Berkshire
DIVIDEND STRATEGY

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Dividend Growth Commentary
3Q 2021

EQUITY MARKETS HAVE BEEN TRICKY THROUGH 9.30.21

We've come a long way since the depths of the pandemic, and many U.S. large-cap indices have gained well in excess of 50% since that time. This year the momentum continues largely uninterrupted, and stocks are posting solid gains from the mid to high teens. However, markets wobbled a little towards the end of the third quarter as Delta-variant issues surfaced, as well as a potential real estate problem in China. After outperforming since coming off the bottom of the pandemic, value stocks were about flat for the quarter, and growth indices posted slightly positive gains.

The macro picture remains cloudy, and making broad-based decisions based on it is generally not our style. But we still closely monitor indicators that market timers and macro strategists care about, as eventually these may affect our views of individual companies. China's real estate problems top the current list of worries, as does fiscal policy (infrastructure bills, potential tax hikes, etc.) and threats of a government shutdown. Add in some border issues and potential instability from the withdrawal in Afghanistan, and it becomes easy to see potential risk in the environment.

Long- term inflation is also in the news, as labor shortages and supply chain issues continue to push the cost of virtually everything much higher. Of course, the Delta variant and vaccination policies are also being hotly debated. But even with all the potential problems, we'll point out that earnings and corporate performance remain absolutely stellar, which in large part justifies the market's healthy advance. We are still optimistic fundamentals are good enough and valuations are reasonable enough to generate positive results over time.

FOCUS ON INTEREST RATES

But the big macro news that really does affect our outlook, portfolio positioning, and performance is interest rates.

Over short intervals — three (3) to perhaps thirty-six (36) months — performance can often be chalked up to idiosyncratic market movements that don't make a trend or make for meaningful analysis. Conclusions about investment results should be better when they are based on trends five years or longer. While that's true, there may be some bigger forces currently at work that are worth commenting on.

Recent manager performance, we believe has been dictated by two interconnected things: growth stocks and interest rates. Let's break this down, beginning with the start of the pandemic.

At the start, rates plummeted on fears of slow economic growth. Given many of the S&P 500's top companies are growth and technology stocks and have the allure of being transformative (and in many cases, that's true), investors believed they would thrive regardless of, or potentially because of, the pandemic. They were willing to pay up for these companies and ignore almost everything else — especially cyclical companies, which make up most of the value or equity income space. Interest rates dropped to all-time lows and locking up your money for 10 years in a U.S. Treasury got you a paltry 1.30% per year — and that's before inflation. So, a huge performance gap developed in which growth outperformed value by a wide margin, and this continued from March 2020 to about September 2020.

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IN THIS REPORT

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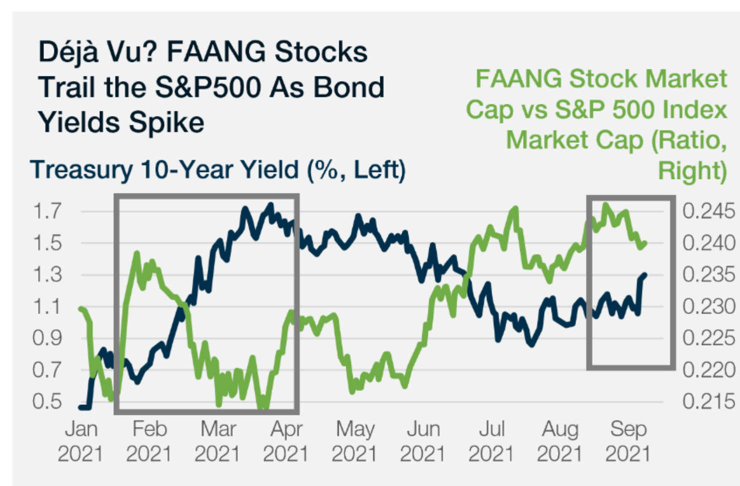
When we came out of the pandemic, people realized earnings from many companies would likely recover and they didn't need to pay 30+ times earnings for growth stocks to get growing earnings. So, a meaningful outperformance of value/equity income occurred from September 30, 2020 to March 31, 2021. Berkshire, along with other managers who follow a similar style, generated attractive advances. The Russell 1000® Value Index exceeded the Russell 1000® Growth Index by nearly 25%. (It's worth noting performance gaps can be made up in a hurry, especially when a large valuation anomaly exists.) Interest rates climbed to nearly 1.70% — still low, but rising steadily, which often happens during periods of economic expansion.

But from April through mid-September 2021, investor fears resurfaced regarding the Delta variant and potential real estate problems in China. The market briefly corrected by 5% on these fears. Rates again dropped to 1.30%, and growth outperformed value once again.

Late September 2021 brought news that may lead to yet another meaningful pivot. The Federal Reserve's meeting gave an upbeat view of the economy, and the Fed announced it was on track to make monetary policy slightly more restrictive. Interest rates again went higher, and like clockwork, value started outperforming growth in a meaningful way. A recent Bloomberg headline highlighted "Tech stocks lag on higher rates," showing how interest rates are driving investment returns.



Source: Bloomberg

OUTLOOK – WAITING FOR "NORMAL"

The point of all these twists and turns is to try to share with you how our portfolio is positioned now and how we believe it should perform as things return to "normal." What's normal? An economy and market environment where earnings growth is solid across a wide range of sectors, and interest rates rise from artificially low levels to levels consistent with positive real rates of return. This should help the areas of conviction in the portfolio — financials, industrials, and to a lesser degree, consumer, energy, and materials.

Right now, the portfolio appears to do relatively better when rates rise and economic prospects are favorable, which is consistent with our longer-term outlook for corporate performance. In times of volatility, time frames get short, but we are making our portfolio decisions based on three to five years, not three to five months.

"Normal" may seem a little elusive right now, but that's one reason we focus so much on company fundamentals and financial relationships that endure over time. The portfolio still performs more or less as we expect it to given changes in the environment. And if market trends are working against us, our portfolio still provides consistent results in the form of dividends. We find these aspects of our portfolio comforting during tricky times.

Even if you are not currently drawing dividend income, stocks with above-average dividends can work wonders for your portfolio over time. In our latest BONUS, we put together a report that shows the power of dividends:

https://berkmgt.com/wp-content/uploads/2021/09/The-Power-of-Dividends-and-Dividend-Growth.pdf

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