Berkshire
DIVIDEND STRATEGY

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Dividend Growth Commentary
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EXECUTIVE SUMMARY 2021

S&P 500 EPS surprised massively in 2021. Estimates started the year at $190 and ended up at $223. Even in normal times, predicting earnings is hard.

Few called for a huge rally this past year, (especially in the wake of rising rates and endless COVID) yet the S&P 500 gained roughly 28%. Market timing is hard.

If we polled in Jan 2021 – "which stock will outperform this year… Zoom (ZM) or Bank of America (BAC)" – we suspect few would have picked Bank of America (BAC). And even fewer would have predicted Zoom would end 2021 down roughly 50%. Sticking with value stocks when so many sexy growth stories are "working" is REALLY hard!

While we were not perfect, we believe Berkshire Dividend Strategy enjoyed a solid year. Our goal is not to indict others or do any kind of victory lap. A manager's race is NEVER over and value still owes us all a huge rotation! Instead, our goal is to keep investors focused on the activities we believe add the most value over time: quality and valuation vs. market timing and a singular obsession on rate of earnings growth. What adds the most value over time? We believe it's the ability to stay invested and let stocks compound OVER TIME. 2021 once again proved that's hard given the crazy macro environment. Staying invested is a simple concept – but certainly not easy.

(Source: Bloomberg)

BERKSHIRE DIVIDEND GROWTH PORTFOLIO HIGHLIGHTS 2021

- # Of Dividend Increases: 34 out of 36 Companies – No Dividend Cuts
- Dividend Growth – Simple Average: 7.5%
- Total Return Estimate Net of Fees: 23.50%
- Top Performing Sectors: Financials, Tech and Energy
- Bottom Performing Sectors: Staples, Cyclicals and Health Care
- Current Forward P/E as of 12.31.2021: 14.95
- Current Dividend Yield as of 12.31.2021: 2.55%

BERKSHIRE OUTLOOK

Inflation, interest rates, and their impact on valuation are going to be critical market topics in 2022. Wage, commodity and supply chain problems are real and will likely persist. However, lower fiscal stimulus (the kind that goes directly to consumer wallets) should be incrementally lower post Covid, and the Fed is likely going to tighten monetary conditions. These should moderate inflation. But strategies that immunize specific cash needs and provide real increases in purchasing power will remain in demand.

We think earnings and the economy should be ok as long as: inflation isn't the runaway kind, geo politics are drama free and China doesn't have a credit problem. Still, it's usually the thing

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IN THIS REPORT

- 2021 Executive Recap
- 2022 Outlook
- Berkshire Firm Update
- Equity Selection Process

no one is talking about that can cause the most pain. Valuations are at the higher end of the range. An overvalued market does not guarantee corrections, crashes or negative returns, but common sense would say they portend lower returns going forward. Speaking of corrections, they are inevitable and have averaged about 14% per year and a 30% correction blows through every 5 years. Allocate and moderate expectations accordingly. Rebalance when opportunities arise.

(Source: Bloomberg)

A REVIEW OF BERKSHIRE AND THE INVESTMENT PROCESS

At year end it is our tradition to update you on our firm and to review the investment process.

Our current business fundamentals are the strongest in our history

- Ownership: 100% employee owned with more than a 30-year operating history*
- Extremely low professional turnover
- Controlled, measured growth
- Low overhead cost structure enhancing the long-term stability of the firm

Our investment principles remain consistent and focused

- Deliver quality investment results
- Narrow focus on large cap dividend investing
  - Enduring dividend growth to meet client goals and objectives
  - "Forward looking" fundamental process vs. backward looking screening

Our service model provides distinguished support

- Maintain premier boutique status
- Direct and substantive communication
- Customized portfolio management

DIVIDEND STRATEGY PROCESS REVIEW

The Berkshire Dividend Growth Strategy's primary objective is aimed to generate a growing stream of equity income through investments in a diversified portfolio of stocks generally with a high, safe and growing dividend. If we are able to achieve this primary goal by purchasing vibrant growing companies with fine economic prospects, capital appreciation should follow. A risk profile below that of the average stock in the S&P 500 is also viewed as desirable. Because of its dividend growth orientation, the portfolio also seeks to perform better than non-dividend paying stocks or bonds in a rising interest rate environment.

EQUITY SELECTION PROCESS

We believe intelligent dividend investing is not just composed of shopping for the company with the highest yield. Our process spans three dimensions: current level of dividend, safety of the dividend, and importantly, the growth of dividend.

CURRENT DIVIDEND

First, we identify companies that have a dividend yield at least that of the S&P 500, preferably higher. Companies that fit these criteria should perform better in a slow growth economy and should provide a cash buffer through equity market volatility. In certain instances, the portfolio may purchase securities with nominal or below average dividends, but only if there is a clear and relatively certain path to normal cash payouts. Philosophically however, we don't believe in paying a high price for a future promise.

STABILITY OF DIVIDEND

A dividend springs from excess profits after a business satisfies all other providers of capital. Since the shareholder is last in line to get paid, as analysts we wish to fully understand the claims of a shareholder by assessing other senior capital positions first. This is why companies with high levels of debt and/or volatile businesses can be undesirable holdings. A profitable business that has too much debt may have little left over to pay shareholder dividends. So, we spend considerable time evaluating the company balance sheet:

- **Debt to Equity Ratio:** How much of the total capital is funded by debt vs. equity?
- **Times Interest Earned:** How often do operating profits cover the interest expense?
- **Credit rating and liquidity of underlying debt if applicable:** Bond market spreads and credit ratings provide another view into the company's ability to fund itself.

GROWTH OF DIVIDEND

If our portfolio is going to provide an effective hedge against inflation and provide appropriate cash flow, it is critical that the company under evaluation demonstrates the prospect for future dividend growth. This is one of the most important parts of our screening process and what makes our strategy unique relative to other dividend strategies.

First, we seek a company that has a history of raising the dividend. This gives us good insight into management's view of the dividend, how they allocate shareholder capital, and prospects for growth opportunities within the business itself.

A key metric we use to quantify growth prospects is return on shareholder equity or ROE. In our opinion, return on equity (ROE) is the best financial yardstick to identify, evaluate and compare the desirability of investments. ROE is the rate of growth a company can maintain in its earnings and dividends, without needing to raise capital. By decomposing ROE into its component parts, we understand the 4 key dynamics that drive company profitability, namely:

- **Operating Margins**: *Operating Profit/Sales* "How profitable are core operations?"
- **Asset Turnover:** *Sales/Assets* "How capital intensive is the business?"
- **Leverage:** *Assets/Equity* "How much does the company's use of debt affect returns?"
- **Tax Retention:** *Pretax Income/Net Income* "How well does the company manage its tax obligations?"

Keep in mind there is no "right" number for ROE or any one of the individual components. Some companies have high but volatile ROE's and some companies have lower but highly stable ROE's. Both can be equally desirable. Companies that have very stable operating margins and consistent sales growth (such as drugs or consumer staples) can utilize more leverage than companies that are more cyclical (such as semi-conductors or energy companies). In the end the evaluation of ROE can be a highly reliable metric. Other subjective factors which may play into our process include competitive positioning in the company's end markets, intangibles such as brands and patents, past acquisition strategies of management, and volatility of earnings, just to name a few.

SUMMARY OF PROCESS

While there are many factors, some quantitative and some qualitative, the goal is to buy companies with an attractive, safe and growing dividend and a risk adjusted total return profile that is superior.

SELL DISCIPLINE

A company is typically sold when it: reaches a price beyond our estimate of intrinsic value, ROE falls below acceptable levels, loses its superior competitive position in the market place, abandons sound dividend policy, increases debt to uncomfortable levels or does a misplaced acquisition.

PORTFOLIO CONSTRUCTION

As long as there are attractive candidates, the portfolio will attempt to be broadly diversified across a wide range of sectors. While the portfolio will be largely "bottom up", consideration to macro factors may play a minor role. At any one given time, certain portfolios in aggregate, may appear more attractive than another (fundamental or valuation wise). However, large or extreme sector concentrations relative to the benchmark in general should not occur. We seek a final portfolio with reduced systematic risk, above average quality and lower volatility. From a cash flow perspective, we believe a typical Berkshire portfolio can deliver dividend growth of at least 7.5% per year, and the portfolio yield should exceed the S&P 500. If our companies deliver on earnings and dividends, attractive appreciation should follow -- thus providing strong total return characteristics.

RISK AND PERFORMANCE CHARACTERISTICS

We owe our investors a frank discussion of potential risks associated with our strategy and baseline expectations of our performance in various market conditions.

Dividends arise from the profits of a business after all other legal obligations to other providers of capital have been satisfied. These include trade creditors, bank loans, senior bond holders, subordinated bond holders, preferred shareholders and of course taxes owed to the government.

The dividend is last in line. So, while these claims are mandatory, dividends are paid at the discretion of management. Some managements view growing the dividend as an "implicit promise", while some managements want to remain flexible to right size the dividend to adapt to changing business and capital needs. For a very stable business with low capital needs, the former approach is appropriate. For businesses that have higher capital needs but perhaps higher growth prospects, the latter approach is appropriate. Dividend policy often sends a powerful signal about how management views its own prospects. Management needs to make tradeoffs between growing the business and maintaining the dividend. Not all decisions will be correct.

There are no guarantees even the best businesses remain profitable, that past growth rate of dividends will continue, or that management will remain committed to its dividend. So, there have been instances where a dividend appeared “safe” only to have management cut it at some point due to: deteriorating business conditions, or even they, at their discretion, find what they think is a better use of the money. In aggregate, we believe our screening and fundamental research is effective at selecting the managements capable of generating the type of cash flow growth our clients expect.

As for share price fluctuations, we stick to the premise that risk and return are directly related. The Berkshire Dividend Strategy seeks a risk posture that is below that of the S&P 500. So, in theory the portfolio should perform better in a declining market, but we are realistic for its prospects in a rapidly rising market – particularly one characterized by speculation and where low-quality assets are coming back in favor. Still, in that rising market we expect a total return that will beat inflation and satisfy individual client objectives.

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