Berkshire
DIVIDEND STRATEGY

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Dividend Growth Commentary
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Happy New Year

CALM, PANIC, RECOVERY + BERKSHIRE'S ALL-SEASONS STOCK PICKING PROCESS

It's an annual Berkshire tradition to remind clients of how we pick stocks in our year-end commentary. But this was no normal year, so first we reflect on the events of 2020.

Calm:

2020 started with relative calm. The market hit all-time highs. Earnings were growing, and valuations still looked reasonable in most sectors (even if some sectors, like technology, were starting to look stretched). Most analysts reported their usual "cautious optimism," and investors were seeking another year of modest gains.

Panic:

Then Covid hit, rendering virtually every macro forecast utterly useless. Markets descended into chaos and many of the same media folks who made rosy forecasts were now predicting economic calamity.

The investment lesson is markets are prone to shocks exactly like these – that's the very nature of risk. Stocks decline sharply when things like Covid come out of left field. The other lesson: reality is never quite as good, nor quite as bad, as things seem on the surface.

In most cases, Berkshire tried to assure investors a path to recovery was possible and wholesale liquidation of stocks was probably not the right call. Amidst this panic, we were as surprised as any to see value stocks, or stocks with a dividend yield component, fall more than the averages.

Recovery:

Stocks indeed recovered mightily toward year end. Earnings forecasts proved to be bad, but not as catastrophic as feared. Meanwhile the nation adapted with mitigation and treatment strategies, and by fall there were legitimate vaccine candidates.

Stocks have soared from the depths of this crisis, but the story does not end there. The recovery created 2 markets – one where growth stocks, speculation and new business models racked up huge gains, and another characterized by pedestrian returns for value stocks. Berkshire strategies generally fall into this latter camp, but we are pleased that most equity portfolios were positive for the year after being down sharply in February and March.

Observations:

The valuation gap between growth stocks and value stocks is now higher than it was during the dot.com craze in 1999. Why? Investors still don't believe in a broad recovery, so they are paying up for a select group of companies they think can grow regardless of the environment.

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 THIS REPORT

Hence, 2020 market returns were "narrow," meaning the S&P 500 index reached new highs on outsized gains for a few of the largest stocks, but the average stock didn't do as well. Many managers who follow a value style and don't own the market darlings had trouble matching the returns of that index. Can this trend reverse? Yes, we believe once the economy normalizes a much broader list of companies will rebound. We are currently observing the potential beginning of this trend.

We also noted that 2020 showed signs of rampant speculation. There was the Bitcoin craze. "SPACS" – special purpose acquisition companies with no business model, just a blank check from investors – fetched huge valuations. And then there was the electric car frenzy, where investors pushed up stock prices on companies that don't have road-ready vehicles or even batteries. While some technologies are indeed appealing, the mania surrounding them truly reminds us of the dot.com bubble of 1999.

The good news, after August there was a dramatic change in these market dynamics. As vaccines came out and economic prospects improved, all the trends from 2020 showed signs of reversal. Value stocks perked up. Dividend-oriented stocks performed better, and capital requirements on banks were loosened. In short – what didn't work in 2020 is starting to make up ground vs. what did. And for those who think it will take forever for value to catch growth, we offer 4th quarter of 2000 as hope…during that quarter, value outperformed growth by nearly 22%. So, in our opinion fortunes can change in a hurry, especially when there are excesses. (Source: Bloomberg)

And now back to our regularly scheduled methodology for picking stocks for your portfolio.

DIVIDEND STRATEGY PROCESS REVIEW

The Berkshire Dividend Growth Strategy's primary objective is 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.

ECONOMIC CONDITIONS FAVOR DIVIDEND ORIENTED STRATEGIES

Over time, dividends have made up a substantial portion of the total return generated by US stocks. While high, healthy growing dividends rarely "go out of style", the current economic conditions may make the 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. Afterwards, consumers, businesses and many governments were being faced with paying down debt. This paying down of debt ("deleveraging") had a retarding effect on world economies. Economic growth is likely to remain positive but may be below average for some time. A 2-4% dividend may be viewed as "quaint" in a roaring stock market - but is now likely to make up a large part of an investors total return, particularly in light of current market valuations. Many high-quality dividend paying stocks also offer an attractive alternative to certain fixed income investments and offer investors the chance to grow cash flow vs. accepting a fixed one. Global rates still remain at near record lows and may remain until inflation picks up.

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 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 clear 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 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 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 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 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 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 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 so as 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 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 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, 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 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. 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 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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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.