Berkshire
DIVIDEND STRATEGY

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"Casual Friday" Commentary

Casual Friday: "Rates And Dividends?" + $1.25 Per Acre... *March 19th 2021*

"How is the Berkshire Dividend Strategy performing in a rising rate environment"? - *Advisor question.*
There's an echo of rate discussion in today's market… It's a genuine concern as bonds and stocks essentially compete for dollars. As interest rates rise, the safety and higher cash flow of bonds become more attractive and the "call option" on future earnings of stocks becomes less attractive. Specifically, for dividend strategies, the composition of dividend stock holdings can produce vastly different outcomes. Higher interest rates typically mean a strengthening economy and broader earnings growth. Banks, industrials, other cyclicals and low P/E tend to perform well in these environments. Utilities, non-cyclicals and high P/E tend to lag. Also, rising dividends have a tendency to perform better than high and stagnant dividends. High and low growth dividends may act like bonds proxies.

Berkshire's positioning?
We believe Berkshire is in a strong position for rising rates:

- **Industrials and Cyclicals – 22% Portfolio Weighting**
  - Broader earnings growth as economy "reopens"
  - Lower relative valuations coming out of 2020 recession
  - Pricing flexibility / margin expansion as demand grows

- **Banks – 20% Portfolio Weighting**
  - Levered "Reopening Trade"
  - Fed has anchored short rates near zero, long rates could continue rising allowing for NIM expansion
  - Better than expected credit quality
  - Excess capital on bank balance sheets may lead to:
    - Dividend Growth
    - Buybacks

- **Healthcare / Drug Stocks - 18% Portfolio Weighting**
  - Secular tailwinds in drug space, 6% - 8% overall growth expected
  - Strong current yields, dividend growth and attractive valuations
  - IP importance on full display over the past year

Berkshire performance in past rising rate environments?
In the past decade, we've seen a number of rising rates environments. Performance was strong through these periods especially as compared to many other dividend managers. The end of September 2020 marked a real turning point in the current interest rate cycle. Over the past six months we've seen the 10 Yr. Treasury move from 0.70% to 1.71%. Investors are believing the economic recovery story. For Berkshire's portfolio, we're happy to report the portfolio in general is benefitting from the reversal. Last year's headwinds have become this year's tailwinds. We believe this market environment could persist for some time. Since 9.30.2020 the Berkshire portfolio is up roughly +20% though 3.18.2021*. (Source: Bloomberg) *Berkshire performance based on composite estimates only. Individual account performance can and will vary. Performance measurements are net of fees.

Stocks Still the "Champ"?

Clients often feel pressured by short term biases of the market. At a client event a few years back, we shared a story to demonstrate the truly amazing power of long-term compounding. Instead of droning on and on about the same ol' boring dividend growth charts… We did a little research to tell the tale of how the storied Pinehurst golf community was founded. James Tufts, a wealthy Bostonian, secured land in 1895 for the tidy sum of… $1.25 per acre. Tufts original vision was to create a high-end health resort community. He purchased 598 acres totaling a whopping $747.50. Using real estate web services, we found an acre of land in the area now sells for roughly $40,000 an acre! So, we asked the investors how they would feel about parlaying $747.50 into a cool $24 million. Most agreed while they didn't have a 122-year time horizon they'd love to dial in that kind of return for future generations. We did wonder, however, just "how high was Tufts annual rate of return"? We pulled out the financial calculator and low and behold we calculated an annualized rate of return of…8.95%. Thinking it had to be higher we checked 2 more times! Same result. We also posed the idea that stocks over a similar time period generated returns close to 10% exceeding Pinehurst land appreciation by over 1% annually. As you could imagine the additional 1% over that time would yield a far greater result. Trying to make a true apple to apples comparison however is different because of course we don't know: incomes, the costs of clearing the land, real estate commissions, capital/infrastructure improvements, taxes, permitting fees, marketing just to name a few. But we do suspect this might change the gross return and of course would not account for the illiquidity associated with the investment (when compared to stocks). The overall concept being, time and compounding truly work wonders. Investors who can take their eyes off day-to-day market fluctuations can harness this same power.

Linking Real Estate's Appeal with Dividend Stocks

Clients are still drawn to real estate for many positive and legitimate reasons. We relate how owning Berkshire's dividend growth stocks can be akin to owning an apartment building where the "tenants" are high quality companies like Microsoft, Johnson and Johnson, Cisco and others. And the "rents" realized by the owner of that building come in the form of a call option on the success of their business operations growing dividends. They also cleverly deemphasize the value or volatility of the underlying building provided the rent checks grow each year and cover the investors cash needs every month. It's a "buy and grow rent" vs. a "buy and flip mentality." Occasionally we get a bad tenant or two (maybe some who aren't increasing rent because of an extra private jet or two) but they eventually come to their senses and get back on track. Otherwise, we have decisions to be made about occupancy. Investors seem to relate well to this analogy and while cash flow is emphasized, there is a strong case to be made, over time, the underlying asset may appreciate and will be "the icing on the cake".

Call/Email with any questions!

Best Regards,
Gerry

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