Berkshire
DIVIDEND STRATEGY

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Dividend Growth Commentary
3Q 2023

S&P 493

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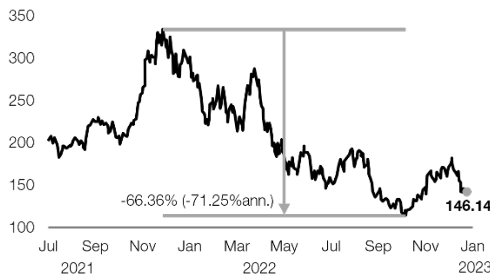
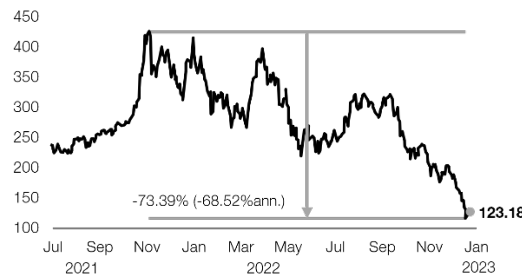
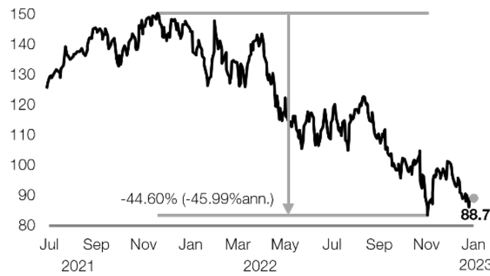
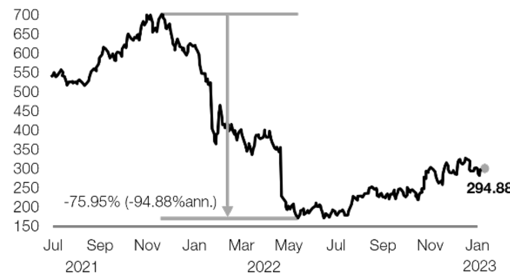
The growth stock frenzy, partly fueled by AI, is on full display in '23. Many managers focused on value investing express their concerns about the market's narrowness. Only a few large companies, with high price-to-earnings (P/E) ratios, appear to be driving the market to new highs, while the average stock remains relatively flat. I'm sure we all sound like we are whining, but we believe the math is clear. If we exclude the returns of the seven largest companies in the index, its performance drops by ~80%. In other words, the "S&P 493" would only be up ~2% year to date (Source: Bloomberg as of 9.30.2023). Moreover, most of these high-growth companies do not provide significant dividends, making such a comparison irrelevant to our investment mandate. And if downside is at all a concern, how does it make any sense to chase some of the most popular growth stocks when many were down 50-70% just last year? (Source: Bloomberg)









(Source: Bloomberg)

AI speculation harkens memories of '99. Remember, every company became an internet company. Yes, the internet paradigm didn't just benefit a handful of early pioneers… the technology broadened out and most companies figured out how to adapt and best leverage. This technology shift led to increased productivity across the broader economy and created secular tailwinds for the following decades. We envision a very similar path for AI. The handful of companies grouped in the AI trade are not the only ones that will likely benefit… Business leaders across the globe are exploring AI business applications. And just like the internet, AI could permeate all sectors of the economy and may provide tailwinds for the decade ahead.

Moving on to the value index, it is interesting to observe that even within the Russell 1000 Value, a considerable portion of the returns can be attributed to growth/AI-oriented names. Companies such as Salesforce, Meta, and Alphabet became value index components, despite traditionally high P/E ratios and no meaningful dividends.

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 December 2022, iM Global Partner, a leading global asset management network, made a strategic, non-controlling investment in Berkshire.

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Berkshire Hathaway is the largest constituent in the value index and it's up nearly 20%. Its P/E appears low, but pays no dividend. (Source: Bloomberg as of 9.28.2023)

Nerd Alert. Another factor to consider is that due to index constructions and rebalancing methods, many of these stocks will now be excluded from the index because their price-to-book value exceeds the index thresholds. Therefore, even if a manager like us suffered a negative attribution effect, by not owning these stocks during their ascent, we will not receive credit for outperformance relative to the benchmark if they are to decline from their current levels. It's baked into the calendar year number permanently. It is crucial to understand the nuances and intricacies of index construction when evaluating a manager's performance against a benchmark.

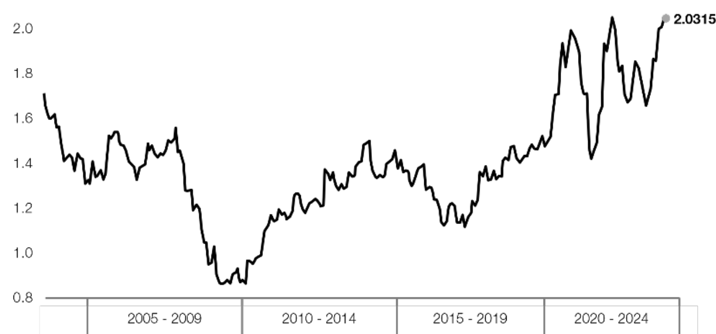
LEADERSHIP CHANGE?

What will spark a change in leadership? While some argue that earnings growth alone drives stock returns, our perspective differs. We firmly believe the price you pay for growth determines future returns.

Data shows that when you pay more than 40 times earnings for growth stocks, as is the case now, the average return 10 years later is around 1.5%. On the other hand, if you pay approximately 17 times earnings for value stocks, the average return over the same period is about 6.18%. (Source: Bloomberg based on 30 years Shiller P/E regression analysis) These figures are annualized returns, meaning that a $100,000 investment would grow to $116,000 in growth stocks and $182,000 in value stocks, based on these historical averages. It is worth recalling that growth stocks experienced a nearly 30% decline, while a typical value portfolio may have only suffered low-single-digit losses in 2022.

Recent dynamics show a change may be underway. As the market dropped in September and risk aversion appears to be increasing, value stocks outperformed growth. Sure, there is a way to go, but gaps can close quickly as we witnessed in 2022. (Source: Bloomberg)

Risk-wise, we won't prognosticate too much on "hard-landing/soft-landing/no-landing" but we believe it is hard to argue that growth isn't going to slow meaningfully when we sit with a deeply inverted yield curve, high inflation, and a national mortgage rate that now averages about 7.5%.



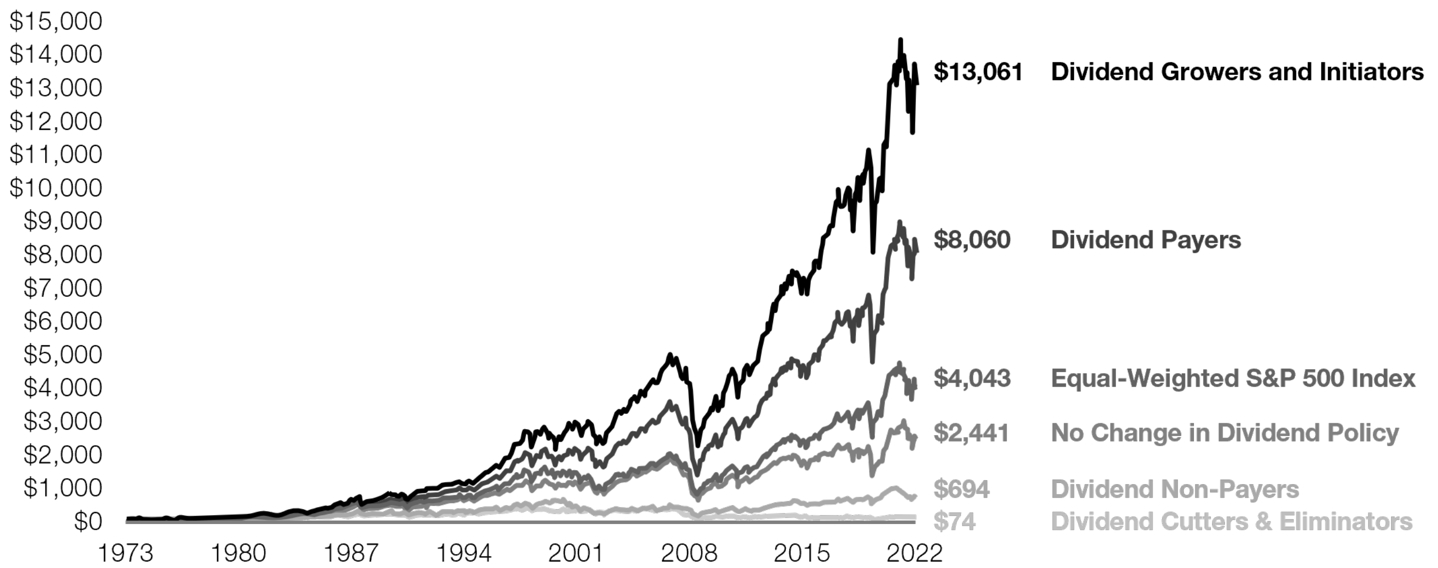
(Source: Bloomberg)

ATTRIBUTION DISCUSSION

It is also important to evaluate the sectors and stocks working for and against us in the current market environment. In some ways, 2023 has turned out to be the opposite of last year. Value stocks that were winners previously have now become losers, while growth stocks have undergone a noticeable shift. The communication sector, which heavily impacted our portfolio last year, has rebounded significantly, but it has become challenging to find companies with strong balance sheets and substantial dividends in this sector. Our industrial sector selections, which performed well last year, are currently facing headwinds despite a strong economy and solid earnings. Furthermore, our bank holdings have been affected by uncertainties surrounding recession fears and commercial real estate, keeping prices low. While it seems unlikely these stocks will grow as we initially expected, their low price-to-earnings ratios and above-average yields offer some consolation. Recent dividend increases in the sector were also better than anticipated. On a positive note, our healthcare stocks have shown signs of improvement in the latter half of 2023, and we remain committed to a few battle-tested tech names.

COMPOUNDING WEALTH OVER TIME?

To recap let's revisit the goals of Berkshire's equity strategies. We aim to generate dividend income, grow income, and minimize downside risk compared to the overall market. This approach appears to provide a path for investors to consistently compound wealth over time. Our intention is not solely to beat a benchmark or chase after the latest high-growth stocks to "make as much money as possible". Other managers exist for that type of investment objective. For a host of reasons, we believe the outlook for those strategies may be less appealing than usual in the current environment.



(Past performance does not guarantee future results. Indices are unmanaged and not available for direct investment. For illustrative purposes only. Data Sources: Ned Davis Research and Hartford Funds, 2/22 - https://www.hartfordfunds.com/insights/market-perspectives/equity/the-power-of-dividends.html)

We encourage investors to think of our portfolio as a permanent part of their financial fortress, much like they would regard a family business or a real estate portfolio. Few investors would abandon their business or real estate just because one swath of the stock market was "hot", so we don't encourage them to abandon high-quality dividend-paying companies either. We continue to believe in active management and maintaining a fully invested sleeve within our strategy rather than attempting to time the market. We believe the best time to allocate funds to a strategy is when fundamentals are reasonably good but relatively unpopular, as is the case now. We are consistently looking to upgrade the portfolio by identifying lower-risk companies with better yields and growth profiles accompanied by attractive valuations. We believe our decision-making process is thoughtful and well-reasoned, reflecting our high conviction and belief that the odds are in our favor when changes are made.

Thank you for your continued participation in our investment strategy. We value your partnership and look forward to navigating the evolving market landscape together.

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