DIVIDEND STRATEGY PROCESS REVIEW

The Berkshire Dividend Growth Strategy’s primary objective is to generate a growing stream of equity income by investing in a diversified portfolio of stocks which we believe have: attractive, consistent and growing dividends. We believe if we are able to achieve this primary goal by purchasing growing companies with solid balance sheets, capital appreciation will follow. A risk profile below that of the average of 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.

ECONOMIC CONDITIONS FAVOR A DIVIDEND ORIENTED STRATEGY

Over time, dividends have made up a substantial portion of the total return generated by US stocks. While relatively high, healthy growing dividends rarely “go out of style”; the current economic conditions may make a dividend component even more important. Excessive borrowing (‘leveraging’) had a profound but artificial growth effect on our economy throughout the 1980’s, 1990’s and 2000’s until the credit bubble burst in 2008. Since then, consumers, businesses and many governments have been forced to pay down debt. This paying down of debt (“deleveraging”) is having a retarding effect on world economies. Economic growth is likely to be positive but below average for some time. Although, a 2-4% dividend may have been viewed as a “quaint” in a roaring stock market, now it is likely to make up a large part of an investors total return. Many high quality dividend paying stocks offer an attractive alternative to certain fixed income investments and offer investors the chance to grow cash flow vs. accepting a fixed one. What’s potentially more exciting is many of the equities that fit our evaluation criteria are trading at valuations that are relatively inexpensive.

EQUITY SELECTION PROCESS

Importantly, we believe that 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, relative 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 clear relatively certain path to normal cash payouts. Philosophically however, we don’t believe in paying a high price for a future promise.

POTENTIAL RELIABILITY OF DIVIDENDS

Dividends spring 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 individual 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 itself 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 as opposed to equity.

**Times Interest Earned:** How often do operating profits cover the interest expense?

**Credit rating and liquidity of under lying 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 client 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 makes our strategy unique relative to other dividend strategies.

First we seek a company that has a history of growing 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 dissecting ROE into its component parts, we understand the 4 key dynamics of 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 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 is a reliable metric that helps us forecast future dividend growth. 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**

So while there are many factors, some quantitative and some qualitative the goal is to buy companies with an attractive, consistent and growing dividend so as the risk adjusted total return profile is superior.

**SELL DISCIPLINE**

A company is typically sold when its yield falls below that of the S&P 500, its ROE falls below acceptable levels, loses its superior competitive position in the market place, the company abandons sound dividend policy, increases debt to uncomfortable levels or does a misplaced acquisition.

**PORTFOLIO CONSTRUCTION**

So 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. We seek reduced systematic risk, above average quality and lower volatility. From a cash flow perspective, we believe that a typical Berkshire holding can deliver above average dividend increases. The yield on the portfolio should exceed the yield of the S&P 500. If our companies can deliver earnings and dividend wise, attractive appreciation should follow and thus providing strong total return characteristics.

**POTENTIAL 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’s 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 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 risk and returns 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 still expect a total return that will beat inflation and satisfy individual client objectives.

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