Berkshire
DIVIDEND STRATEGY

Gerard Mihalick, CFA
gmihalick@berkshiream.com

46 Public Square
Wilkes-Barre, PA 18701

570.825.2600

Third Quarter 2017 Commentary

Keeping Biases In Check

Markets tend to climb a wall of worry, and as the markets have surged this year, the worry wall has grown as well. We hear investors and the media asking all the time: Is the market overvalued? The answer depends on a lot of factors…but one thing it doesn't depend on is recent market activity.

Here's an example. Let's say an investor sees a stock rise from $50 to $75. That investor might conclude: "the stock is up a lot. It must be expensive." But the same investor a few months later might see that stock go from $100 to $75 and conclude "hey this stock is down quite a bit. Maybe it's cheap."

This way of thinking – allowing a particular reference point cloud your perception and decision making – is called reference dependency. As bottom up investors, we have another name for it – an exploitable market inefficiency. Stock prices are nothing more than the present value of all future cash flows, so what matters is the future, not the past. Wise investing demands that we set aside biases such as reference dependency and focus on the real drivers of value in the market.

Imagine you had no knowledge of market returns prior to today, no Wall Street consensus P/E ratios or financial media sensationalism to bias your decision making. All you would have is your analysis of current and future conditions. How would you decide what stocks should be trading at?

- You might notice that interest rates are at 2.35% for the 10-year Treasury. Even if the U.S. Federal Reserve moves rates 100-150 basis points higher, the 10-year would still be under 4%. Historically speaking, that leaves stocks as the much more attractive investment.

- You'd then move to company performance and see that earnings growth is strong market wide. Sales grew 7% last quarter, and earnings were up nearly 15%, with many of the gains coming from key industrial sectors like autos, housing and semiconductors.

- A broader view would tell you that all major world economies are in expansion mode (even Europe and Japan).

- Importantly, if you hadn't seen bank balance sheets in a while, you'd see record capital positions, increased risk aversion and virtually no loan losses. Non-financial balance sheets would tell a similar story.

- Finally, you'd see long-term growth drivers in numerous areas of the market. Technology advances in health care, aerospace, and the internet of things could open up entire new industries while driving greater efficiency and margins in established industries.

So without hindsight but with these facts, do you think it's fair to pay valuations that are just slightly above the market's long-term average? We think so.

Berkshire is a fee-based, SEC registered advisory firm serving the portfolio management needs of high net worth and institutional clients. Over the past 30 years, we have successfully implemented highly focused equity, fixed income and balanced portfolios. Our guiding principle is a belief that success is 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.

IN THIS REPORT

When Berkshire clients have had success, it is because we have been able to tune out market noise and found individual companies with unique strengths that generated cash flow year in and year out. In some years, our approach will outperform the market, and in some they will not. So far this year, it's the latter. But our mission is broader – to consistently produce solid increases in portfolio value that give our investors the confidence to stay invested and compound earnings for superior long-term gains.

A final note. We're not saying that a correction is impossible – quite the contrary, they are a normal part of equity investing. But large-scale corrections, like we saw in 2000 or 2008, are usually born out of large-scale recessions. Given the health of the world economy, that does not appear imminent. Still, we advise investors not to expect returns as high the next 7 years as they did in the past 7.

Structurally Broken or Is the Market Short Sighted?

One unusual facet of our performance this year is that client portfolios have benefitted from both outsized winners and some more pronounced setbacks from individual holdings.

But despite this dispersion, we find that the winners share something in common with the losers – not so long ago, they were considered losers themselves. It wasn't long ago that 2 of our outsized winners, **Microsoft (MSFT) and Abbvie (ABBV)** were deemed by the market as: "Dead! Broken! No Hope! Sell!" …with the languishing stock price to go along with it.

Prior to this year, the story on Abbvie (up 45% year to date) seemed dire: too reliant on one drug, too much competition, the loss of patent protection, a weak pipeline. However, growth for its flagship drug Humira has proven more durable than people thought. Plus, its copious cash flow is starting to fuel a robust pipeline of promising new drugs. The market is taking notice now.

When CEO Satya Nadella took over Microsoft (up 21% year to date), Microsoft was berated for a lack of innovation, non-competitive products and ineffective management. I-phones and tablets were getting all the glamour. Many investors left this once great American icon for dead. But we felt the real value lied in the longevity of the cash flow from the existing install base and that could be leveraged into something more – if properly led. Nadella proved to be that leader and the catalyst for a much higher stock price as he has shaped the company into a cloud juggernaut.

That brings us to today's portfolio holdings we believe can prove the naysayers wrong. The first is General Mills (GIS), whose brands include Cheerios, Betty Crocker, Pillsbury, Haagen-Dazs, Annie's and Cascadian Farm, to name a few. The company has an efficient global footprint and distributes to more than 100 countries on six continents.

For General Mills and other 'big food' companies, the formula is quite simple: make products that fit changing consumer tastes. Recently the company has been in a slump, especially when it comes to yogurt. Sales are declining. But the company has a great international distribution platform, and that can create synergies. For example in 2014 they acquired leading organic food company Annie's; by leveraging their distribution skillset, they doubled Annie's sales in a short period of time.

Like great sports teams, authors, or movie studios, companies need a little time to break out of a slump. While we wait, the stock sports nearly a 4% dividend – which we think is attractive in this environment.

But perhaps the idea that most closely fits the mold of "Storied U.S. company left for dead" is GE (GE). Right now the company appears mired in a perception quagmire – not unlike Microsoft, McDonalds (MCD) and Disney (DIS) before it. The stock seems stuck in permafrost despite a long list of positives, including:

- Dominant market position.
- High margins on perpetually renewable contracts.
- International foot print in high-growth regions.
- Well positioned in growth industries.
- New management.
- An activist shareholder who is agitating for change.

The firm has made a series of missteps, mainly in their high-profile energy business, and that has dominated investor perception. But the firm's issues all appear fixable, and that is what is creating the opportunity.

We share these examples to highlight two points:

- Companies are not static sets of historical statistical parameters like P/E ratios, return on shareholder equity or other quantitative items. They are living, breathing, adaptive entities whose fortunes are tied to what happens in the future…
- …and sometimes that positive future is a few years out, but few investors want to wait that long. They remain focused on near-term events, and short-term gratification.

And this is another thing that we at Berkshire call an exploitable market inefficiency. In our view, if you combine a little more patience than the average investor with a more forward-looking approach, and you get a formula we believe gives our investors an edge. Certainly it's a more effective approach trying to gauge which way the market will turn next.

Thank you for your continued partnership with our firm.

Please Contact Us:
Berkshire (570) 825-2600

Disclosure Berkshire Asset Management, LLC claims compliance with the Global Investment Performance Standards (GIPS®). Berkshire Asset Management is a fee-based, SEC registered advisory firm serving the portfolio management needs of institutional and high-net worth clients. The Dividend Growth Composite contains portfolios invested in Berkshire's Dividend Growth Strategy with an equity allocation target of 90% - 100%. The Dividend Growth Strategy's primary objective is to generate a growing stream of equity income by investing in a diversified portfolio of equities with stable, high, and growing dividends. The benchmark is the S&P 500 Index. The index returns are provided to represent the investment environment existing during the time periods shown. For comparison purposes, the index is fully invested, does not include any trading costs, management fees, or other costs, and the reinvestment of dividends and other distributions is assumed. An investor cannot invest directly in an index. Gross returns are presented before management and other fees but after all trading expenses. Net returns are calculated by deducting actual management fees from gross returns. Returns reflect the reinvestment of dividends and other earnings. Valuations are computed and performance is reported in U.S. dollars. To receive a complete list of composite descriptions and/or a compliant presentation, contact Jason Reilly, CFP® Tel: 570-825-2600 or info@berkshiream.com. Past performance does not guarantee future results.

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.

Risks: Past performance does not guarantee future results. All investing carries risk including risk of principal or income loss. Dividends are subject to change, are not guaranteed, and may be cut. Investing based on dividends alone may not be favorable as it does not include all material risks. There is no guarantee any stated (or implied) portfolio or performance objective mentioned by Berkshire can be met. Berkshire's equity style may focus its investments in certain sectors or industries, thereby increasing potential volatility relative to other strategies or indices.