficult for them to be switched out by **Lockheed Martin**.

L3Harris has a strong history of EPS and free cash flow generation, as well. Their 10-year EPS CAGR is 10% per year, and they've generated free cash flow over the past 10 years at a 9% rate. Its return on invested capital is also very impressive; they've averaged 20% over the past several years.

The next attribute we consider is the balance sheet, and **L3Harris** does not meet what we would define as a quality balance sheet, and that is anything under 3 times levered. They're 3.2 times debt to EBITDA, although the increase in debt is due to the $4.7 billion acquisition of Aerojet Rocketdyne, which develops and manufactures advanced propulsion and energetics systems for rockets, spacecraft, and other space vehicles.

L3Harris has a history of generating free cash flow, and we would expect them to de-lever over the next several years.

We're not bothered by high debt levels if there's a reason why the debt levels are high — did they make a good acquisition? Do they have a history of paying down debt via free cash flow? Within the defense industry, typically the bigger you are, the stronger your moat position can be, and so consolidation has been a big part of the defense industry.

We feel **L3Harris** is guided by competent management, as judged by double-digit return on investment metrics. And its compensation structure, which is 85% tied to performance, aligns very well with shareholders.

Their valuation is very attractive, too, it trades at 17 times earnings, and I would expect them to be able to grow at low-double-digit EPS over the long term.

As I mentioned with **Abbott**, the health care industry offers both growth with lower volatility than the market. The defense industry shares these same attributes. Thus, if the market gives up some of the strong market performance it has achieved over the past year, **L3Harris** should outperform.

TWST: What do you pay most attention to with existing holdings in terms of ongoing portfolio management and risk management?

Mr. Shelton: Position size would be one of the main things we keep track of, and how we would define that is a stock that's over 5% position in the portfolio.

Also, the other way I look at risk management would be, if we are significantly overweight or underweight a sector. We're bound by the prospectus to not own more than 25% in any area, health care, for example. The 25% and the 5% are two ways to implement risk management, so you don't get too over your skis, so to speak.

You find some funds where their top three positions will be 15%, 18% of the fund, and if those stocks do great, fantastic, but you're also taking quite a bit of risk on as a shareholder.

TWST: Thank you. (MN)

MICHAEL L. SHELTON, CFA
Senior Research Analyst & Portfolio Manager
Nicholas Company, Inc.
(800) 544-6547
www.nicholasfunds.com

See next page for disclsoures.

Standardized Total Returns as of 12/31/23
1Year: 7.87% 5Years: 12.21% 10 Years: 8.46%
Expense Ratio: 0.70%

All Fund performance data reflects the reinvestment of distributions.

The returns represent past performance. Past performance does not guarantee future results. The Fund's investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance quoted above. Please visit our Web site at: www.nicholasfunds.com to obtain the most recent month-end returns.

Top Equity Holdings as of 12/31/2023

Microsoft Corporation	***3.31%***
JPMorgan Chase & Co.	***2.31%***
Abbott Laboratories	***2.17%***
TJX Companies Inc	***2.11%***
Charles Schwab Corp	***2.05%***
Lincoln Electric Holdings, Inc.	***2.04%***
Medtronic Plc	***1.99%***
Merck & Co., Inc.	***1.98%***
AbbVie, Inc.	***1.97%***
Equinix, Inc.	***1.92%***

Portfolio holdings are subject to change and risk.

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

Diversification does not assure a profit or protect against loss in a declining market. There is no guarantee that distributions will be made.

The information, data, analyses, and opinions presented herein (including current investment themes, the portfolio managers' research and investment process, and portfolio characteristics) are for informational purposes only and represent the investments and views of the portfolio managers and Nicholas Company, Inc. as of the date written and are subject to change and may change based on market and other conditions and without notice. This content is not a recommendation of or an offer to buy or sell a security and is not warranted to be correct, complete or accurate.

Any forecasts contained herein are for illustrative purposes only and are not to be relied upon as advice or interpreted as a recommendation. Prospective investors should consult their financial and tax adviser before making investments in order to determine whether an investment will be suitable for them. This is not an offer for any mutual fund mentioned other than Nicholas Equity Income Fund, Inc.

Mutual fund investing involves risk. Principal loss is possible. Investing in small and medium sized companies involves greater risks than those associated with investing in large company stocks, such as business risk, stock price fluctuations and liquidity. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer term debt securities such as limited liquidity and greater volatility. Investment by the Fund in lower-rated and non-rated securities presents a greater risk of loss of principal and interest than higher-rated securities. The Fund may invest in REIT's and other Real Estate Securities which involve additional risks related to the real estate industry. The performance of these securities is dependent on the types and locations of the properties owned by the entities issuing the securities and how well the properties are managed.

The Nasdaq 100 Index is a stock index of the 100 largest companies by modified market capitalization trading on Nasdaq exchanges.
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.
One cannot invest directly in an index.

Glossary of Terms:
Alpha - is a term used in investing to describe an investment strategy's ability to beat the market.
Compound Annual Growth Rate (CAGR) - is the annualized average rate of revenue growth between two given years, assuming growth takes place at an exponentially compounded rate.
Debt-to-EBITDA - is a ratio that measures the amount of income generated and available to pay down debt before a company accounts for interest, taxes, depreciation, and amortization expenses.
Dividend / Indicated Yield - The annual dividends per share divided by the price per share expressed as a percentage.
Earnings Per Share (EPS) - Company total earnings divided by outstanding shares.
Enterprise Value to Earnings Before Interest, Taxes, Depreciation, and Amortization (EV/EBITDA) - compares the value of a company—debt included—to the company's cash earnings less non-cash expenses.
EBITDA - Earnings Before Interest, Taxes, Depreciation and Amortization
EPS Growth - illustrates the growth of earnings per share over time.
Free Cash Flow (FCF) - is generally defined as cash flow from operating activities minus total capital expenditures. It may be specifically defined as Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) less Capital Expenditures and Interest Expense.
Free Cash Flow Yield - is a financial solvency ratio that compares the free cash flow per share a company is expected to earn against its market value per share. The ratio is calculated by taking the free cash flow per share divided by the current share price.
Gross Domestic Product (GDP) – is the market value of the goods and services produced by labor and property located in the United States.
Market capitalization - the total dollar market value of a company's outstanding shares.
Payout Ratio - a financial metric showing the proportion of earnings a company pays its shareholders in the form of dividends, expressed as a percentage of the company's total earnings. On some occasions, the payout ratio refers to the dividends paid out as a percentage of a company's cash flow.
Price-to-Earnings (P/E) multiple - measures a company's share price relative to its earnings per share (EPS).
Return on invested capital (ROIC) - is a way to assess a company's efficiency at allocating the capital under its control to profitable investments.
Standard Deviation - a statistical measure of the historical volatility of a mutual fund or portfolio, usually computed using 36 monthly returns.
VIX Index - a calculation designed to produce a measure of constant, 30-day expected volatility of the U.S. stock market, derived from real-time, mid-quote prices of S&P 500® Index (SPX℠) call and put options.
30-day SEC yield - A standardized yield computed by dividing the net investment income per share earned during the past 30-day period by the share price at the end of the period.

Quasar Distributors, LLC – Distributor

© 2024 The Wall Street Transcript, 622 3rd Avenue, New York, NY 10017