Berkshire
DIVIDEND STRATEGY

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Dividend Growth Commentary
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"STATE OF THE UNION?" – WHAT THE MARKET IS SAYING ABOUT DIVIDEND-PAYING STOCKS

Recently, one of our clients asked: "Give me the state of the union on dividends and the Berkshire portfolio." Here's a quick recap of that discussion, and a few others, based on questions we've fielded recently.

"Is it still OK to buy equities?" (Our most common question!)

Yes, we always believe equities are a good long-term asset. But the current market does present a few caveats.

- You should be willing to accept lower returns going forward.
  - The S&P 500 has returned roughly 18% annually over the past 3 yrs.
- Mid-single-digit annual gains would be a win over the next 3-5 years.
- While the S&P 500® and Nasdaq look expensive, value and equity income stocks still look reasonable.
- The possibility of rising bond yields could undermine stock performance, but continued robust economic growth should mute that effect.

Will there be a correction?

At some point, yes, but what else is new?

- The market has been correction free for a long time, so a little bit of caution is warranted.
- You should almost *always* invest as if there were going to be a correction and make sure your balance sheet and personal risk tolerance can handle it.
- Dividend stocks have historically proven resilient in corrections.
- Timing corrections has proven to be an exceptionally difficult game. Corrections are nearly impossible to predict, and it proves even harder to get back in because the news is typically bad.

Is the reopening trade real? Can the reopening trade come back to life?

We are believers that a genuine economic rebound is underway.

- The Fed remains very accommodative, and liquidity is exceptionally high.
- GDP growth could be 12% this quarter, and EPS growth could go north of 50% (off a horrible quarter this time last year).
- As with all rebounds, this one should boost earnings for cyclical businesses.
- Any inflation we experience may benefit dividend-growing stocks most.

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- Dividend Stock State of Union
- Inflation here to Stay?
- History Lesson: Dividends & Inflation

What is the outlook for dividend growth?

We are pleased with what the market is telling us.

- We've done a 180 from this time last year, when everyone was worried about mass dividend cuts. Now the question -- "How *fast* will they grow the dividend?"
- The trend is toward dividend increases, but we expect companies will remain conservative in their dividend policies.
- Valuations in our world are reasonable, and hidden growth opportunities are available in reasonably priced companies.
- Again, mid-single-digit growth expected over the next 3-5 yrs.

What sectors do you like?

Here's a quick rundown:

- **Banks** should benefit from higher interest rates, improving credit quality, and loan growth. Higher dividends and buybacks were recently announced thanks to exceptional capital reserves.
- **Industrials** are likely to be major beneficiaries of the reopening trade. We see potential for margin expansion and rapid earnings growth for select companies.
- **Health care** is compelling regardless of the economy. Several quality companies in this field offer strong cash flow and good product pipelines, and the valuations are very attractive.
- **Technology** stocks are attractive *if* you steer clear of the young guns and focus on "old" tech. There is an undeniable surge of new and powerful technologies, such as 5G or the internet of things. Many of the established players that are poised to benefit offer pristine balance sheets and reasonable valuation.

What do you **not** like in this market?

The short answer? Too much speculation and rising interest rates.

- We see a lot of "casino mentality" in chasing hot stocks and media darlings. Not to sound too old-school, but crazy speculation distracts from a logical investment thesis and creates poor investor behavior.
- Lots of Nasdaq-type names are in valuation rarefied air. The odds of their being able to justify current valuations and produce ongoing gains seem low.
- It's less headline-worthy, but if interest rates rise, it will challenge some market sectors. Utilities and REITs in particular are too interest rate sensitive, with limited growth potential.

What is the outlook for Berkshire's portfolio?

There's some good news and some bad news.

- High-quality value and dividend-paying stocks are, in our view, reliable plays. They generally offer steady returns, good protection against risk, and attractive valuations.
- However, in the short term, there's no accounting for investor taste. As long as investors chase after speculative growth stocks, or deep-value/low-quality names, our quality bias may limit us on a relative performance basis.
- This is what we've seen for most of the past year – value leaps out front, and then growth takes over as some new trend catches investor fancy.
- In the longer term, we also worry about the state of interest rates and inflation. There has been a lot of easy money sloshing around, driving up prices. What happens when the punch bowl gets taken away? Also, profligate government spending and higher taxes are not exactly stimulative. Is stagflation around the corner?

Conclusion?

All in all, we think it's an OK time to put money to work in dividend equities – maybe not full allocations, but you have to play to win. We do, however, think it's prudent to use dividend equities to "de-risk" portfolios. We see froth in areas of the market, and there is certainly an opportunity to capitalize on gains and shift portfolios to more risk-balanced allocations.

Those decisions are never exact, and never easy. There is no all-clear sign in investing. But over time, the trend is up. Market activity in the next 12 months is anybody's guess, but we think at these prices and fundamentals, dividend stocks can provide a decent return going forward.

DIVIDENDS AND INFLATION – A HISTORY LESSON

Now that we've examined what the market is telling us today, let's dive a bit deeper into some historical lessons about dividend performance. This again comes from a client question: **"How do dividend growth stocks do in periods of high inflation?"**

Inflation has been a big question mark this year. Consumer price index (CPI) observations have been high, but the Fed insists these pressures are "transitory." This may be true to a degree. There are unique supply/demand forces at work (thank you, COVID-induced supply chain disruptions) but ultimately, we believe inflation is a monetary phenomenon. There are too many dollars out there chasing goods and services.

Prior to the pandemic, commercial banks held $12 trillion in deposits; now deposits have soared to $17 trillion. As the perceived value of a dollar goes down (from a massive supply of them), people may demand more of them to keep their purchasing power constant. So nominal prices will go up.

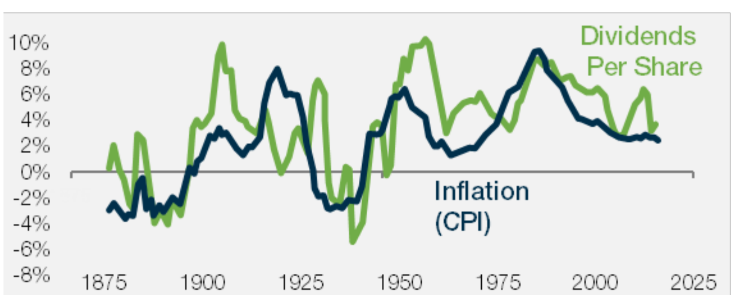
(Source: Bloomberg)

Statistically, inflation has been kept in check since 1982. Rates have ebbed and flowed, but secularly have gone down to ridiculously low levels. So, we have somewhat limited data about how dividend stocks perform with higher-than-usual inflation and higher rates. Our thought was to compare dividend aristocrats (a good proxy for dividend growth stocks) against the S&P 500® when monthly inflation (as measured by CPI) ran over 4%, and when it ran over 3%.

S&P 500® DIVIDEND ARISTOCRATS PERFORMANCE, 7/1/1991-6/30/2021

1. Monthly CPI YOY of +4% or greater, 18 observations
    - During these observation months, the Dividend Aristocrats outperformed S&P 500 by +1% on average.
2. Monthly CPI YOY of +3% or greater, 96 observations
    - During these observation months, the Dividend Aristocrats outperformed S&P 500 by +0.65% on average.
    - Absolute total return during +3% CPI observation months: **S&P 500® Dividend Aristocrats** +78% vs SPX +17%

(Source: Bloomberg)



(Source: Dividend.com)

3 THEORIES ON WHY DIVIDENDS OUTPERFORMED

Duration Theory. Since value and dividend stocks are generating more cash flow in the early years (and subsequently paying them out to shareholders) and growth stocks tend to have their cash flows farther out, value/dividend stocks essentially have lower duration. Like higher-coupon or shorter-duration bonds, they should do better as rates rise. Expectations for brisk economic growth and/or inflation are often accompanied by these higher rates. Recent price action seems to bear this out. When the 10-year Treasury goes up in yield, value seems to do better, and when rates go down, growth seems to do better.

Cyclicality Theory. Rising rates could also be a signal the economy is growing. During periods of strong economic growth, earnings are broader and cyclical-type stocks may have strong earnings. These cyclical-type stocks – i.e., industrials, financial services, energy, real estate, etc. – could often pay a dividend as well.

Growing Cash Flow Theory. Finally, it's all about the allure of growing cash flow. As people decide there is inflation, they flock to assets that might give them a pay raise.

As always, the economy and markets are fluid. Technology disruptions, a unique COVID landscape, and a globalized economy are all aspects to study as you build a stock portfolio. You can't just rely on a single indicator and predict outcomes. But overall, we do believe that dividend stocks, and dividend growth stocks in particular, are positioned very well relative to the broader market.

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Definitions: The S & P 500 Index is a market capitalization weighted index of the largest 500 U.S. stocks. It is a market-value weighted index (stock price times # of shares outstanding), with each stock's weight in the index proportionate to its market value. The index is designed to measure changes in the economy and is representative of most major industries. You cannot invest directly in an index. Beta is a measure of volatility vs. an index. Current yield is the mean estimated annual dividend amount based on current calendar year, divided by the current stock price. Dividend Payout ratio is the fraction of net income a firm pays to its shareholders in dividends, in percentage. Forward Price Earnings Ratio (P/E) is the ratio of the price of a stock and the company's projected earnings per share.