Berkshire
DIVIDEND STRATEGY

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Dividend Growth Commentary
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THE NEW "AB-NORMAL"?

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Happy New Year,

Reflecting on 2023, what a year…again! Massive bank failures, wild moves in interest rates, AI mania, concentrated indices, unprecedented shifts between investment styles, and global unrest.

Every year it seems there is something that makes you say "Wow. What a year!" Perhaps "ab-normal" is the new normal?

Investment-wise, 2023 will be remembered as a relatively challenging year for strategies that lean towards a "value-oriented" style.

While chaos, speculation, and "new investment abnormalities" personified 2023, Berkshire shall remain steadfast to the pillars of its investment strategy. Quality… reliable cash flow and dividends…reasonable prices that may provide upside AND a reasonable margin of safety.

Thank you for your continued participation in our strategy, which we believe is poised to thrive in an evolving and potentially challenging investment landscape.

As we enter the new year, it is customary to review our approach to buying businesses for your portfolio. Below, please read the step-by-step methodology by which we evaluate companies.

DIVIDEND STRATEGY PROCESS REVIEW

The Berkshire Dividend Growth Strategy's primary objective is intended 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 can achieve this primary goal by purchasing vibrant growing companies with fine economic prospects, capital appreciation can 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.

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EQUITY SELECTION PROCESS

Importantly, we believe intelligent dividend investing is not just composed of shopping for the company with the highest yield. Our process spans across three dimensions: current level of dividend, "safety" of the dividend, and notably, 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 may perform better in a slow growth economy and could 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 pays off all other providers of capital. Since the shareholder is the last in line to get paid, as analysts we wish to see how substantial the claims of individuals in a senior capital position are to us. This is why companies with high levels of debt and/or volatile businesses can be undesirable investments. A profitable business that has too much debt can find the company 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 demonstrate the prospects for future dividend growth. This is one of the most important parts of our screening process and what we believe 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. A company that has very stable operating margins and consistent sales growth allows for management to utilize (think drugs or consumer staples) versus a company that is more cyclical (think semiconductors or energy companies). In the end, the evaluation of ROE can be a highly reliable metric. Other subjective factors that 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 so that the risk adjusted total return profile 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 marketplace, 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 economic sectors. While the portfolio will be largely "bottom up" some 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. In aggregate, we seek a final portfolio: reduced systematic risk, above-average quality, and lower volatility. From a cash flow perspective, we believe a typical Berkshire holding can deliver cash flow growth of at least 7.5% per year, and the yield on the portfolio should exceed the S&P 500. If our companies can deliver earnings and dividend wise, attractive appreciation should follow and 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 management teams view growing the dividend as an "implicit promise", while some managements want to remain flexible to right size the dividend if they need to adapt to their 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. We believe our screening and fundamental research will be effective in aggregate 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 could perform better in a declining market, but we are realistic about 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 can potentially beat inflation and satisfy individual client objectives.

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