



# Berkshire

## DIVIDEND STRATEGY

Gerard Mihalick, CFA  
gmihalick@berkshiream.com

46 Public Square  
Wilkes-Barre, PA 18701

570.825.2600

Fourth Quarter 2017 Commentary

### 2017 YEAR END RECAP

2017 was another good year for U.S. equity markets. The increase on top of last year's gains surprised many, especially those who rely heavily on macro forecasts.

True to our process, we recommend investors eschew trying to analyze which way the stock market will go on any given year. Instead we focus our analysis on individual companies we believe can compound cash flows for our shareholder's at attractive long term rates. Below we outline the process we use to evaluate these companies as well as some important information about how we run our firm.

### BERKSHIRE FIRM UPDATE

Unlike other "brick and mortar" companies, Berkshire has only two assets: the quality of our client base (you) and the talent, dedication and investment acumen of the people who serve them (us). By the first measure we are extremely fortunate to work for a wonderful group of clients who share our philosophy and have assimilated into our investment style and firm culture. This shared mindset is critical to continued mutual success.

By the second measure, Berkshire enters its year 32nd year, stronger than ever. We are galvanized around a consistent investment philosophy and impeccable client service model.

On the investment side, we continue to seek solid businesses at sensible valuations to provide an attractive compounded return over time. On the service side, we continue to be proactive in our communication and extremely responsive to all service matters. Please call us with questions, feedback or concerns as we always enjoy speaking with you directly.

### 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 with a high, safe and growing dividend. We believe if we are able to achieve this primary goal by purchasing vibrant growing companies with fine economic prospects, capital appreciation will 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.

**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

- 2017 Recap
- Firm Update
- Process Review

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 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 vs. 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 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

*cont.* 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, 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, 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. In aggregate we seek a final portfolio: reduced systematic risk, above average quality, lower volatility. From a cash flow perspective, we believe and history has shown that a typical Berkshire holding can deliver cash flow growth should 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.

Contact Berkshire:

Gerard Mihalick, CFA, Portfolio Manager,  
gmihalick@berkshiream.com or (570) 825-2600

Jason Reilly, CFP®, VP Advisor Distribution,  
jason@berkshiream.com or (570) 825-2600

**Berkshire**  
DIVIDEND STRATEGY

*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.*