Berkshire
DIVIDEND STRATEGY

Berkshire Asset Management, LLC

46 Public Square, Suite 700
Wilkes-Barre, PA 18701
570.825.2600
www.berkshiream.com

Dividend Growth Commentary
1Q2021

THE STATE OF BERKSHIRE DIVIDEND GROWTH – A (KIND-OF) DIALOGUE

This market is raising all sorts of questions. Our behind-the-curtain look offers some potentially positive answers.

Spring is upon us, and so are the COVID vaccines. Finally, we can get back to something like normal! But as we poke our heads back out into the sunshine, we're finding that our investors have many questions and some lingering concerns about the state of their investments after a year of market and economic turmoil.

Fortunately, there is a lot of good news to report, if you know what to look at. Let's tackle the many questions we've heard head on as we provide our regular quarterly update.

1 | How has Berkshire survived the pandemic?

We are pleased to report that Berkshire is healthy and that our portfolio we feel has rebounded nicely. We've also seen healthy growth in our assets under supervision. We think our growth is attributable in part to our dividend-growth focus. We're a boutique shop, maybe, but we want to be the best at what we believe is the most beneficial strategy for the widest group of investors.

We remain committed to providing our clients with great communication and support, in addition to an effective strategy for meeting long-term financial goals. As always, we have reinvested in our operational processes to try to provide a better experience – we've always benefited from going to extra lengths for our clients.

2 | The market seems to have pulled a 180. How, and why?

What a difference a year makes. A year ago, the perception was that we were in the grips of a runaway pandemic that would lead to 30% unemployment, a massive recession, bank failures and dividend cuts. The "stay at home trade" – that is, buy growth stocks and nothing else – was in full effect. Interest rates were falling too fast, and oil actually traded at -$37 a barrel. Stock markets were tanking.

As of this writing, however, the pandemic is being contained (thank you big pharma), the economy is expanding, bank balance sheets are healthier, and we are wondering how fast dividends will rise. Interest rates look to be moving up, as are oil prices. Markets are pushing all-time highs.

We weren't too surprised to see this pattern of recovery, where value-oriented stocks with low P/E ratios and relatively high yields flipped from "bad" to "good." When evaluating managers in 2020, the below four data points were typically used:

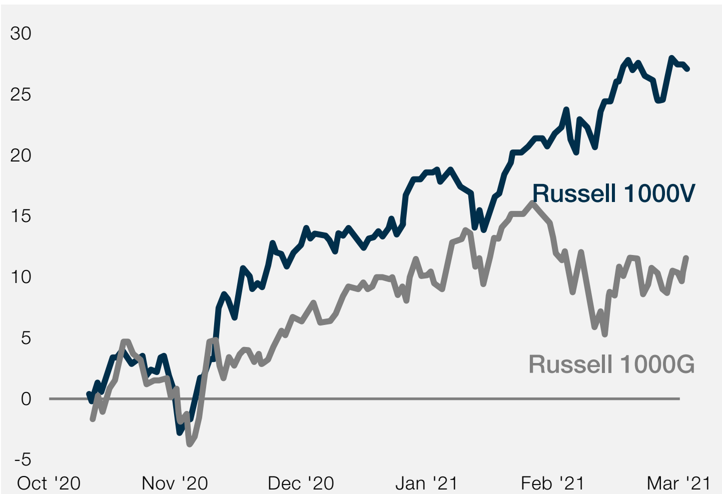
- What was your yield (higher did worse)?
- What was your average P/E (lower did worse)?
- How much tech did you own (more was better)?
- How much financials did you own (more was worse)?

Berkshire Asset Management, LLC (Berkshire) is a fee based, SEC registered advisory firm serving the portfolio management needs of high net worth and institutional clients. Our guiding principle is a belief that success can be achieved by combining rigorous, well-crafted investment processes with an exceptional level of client service and attention to detail. Asset Management with a Difference... Diligence, Integrity and Focus. Berkshire Asset Management, Inc. was formed in 1986 as a SEC registered investment adviser. In 1999 the company was sold to Legg Mason. In 2007, senior leadership repurchased the firm, forming Berkshire Asset Management, LLC, the company built to serve you today.

IN THIS REPORT

- Firm update
- The market's 180
- Value's renaissance
- Berkshire portfolio: sector by sector
- Select company highlights

This was a dreadful environment for the typical value manager. Many feared that value strategies would take forever to recover, if indeed they ever did. But the tide has turned. Since early September, value has outperformed growth by nearly 20%, and these four factors have flipped on their head in 2021. Portfolios with attractive dividend yields like Berkshire are coming back into favor and typically are performing better.



3 | Is the value renaissance real?

How many of you expected that, with the S&P 500 up more than 6% in the first quarter, the stock prices for Apple, Google, and Amazon would struggle? To us it seems to be a case of investors saying, enough is enough.

Now that the COVID vaccines promise a sustained recovery, investors are naturally drawn to the economy-sensitive companies that are most likely to benefit. But we see two important reasons the value renaissance could have legs.

1. **Predicted earnings.** According to Bloomberg data, 2021 earnings for growth companies are expected to rise by 21% on average. But for the average value stock, earnings are expected to rise by 50%+.
2. **Dividend rebound.** Dividend-paying stocks have been hesitant to raise their dividends, even though roughly 90% of our holdings have beat earnings estimates. Once the pandemic is clearly in the rearview mirror, we expect a rebound in dividend increases.

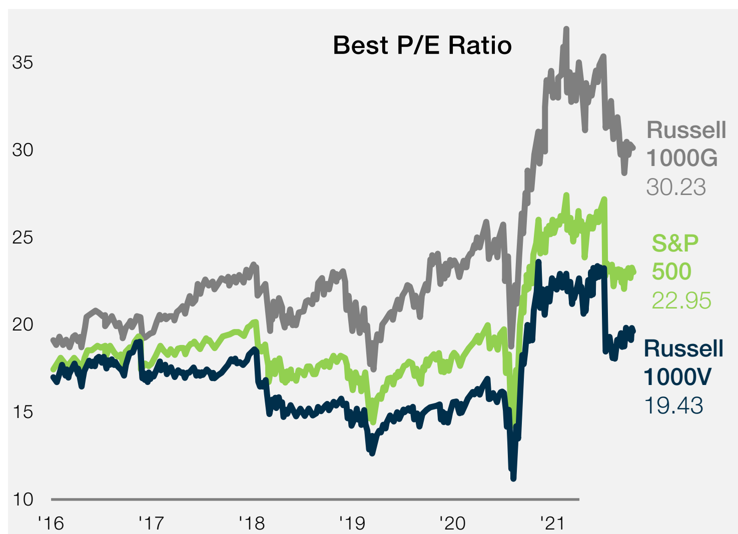
Still, caution is warranted. There is a lot of “get rich quick” energy in the markets. In our space, that means gains are being driven by many of the most distressed companies – those who are cutting dividends or not bothering to pay them in the first place. That is why, in the first quarter, Berkshire’s portfolio results were better than for the S&P 500 and significantly better than growth stocks but did not quite keep up with pure value indexes.

This is mostly a short-term concern. We find there’s a lot of value remaining in the high-quality, dividend-paying stocks we prefer. We also know that, in an environment of very low interest rates, investors are looking for reliable sources of income. In general, this bodes well for the sustainability of this trend.

4 | Yes, but isn’t the market expensive?

Many investors – and not incidentally, many media figures – are worried about what they fear is a broadly overpriced market. We agree with this concern…kind of. Taken as a whole, market multiples are relatively high. Moreover, there is a lot of weird stuff in the headlines: bitcoin speculation, meme stocks, and whatever the GameStop business was. It’s the kind of activity that always seems to pop up in an overheated market.

To dive more deeply into the numbers…based on historical price earnings ratios, we still see room for modest appreciation. Our historical regression analysis shows that from the current market P/E multiple, the S&P might earn 3-4% over the next few years – primarily thanks to an above average yield. We think value stocks or those with a higher yield have a better chance of a higher total return based on a similar statistical analysis.



But down in the more boring parts of the market, prices are more sedate. There seems to be no shortage of value stocks that have room for higher multiples even after the first quarter value rebound. Moreover, we are expecting a fairly robust round of upward earnings revisions for many value stocks as the economy comes back to life, which should support further value stock gains.

Our conclusion is that the market now has 3 tiers. Your average value stock still appears reasonably priced. Then you have the top holdings of the S&P 500, heavily concentrated in growth stocks, which appear to us to be anywhere from fully valued to richly valued. Finally, you have the “casino market” and the “robin hood” stocks. From our lens, speculation here is running amok. When people get on the web and start touting how [they pick stocks from letters in a scrabble bag](), it's likely to end poorly.

5 | What about higher interest rates, won't that kill dividend stocks?

The short answer is, not as long as dividends are rising.

With the economy expected to improve, it's a fair bet that interest rates will rise this year. And it's certainly true that rising rates will hurt prices for any income-paying security whose payouts are fixed or inflexible. But our strategy emphasizes firms with a history of dividend increases, and there are a lot of opportunities now because the same economic gains that are pushing up rates are also making dividend increases more likely.

6 | Why invest with Berkshire now?

We focus on dividend growth because we believe the strategy adds value to almost every investor portfolio in every market. Dividend stocks are an ideal way to diversify your sources of investment income, and historically they have reliably provided low-beta growth potential.

But there are several reasons we believe the Berkshire Dividend Growth strategy is a great investment right now:

- Berkshire is benefiting from market rotation toward value.
- An improving economy will likely benefit many of our holdings in the financials, industrials, and consumer sectors.
- We believe our portfolio is reasonably priced, especially compared with growth stocks and some of the more expensive names atop the S&P 500.
- Dividend stocks are attractive compared with 10-year bond indexes.
- Demand for these stocks should be high in a low-rate environment, which supports our expectation of rising stock prices.
- While interest rates are expected to rise in the next year, it could take several years before short-term bonds offer returns comparable to dividend stocks.

PORTFOLIO POSITIONING

Let's take a deeper look at the specific sectors and companies we find attractive in this market. As you will see, the portfolio is strongly focused on banks, healthcare, and industrials and cyclicals at this moment. In part, this positioning reflects our past experiences in managing through rising rate environments. But we also believe there are some compelling theses for investing in select firms in these sectors.

Banks

- **Positioning:** Financials is one of our largest sectors of conviction at nearly 19% of the portfolio. We believe banks in particular are offering a combination of growth, low valuation, and relatively high yield to shareholders.
- **Thesis:** The sector has been much maligned over the last 10 years, but we believe it offers compelling value, as well as dividend growth right now. On average, stocks in this category have a 2.3% dividend yield and only trade for 11 times earnings as of 3/31/21. (Source: Bloomberg)

  Financials, and banks specifically, are a solid "reopening trade" – they are poised to reap outsized benefits as Covid ends. Loan demand is expected to grow as the economy rebounds, and loan profitability should too. Their net interest margins should expand in a steep yield curve environment, where long interest rates rise while the Fed keeps short rates near zero.

  We see many examples of banks who are also succeeding through good operational practices, like controlling expenses and adding other sources of non-fee income. Risks in the sector appear muted to us because credit quality is relatively good right now. But our favorite reason is the dividend growth story. Banks could post the highest dividend growth of any sector over the next 12 months.
- **Company Spotlight: BAC**

  Bank of America (BAC) is leading the tech revolution in banking, investing $3.5B annually in technology to provide better digital services to its customer base. We see strong growth potential as interest rates rise and the yield curve steepens. By our calculations, every 100 basis-point move in the 10 year potentially yields an additional $1 in earnings per share. In addition, BAC has higher credit quality than even before the financial crisis. It is buying back about $3 billion of stock in the current quarter and hopes to continue that pending word from federal regulators. Prior to the pandemic, BAC was growing its dividend rapidly and we believe they will resume that trajectory after June 30th.

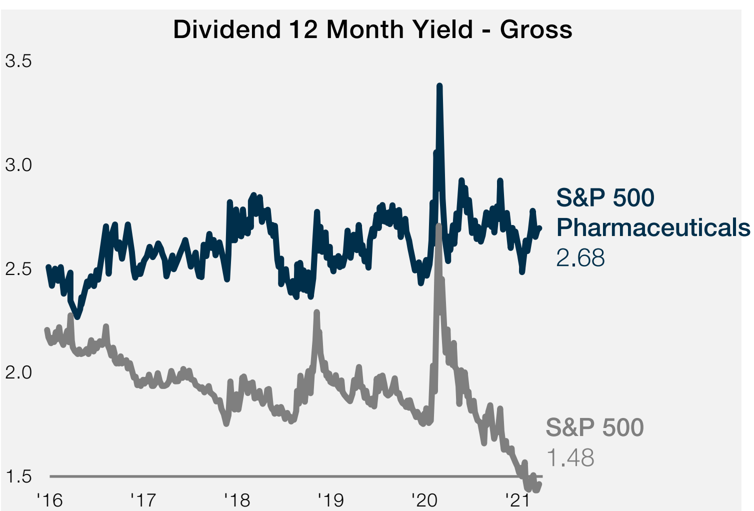
Health Care

- **Positioning:** You would think after saving the world from a runaway pandemic, health care stocks would be feeling the love! They're not, at least in the first quarter. Yet they remain an area of conviction in the Berkshire Dividend Strategy, at approximately 18% of the portfolio.
- **Thesis:** The sector remains cheap with below average P/Es and good growth prospects. We believe companies in this

space offer the best of American industrial innovation, efficiency, and excellence -- and that was on full display during the pandemic. We remain impressed at how fast companies like Abbott (ABT), Johnson and Johnson (JNJ), and Pfizer (PFE) provided much needed ventilators, test kits, and vaccines. Society has benefited greatly, and we believe patient investors could benefit too.

The big risk in the sector, as always, comes from potential regulation, especially as it relates to drug pricing. But the stocks now have a relative dividend-yield advantage over the S&P 500 not seen in years. For dividend investors, these stocks offer a combination of solid balance sheets, copious free cash flow, and potential for growth. Pipelines look attractive across many important classes of drugs, including oncology, hematology, MS, and genetic disorders.

But for a long-term investor, the real excitement resides in the transformative technologies that appear to be lying just beyond the horizon. Very recent advances in wearable health devices, big data, biotechnology, bionics, genetics, personalized medicine, surgical robotics, and even AI drug design all offer potential to become futuristic mega trends. The stocks might be a value today, but this is a growth industry folks.



- **Company Spotlight: BMY**

  Bristol Myers (BMY) – Loss of drug-patent exclusivity is always a concern with health care companies, and BMY has expiring patents. But BMY also has a strong pipeline, with eight new or upcoming launches that have potential for more than $20 billion in sales. BMY's acquisition of Celgene in 2019 is becoming fruitful, as a CAR T-cell therapy drug acquired through the acquisition received approval from the US Food and Drug Administration for multiple myeloma. At 8.4x earnings, we believe BMY is undervalued compared with its 5-year average of 14.6x earnings, and its peers at 13x earnings.

Industrials and Select Cyclicals

- **Positioning:** Companies that fit in these categories take up about 22% of the portfolio. This robust positioning makes sense to us as the economy reopens and GDP growth recovers. Valuations for these firms are lower on average than pre-pandemic levels, and dividend growth could reach 8-10% in the long term.

- **Thesis:** The sector is an obvious play on economic recovery. But the more compelling story is that, quietly, many boring old industrial/cyclical companies are transforming into high-tech innovators! These firms are learning to use increases in computing power, the "Internet of things," artificial intelligence, and other digital tools to expand their engineering capabilities and generate operational efficiencies for themselves and their customers.

  For example, Honeywell currently owns the world's largest quantum computing system. Quantum computing promises to tackle classically challenging problems across a variety of industries, from optimizing traffic control to refining supply chain logistics, and from discovering new drugs to detecting fraud more rapidly. We have confidence Honeywell will be able to turn that promise into sustainable growth.

  Down the road, we see these firms benefiting from renewed pricing flexibility and margin expansion as demand grows for their innovations. We have even sometimes caught ourselves referring to them as "growth cyclicals."

- **Company Spotlight: LMT and NSC**

  Lockheed Martin (LMT) is a classic holding for a dividend growth company. It benefits from sustainable defense spending, it's cash rich, and it offers a healthy dividend of 3%. It ended 2020 with a $147 billion work backlog and cash from operations of $8.3 billion, but it has a very reasonable P/E of 14X earnings.

  But Lockheed's capabilities go beyond traditional high-tech military weapons. LMT is generating numerous innovations in AI, quantum computing, and hypersonic technologies. They are reshaping traditional satellite GPS using "Dark Ice" – a series of 12-inch magnetometers that can provide much cheaper and reliable location paradigms for the military, maritime, and other commercial applications.

  Meanwhile, Norfolk Southern (NSC) is proof that even a REALLY boring old rail company can transform with technology. Predictive locomotive analytics, automated maintenance, and network designs all ensure more efficient transportation – ultimately helping margins and earnings. As a consequence, personnel and locomotive productivity were up 15% YOY in 2020.

Updates from Other Sectors

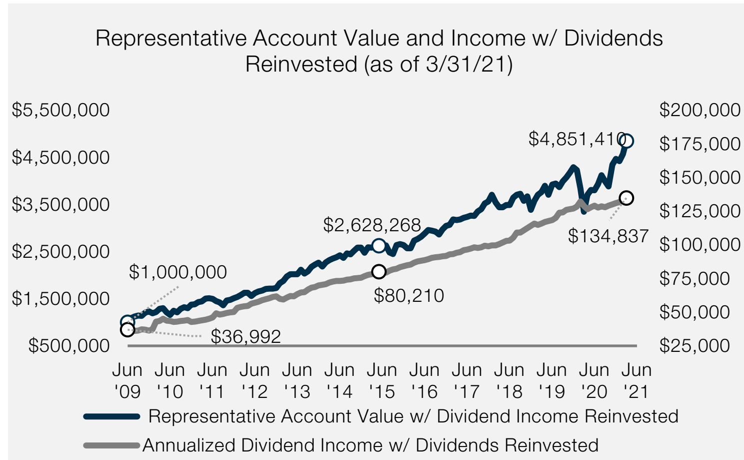
The portfolio has a weighting in **technology**, at approximately 17%. Our holdings don't typically include the sexier companies that make headlines, but we are drawn to some established mega-cap tech names with strong underlying fundamentals. Many are entrenched, mission critical companies with wide moats around their cash flow. Yields are modest, but valuations are mostly reasonable in our holdings. As the world continues to transform via technology, it is impossible to ignore their balance sheets, pricing power, and potential for dividend growth in these firms.

Consumer staples represent a modest weighting of less than 10% of the model portfolio. We prefer strong, reliable firms with generally consistent cash flow and history of dividend growth. We also like the fact they have strong brands to offset input costs and relatively low capital spending. They may be somewhat susceptible to higher interest rates, so we think it is important to be selective. For example, we recently switched out of Coca Cola to Pepsi based on a more diversified product line up and a better history of dividend growth.

We are generally underweight interest-rate sensitive sectors like **utilities**, **REITs**, and most **telecom** firms. We feel they have limited growth prospects, especially in light of their current valuations. As such they are at risk of underperforming in a rising rate environment.

DIVIDEND GROWTH

Finally, we'd like to show you the portfolio's dividend growth record over the past 10 years. We often argue that headline news and index results are more of a distraction than anything else – history shows that dividend growth is one of the best ways to make steady progress toward your personal income goals.



This chart is the proof in that pudding. Portfolio value has grown nicely over the past 10 years, as you would expect. But perhaps more importantly for an income-focused investor, annualized dividend income has risen substantially – and consistently! – over that time period, regardless of market activity. Steady progress toward your investing gwoals is a great comfort during economic or market turbulence.

This is the reason we focus so intently on executing a successful dividend growth strategy. We are pleased at the characteristics of our current portfolio – an overall P/E of 16x forward earnings, healthy growing companies, and a history of dividend growth – because we are confident it can sustain that tradition.

CONTACT BERKSHIRE:

Berkshire Asset Management, LLC

46 Public Square, Suite 700
Wilkes-Barre, PA 18701

570.825.2600
www.berkshiream.com