March 13, 2023

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

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Latest Comments

"If you look back at the 100 highest-yielding stocks in the S&P 500 in 2020, 30 of them cut their dividend yield. But if you look at the next 100, only eight cut it."

Austin R. Kummer, Fort Washington Investment Advisors, Inc.

"… the last thing you want to do, once you've established that dividend, is cut it, because that is one of the most negative signaling events in the life of a dividend stock."

Christopher P. O'Keefe, Logan Capital Management, Inc.

"So when we think about an overarching view on dividends, the optimal performance is really achieved through a balance of growing dividend payouts and earnings growth."

Michael L. Shelton, Nicholas Company, Inc.

Dividend-Oriented Strategies

The money managers featured in this issue of *The Wall Street Transcript* share a belief that current market conditions favor a return to quality, value-oriented, dividend-paying companies.

Austin R. Kummer, CFA, is Vice President and Senior Portfolio Manager for Dividend Equity and Multi-Sector Fixed Income strategies at Fort Washington Investment Advisors.

"Over the past year we've added two names to the portfolio ... Stanley Black & Decker and Fortune Brands. ... These are both industrial products companies that have been impacted by the housing market slowdown and weakening in consumer demand over the last year, but despite these short-term headwinds, long-term prospects for both companies remain favorable.

"Lockheed Martin and Raytheon Technologies were two outperformers during 2022. ... Both names fit our style perfectly: market leaders with barriers to entry in their space, high profitability, and high-quality dividends with favorable valuations."

Christopher P. O'Keefe, CFA, is a Managing Director of Logan Capital Management and the Lead Portfolio Manager of its Dividend Performers and Dividend Performers Balanced Strategies.

" ... within banks, we own JPMorgan. It certainly has been a good long-term dividend growth stock with very good management, a strong balance sheet, the kind of durability within financials that you want to have for long periods of time. Getting into health care, we own Johnson & Johnson, a stalwart within pharma. JNJ has a great long-term track record of growing dividends.

"[Parker Hannifin] designs and manufactures industrial and aerospace systems such as motion control, fluid systems and flight control. Parker is benefiting from increased spending in the aero area as well as the integration of recent acquisitions."

Michael L. Shelton, CFA, is lead Portfolio Manager of Nicholas Equity Income Fund and Co-Portfolio Manager of Nicholas Fund. He is also a senior research analyst at Nicholas Company, Inc.

"[American Tower is] one of the largest global REITs and a leading owner of cell towers globally. ... The tower business is very attractive, as wireless carriers enter long-term leases that include rent escalators, which really gives American Tower high visibility and stable revenue streams.

"[Analog Devices is] the world's second largest analog chipmaker. The company is well positioned to benefit from more advanced and higher-priced semiconductor content in automobiles, 5G wireless equipment, industrial applications, and factory automation.

"They've raised the dividend 19 years in a row, and their payout ratio is only 32%. So we think it's well positioned to drive double-digit dividend increases for the foreseeable future."

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Dividend Growth Better Performance Indicator Than Dividend Yield

CHRISTOPHER P. O'KEEFE, LOGAN CAPITAL MANAGEMENT

CHRISTOPHER P. O'KEEFE, CFA, is a Managing Director of Logan Capital Management, Inc. and the Lead Portfolio Manager of both the Dividend Performers Strategy and the Dividend Performers Balanced Strategy. Prior to joining the firm, he managed these strategies at Manulife Asset Management, where he was also the Lead Portfolio Manager. Earlier, Mr. O'Keefe was an equity Portfolio Manager and Director of Research at Compu-Val Investments, and before that he held analyst positions at CoreStates Investment Advisers and First Pennsylvania Bank. Mr. O'Keefe earned a B.A. at Villanova University. He is a member of the CFA Institute, as well as a CFA charterholder.

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SECTOR — GENERAL INVESTING

(AHV509) TWST: Please tell us a bit about Logan Capital's overall business and overall investment approach and philosophy.

Mr. O'Keefe: Logan Capital is a Philadelphia-based investment management firm. It was started back in 1995, and started off primarily focused on growth equity strategies, and then added value strategies with the addition of a new team. And then, just a few years ago, they acquired my team, which was originally called Sovereign/John Hancock Dividend Performers, but was part of Manulife Asset Management. So we left Manulife about three years ago and we moved over to Logan.

Our strategy is primarily a dividend growth strategy. I'm sure you've heard of rising dividend strategies as they are fairly common today. Vanguard has one; we definitely have a few other competitors out there. It's purely equity, although we do have a 60/40 balanced product. The idea is to invest only in companies that consistently increase dividends over time. What we find is, over long periods of time, those stocks outperform, but they do so at less risk than the overall market.

TWST: What else would you add in terms of the key characteristics of the portfolios, and any similarities or differences in the equities you choose for each?

Mr. O'Keefe: The philosophy behind the strategy, as I alluded to, is the principle that investing in companies that consistently grow dividends leads to above average returns at less risk. But the underpinning of all of that is that a company that decides to initiate a dividend policy, and then to grow dividends over time, is a significantly positive event for the valuation of that stock. The signaling effect is very powerful. It just tells you a lot about the company itself, and it tells you a lot about management.

On the company side, in order to be able to pay and grow dividends, and believe that you can grow dividends over long periods of time, means that the company probably has a very strong business model generating strong free cash flow, underpinned by strong margins, good and significant market share, or something that really gives you strong cash flows over long periods of time that can defend that dividend. Because the last thing you want to do, once you've established that dividend, is cut it, because that is one of the most negative signaling events in the life of a dividend stock.

Secondly, what's so important is that paying a dividend puts a level of discipline on management. If the company is generating a lot of cash, you have a lot of decisions you can make with that. Certainly, you can reinvest in the business; you can add another plant; you can go out and make an acquisition; of course, you have the option to go out and buy another corporate jet as well.

But when it comes to dividends, again, it's a significant decision, and it puts a discipline on management teams to make decisions to be good stewards of shareholders' capital, to continue to pay that dividend throughout a long period of time. So it is a question of discipline for them. We like to think about it as sound financial management, because you probably are unlikely to over-lever your balance sheet or do stupid things with capital if you have that commitment.

I'd say another key to it would be that it's not the level of the yield that matters so much, it's actually the dividend growth. We've done studies; we use Ned Davis Research to give us long periods of time looking at the performance of stocks versus stocks that pay dividends, stocks that grow dividends, stocks with high yields and low yields. And the one that always comes out on top is the dividend grower.

So to us, having a high yield isn't necessarily a positive thing. We get a lot of questions like that: What's your current yield? And because every name in our portfolio has a dividend yield, our yield typically is greater than the S&P 500, but it's not necessarily a high yield. Again, we find that the greatest indicator of our performance is dividend growth, not the level of yield. So that's really important, too.

And lastly is how the portfolio is structured. For the most part, our strategy is used in separately managed accounts, so the portfolio tends to be fairly concentrated. We will always have less than 50 names in the portfolio; today it's 39 names. We tend to be well diversified throughout sectors, but our focus is fundamental, bottom up. We don't make big sector bets, it's more trying to find the best names within each sector, and diversify your risk in that way.

"We think last year may have been one of our best years on record, from a relative standpoint. It's not too surprising, because the market was down over 18% last year, and dividend growth stocks do tend to be relatively more defensive. The yield is part of that, for sure, as is their relative quality."

So, diversified, high quality, and in our view you have to have at least five years of dividend growth to qualify for ownership. In our mind, five years is a good indicator that you're likely to continue growing your dividend.

TWST: Can you give us a few examples of favorite investment ideas?

Mr. O'Keefe: Absolutely. I can start with some you expect in a portfolio like ours, something we would typically own. We have **McDonald's** (NYSE:MCD) within consumer discretionary; it's a great long-term grower of dividends. They provide an excellent product within their space, they're global, with a strong balance sheet — all the things that you would add up to being a good long-term dividend growth company. And it's been a great long-term performer for us.

Also, within banks, we own **JPMorgan** (NYSE:JPM), it certainly has been a good long-term dividend growth stock with very good management, a strong balance sheet, the kind of durability within financials that you want to have for long periods of time.

Getting into health care, we own **Johnson & Johnson** (NYSE:JNJ), a stalwart within pharma. **JNJ** has a great long-term track record of growing dividends.

However, the portfolio also owns more mid-cap names as well. What's interesting is, as we go through our bottom-up analysis that we do, we find quite a few mid-cap, or not necessarily the largest cap, companies that are showing above-average earnings growth, but the yield level might be very low, but actually the dividend growth is well above average.

For instance, we have names like **Dollar General** (NYSE:DG) within consumer discretionary, which has 18,000 stores in North America, providing a great service for that demographic of the U.S. population that may not be that close to a Walmart or another store or a mall. Very consistent growth over time, very well managed, and they're growing the dividend at mid-teens levels because of the great growth that they have there. But the yield on that one is about 1%.

Similarly, when you look at the industrials, and sure, names like **Honeywell** (NASDAQ:HON) would not be a surprise to see in our portfolio — but also **Parker Hannifin** (NYSE:PH), that's had more than 50 years of dividend growth. **PH** designs and manufactures industrial and aerospace systems such as motion control, fluid systems and flight control. **Parker** is benefiting from increased spending in the aero area as well as the integration of recent acquisitions. That's one we like a lot, as well.

So, while we have large-cap, high-quality names, we also have some of these more mid-cap names that are showing well above average dividend growth and, I think, will contribute to performance over the long term.

TWST: Where were your best performers in 2022, and what were the biggest detractors?

Mr. O'Keefe: We think last year may have been one of our best years on record, from a relative standpoint. It's not too surprising, because the market was down over 18% last year, and dividend growth stocks do tend to be relatively more defensive. The yield is part of that, for sure, as is their relative quality. As I mentioned, these companies tend to have very strong business models, well managed, so likely to be able to go through a tough market better than most. Investors are looking for that kind of durability in a tough market like that. So it was one of our best years, last year in that market.

And I'd also say that, almost like clockwork, typically dividend growth strategies will outperform in a recession, so we'll see what happens this year, but we're actually pretty optimistic that our relative performance will continue for the year.

1-Year Daily Chart of McDonald's Corp.

Chart provided by www.BigCharts.com

If I look at the one-year performance in terms of what worked and what didn't, the overlay is that the longer-duration growth stocks really had a difficult time. Among the best sectors from a relative perspective were consumer discretionary, technology, and communications services, because there tends to be more longer-duration companies in those sectors where the earnings and cash flows are expected somewhere in the future, not in the near term, and they tend to be less focused on dividends.

Some of the largest social media and e-commerce names lagged as well. Our consumer discretionary names are higher-quality companies such as **McDonald's** and **Nike** (NYSE:NKE) as well as **Home Depot** (NYSE:HD), that provide more durable cash flows and dividends today.

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And then conversely on the negative side, energy was just a huge sector in the market last year, given the fact that there was a war going on, and people were concerned about whether or not they were going to be able to get the energy supply we need, so that tightening of supply drove up oil prices.

"We think that, again, with this much tightening going on, and the Fed really trying to keep growth slow and, unfortunately, try to reduce the strength of the labor market today, which is very strong — that still represents a huge amount of risk for the market. I just don't think we're out of the woods yet."

We don't necessarily have a large position in energy. Because of the volatility in oil and natural gas, these companies aren't always the best dividend growth stocks. Now there are a few, such as **Chevron** (NYSE:CVX), which we do own. They have increased their focus on higher return on capital and higher shareholder returns through dividend growth and share repurchases.

We have a larger position in financials, and financials didn't do as well last year because investors were concerned that seven, eight, potentially nine increases in interest rates would lead to a recession and a credit cycle, and so it was a negative for some of these financials. And you can say the same on the industrials side; some names sold off as they can be impacted by a slowing economy.

But in general, we had some great contributors to performance. **Starbucks** (NASDAQ:SBUX) was one of our better ones. **Chevron** as well, as I mentioned. **Northrop** (NYSE:NOC), a defense related contractor. Defense contractors are companies that, obviously, do well during times of conflict, and Ukraine and Russia are making things interesting. So those were big names for us last year.

But as I mentioned, a very strong year for dividend growth, and a very strong year for us on a relative basis. We outperformed by over 900 basis points.

TWST: Are you expecting any changes or significant shifts this year, and is there anything you're doing to change the positioning of the portfolio as a result?

Mr. O'Keefe: Our process is a three-pillar process, and the first is fundamentals, the second is business momentum, third is valuation. Coming into the end of last year, what we were noticing was that a lot of the more defensive names, whether it be in health care, or staples in particular, the valuations were getting up there relative to our target prices and what we thought they could achieve. That was no surprise, because defensives were being very much favored last year. So we began to reduce some of those positions into the end of last year, and possibly had given up some of the performance we might have had.

Going into this year, it's been surprising how strong the market has been. To us it appears as though the market really is "fighting the Fed," because the Fed is out there raising rates and trying to tighten, and at the same time we've had some animal spirits come back in and drive the market higher, which started back in October. A lot of the losers of last year have been the winners of this year. It's interesting in that sense.

We think that, again, with this much tightening going on, and the Fed really trying to keep growth slow and, unfortunately, try to reduce the strength of the labor market today, which is very strong — that still represents a huge amount of risk for the market. I just don't think we're out of the woods yet.

So we would still think about owning higher-quality, more defensive names, stronger names within each sector, and less inclined to buy companies where the earnings are more at risk or where the business models aren't generating predictable cash flows, earnings and dividends. Our focus on names that have the ability to grow dividends consistently, I think, should continue to win within sectors.

But I think there's going to be a lot of volatility, and you can see it today with the market doing as well as it has. The volatility is creating a lot of opportunity for active managers like ourselves. Last year our turnover rate was up, relatively, quite a bit. It's still low; we're not a high-turnover portfolio. But again, I think this year you're going to see a lot of opportunity from the volatility that we see in the market today.

1-Year Daily Chart of Starbucks Corporation

Chart provided by www.BigCharts.com

TWST: You mentioned valuations getting high and reaching target prices. What would you add about your sell discipline and exit strategy?

Mr. O'Keefe: Longer term, we know that one of the greatest sources of value creation is the compounding of dividends, growing dividends over time. So when we're doing our analysis on a company that we hold, or analysis on a company that is a potential idea, if there's anything that suggests that the dividend growth is going to be challenged in any way, that's something that would trigger the sell discipline.

If a company cuts the dividend, that for us is a sell, but you really want to be way ahead of that. You want to be watching cash flow growth and earnings stability, the strength of the business — that would ensure that dividend growth.

For example, a name we sold a long time ago, **VF Corp.** (NYSE:VFC), they're a clothing manufacturer, had raised the dividend consistently for I believe 50 years. We sold it as we had

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concerns about the health and strength of the business, the ability to pay. And lo and behold, about a year later they did cut the dividend. It's a sad story. But that would be one of the main pillars of our sell discipline.

The other is this constant challenging of new ideas versus what we already own, and seeing it from an opportunity cost standpoint, whether you want to take a name out that has reached fair value, or has less upside, versus a new name that might have much more upside. It's a dynamic process in that way, and during the year, we might have a number of trims and adds as we watch that dynamic on a relative basis.

TWST: What's top of mind these days, in terms of the broader investment market and the macroeconomic landscape, for you and your colleagues, and perhaps even in terms of questions and concerns you hear from clients?

Mr. O'Keefe: From the client perspective, I think most people are still concerned that the actions the Fed is taking right now to slow the economy is going to create volatility and put pressure on corporate earnings. Earnings, we know, are a key driver of stock prices over the long term. We don't know what the ultimate impact of the monetary tightening is, and a lot of clients are hesitant to put more money into the market.

We think the recent dramatic move up in stocks has been driven mostly by sentiment — the feeling that inflation has, and I suppose in many cases inflation has, stopped rising. It's not as bad. But in other places, like consumer services, we still are seeing inflation that is not yet under control, and a lot of that is labor market related.

So I think that's a concern, that this has been a sentiment-driven market, and we haven't yet seen the full negative impact of rising short-term interest rates that now are close to 5% and likely to go higher. It is a drag.

And then, what's been powering the consumer economy, which we know is 70% of the U.S. economy — a lot of that has been pandemic-related savings. People had excess savings from government stimulus and lack of activity. The perception, and the evidence, today suggests that most people have burned through all of that excess, which would suggest that consumer spending will be more crimped as we go forward. And some of the lending that's occurring now may end up in the bad credit box.

So, there may be a lot of weakness yet to come. I wouldn't call ourselves bearish, but I think this recent rally may be a little ahead of itself. We can see why it happened. The market had become undervalued in many segments. Inflation has gotten better. We are definitely closer than we were to a pivot, or a pause and then a pivot maybe, to rate cuts. But I feel like we've gotten ahead of ourselves in the market.

TWST: Is there anything I didn't ask about that you would like to discuss?

Mr. O'Keefe: I would just summarize by saying it was a great year for our dividend growth strategy last year. I think we're still in a tough environment — monetary tightening, quantitative tightening, earnings growth is slowing, and forward earnings estimates have come down.

The framework we were working under for years and years and years was that the Fed would always be there to cut interest rates and provide stimulus, driving up the price of these longer-duration growth stocks. We were all going to be saved by the Fed in the end. I just don't think that's going to be the case going forward. We don't really have a pro-growth administration right now. That's not their objective; he's got other objectives. I don't think the market has fully thought that through.

I think we're going to have an up year, but I do think it's going to be challenging. I think there could be a lot of volatility, and I would continue to recommend quality, dividend growth stocks I think will power through a market like this. I think right now, some of these stocks look more attractive again, because they have lagged year to date. So it's an opportunity, I think, for investors to look again at dividend growth as a good long-term strategy today.

TWST: Thank you. (MN)

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Value Manager Sees Opportunities in Underearning Auto Sector

MATTHEW R. SEGURA, SKBA CAPITAL MANAGEMENT, LLC

MATTHEW R. SEGURA, CFA, is the Director of Institutional Portfolio Management at SKBA Capital Management, LLC. He is a member of the Investment Strategy Team and is also a securities analyst. Mr. Segura joined SKBA in 2007 as a member of its research internship program and rejoined SKBA in 2011. Previously Mr. Segura worked at Charles Schwab & Co. performing several roles: a Cash Management team member in the Treasury, and a Manager in Financial Planning and Analysis for Schwab's largest retail divisions. Mr. Segura also served five years active duty in the United States Marine Corps. Mr. Segura received a B.S. in business administration from Haas School of Business at UC Berkeley and is a member of the CFA Society of San Francisco and the CFA Institute. He is an equity owner of the firm.

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SECTOR — GENERAL INVESTING

(AHV505) TWST: Before we dive into specific strategies and funds, would you mind giving us a brief introduction to SKBA, the business and its overarching investing philosophy?

Mr. Segura: SKBA Capital Management is an independent boutique asset management firm based in San Francisco and was founded in 1989. We are 100% employee and founder owned, with a singular focus on discovering undervalued investment opportunities not yet realized by the market.

We currently offer two mutual funds based off of our Value*Plus* (BVPIX) and Socially*Responsible* (BVSIX) strategies. Value*Plus* is a dividend-oriented, large-cap value strategy, and Socially*Responsible* looks for undervalued opportunities within an ESG framework.

The overall investment philosophy and approach has several differentiators. We use a team-based portfolio management approach to ensure a consistent and disciplined investment process. We believe the market routinely overshoots on both the upside and downside and is therefore irrational. We use valuation metrics that are focused on what we believe a company can earn in a normal environment — that's through cycle — which helps us determine if a company is over- or underearning.

By buying securities when the downside is already priced in, we believe this maximizes upside potential while also minimizing downside risk. We are long-term investors with an investment horizon of about three to five years.

TWST: Is there anything you would add about the investment process specifically for the Value*Plus* strategy and its corresponding Baywood Value*Plus* mutual fund?

Mr. Segura: We utilize our relative dividend yield discipline to identify opportunities and risks for the portfolio. The main point of differentiation is our focus on relative, not absolute, yield. We look at a company's dividend yield relative to a proprietary universe of other dividend paying stocks and to itself over time.

This could lead us to buy stocks with low absolute yields but high relative to its past, because even with a lower absolute yield the high relative dividend yield compared to its own history may capture pessimism priced in the stock. Similarly, we might avoid a high absolute yielding stock if its yield is low relative to its past, like a lot of bond substitutes have been over the past five years or so.

In short, we believe that dividends are important for four reasons. One, as a signal of a company's long-term earning power. Management tends not to set dividends whimsically, therefore a company with a solid long-term dividend policy will have a dividend that is a good proxy for what the company believes its long-term earning power is. Two, as already mentioned, they signal relative valuation attraction. By looking at a company's relative dividend yield, we can identify valuation extremes. Three is to provide income. And four, it lowers the overall portfolio volatility.

We are also fundamental bottom-up investors. As I mentioned, the relative dividend yield discipline is a signal. Most of the work performed is through our bottom-up fundamental analysis, where each analyst at SKBA is responsible for a cross-section of industries. I, for example, am responsible for covering autos and auto parts, IT hardware, independent power producers, insurance, and household products such as **Procter and Gamble** (NYSE:PG). This doesn't necessarily confine us to these industries; for example, if I see an attractive opportunity in another part of the financial sector, like banks, I may analyze it.

Once we identify an opportunity, we look at a company's fundamentals in three main steps. One, is in isolation. What are the company's profitability characteristics through cycle, balance sheet, cash flow, management team tenure and experience, weakness, strength, governance, etc.?

Then we look at the company compared to peers. There we compare the profitability and growth characteristics against the peers. We look at market share gains and losses, competitive positioning, long-term strategy, any unique circumstances, and why they might change over our investment horizon.

Lastly, we look at it compared to other investments within the portfolio.

"We weren't short the market, we didn't invest in any esoteric securities or any hedge that one might assume when you need to be positive for the year. It was just prudent capital allocation among a variety of ignored, neglected, yet fundamentally sound stocks."

In summary, we look for stocks with a combination of strong fundamental characteristics, low valuations, and generally above-market dividend yields. Most companies we put in this portfolio provide a set of characteristics that, over a full market cycle, are very competitive and consistent. We've been able to outperform our benchmarks over every full market cycle since inception, as well as overall since inception, while taking less risk than the benchmark as measured by standard deviation of returns.

We have shown that it is possible to get higher-than-benchmark returns with less risk. We believe that if you don't dig yourself into big holes on the downside, then you don't have to take as much risk on the upside to have an attractive risk/return profile.

TWST: You mentioned a few sectors that you cover. Are you finding that there are certain sectors or industries, or other kinds of general themes, where you're finding the best opportunities right now?

Mr. Segura: Broadly speaking, 2022 was one of the most interesting years in my investing career. Our Value*Plus* strategy had positive returns while the broad market was down significantly. I'm sure you've read how value held up well in the downturn, but it really played into our hands being active value managers, and the fact that we stuck to our knitting and didn't drift outside of our philosophy to keep up with the broad market over the long period of value underperforming growth.

2022 was unique because it was possible to be fully invested and diversified and be a long-only equity manager and be up for the year without making any heroic assumptions about stocks. And, specifically paying attention to what to avoid as much as what to own helped enable Value*Plus* to post positive returns for the year.

We weren't short the market, we didn't invest in any esoteric securities or any hedge that one might assume when you need to be positive for the year. It was just prudent capital allocation among a variety of ignored, neglected, yet fundamentally sound stocks.

As we look forward, we start with what worked well for us last year and ask ourselves if there are any reasons why that might reverse. On the opposite side of the coin, we also look at some sectors and industries that performed the worst, and if we own them, we question whether or not they are still worth owning. Or even, perhaps we should own more?

With the broad market being down so much, we're also looking at opportunities to own good companies which, right now, might trade at much more reasonable prices than they have in a very long time.

Communication services is one of those sectors. It was one of the worst performing last year, mostly driven by **GOOGL** (NASDAQ:GOOG), **META** (NASDAQ:FB) and **Netflix** (NASDAQ:NFLX), some of which are actually really good companies. If or when they pay a dividend they might actually become attractive for our strategy, albeit not right now. For example, **Microsoft** (NASDAQ:MSFT) is another one of those big companies that has done well lately. After the 2007/2008 crash near the bottom of the market, we bought **Microsoft** at a very high relative dividend yield and paid less than $20 per share. We held on to that for almost 10 years before it reached a stratospheric valuation.

Those companies just mentioned might fall into this realm; they haven't yet, and they don't currently pay a dividend, but someday they might.

However, there are a number of other companies in the sector whose underlying fundamentals are not nearly as volatile. Some of these companies underperformed, in our opinion, because they simply resided in an underperforming sector. In other words, they're guilty by association.

Companies like **AT&T** (NYSE:T), for example. It's taking market share from its cable peers and recently unwound years of bad capital allocation decisions by selling DirecTV and spinning off its media assets into **Warner Brothers** (NASDAQ:WBD). It's repaired its balance sheet, and it's focusing on the fundamental blocking and tackling in its core telecom business.

1-Year Daily Chart of AT&T Inc.

Chart provided by www.BigCharts.com

Those are the companies that we like. **Comcast** (NASDAQ:CMCSA) was another one that last year declined 30%, yet its fundamentals are a lot more stable than that price decline would suggest.

Information technology was another sector that led the market lower last year, after years of outperforming with elevated valuations and, in our opinion, higher than normal earnings. This is an important aspect of how we look at stocks and what we do and don't find attractive.

These two ingredients often create a disaster like what we witnessed last year. The market actually begins to believe that the

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elevated levels of earnings growth are normal and then rewards companies with higher valuations. These were similar factors that led to the dot-com bubble, as earnings were pulled forward to fix the Y2K problem in the late 1990s.

"Semiconductors in autos, for example, are expected to grow approximately 13% per year over the next four years. By contrast, semiconductors in PCs and servers started their decline last year, they're going to decline this year, and over the next four or five years they might overall increase around 5%."

Now, we estimate that earnings had been pulled forward to increase bandwidth for all the remote working and living during the pandemic. Coupled with easy monetary policy and low inflation, you have all the ingredients for a market bubble. When the bubble bursts, the opportunities these create for investors like us can be broad based.

More recently, we initiated a position in **NXP Semiconductors** (NASDAQ:NXPI). We believe its competitive position and end markets are very different from a number of other semiconductor peers that tend to operate in more focused end markets, like **Intel** (NASDAQ:INTC), for example. **NXP's** end markets are industrial and auto, which we expect to grow at an elevated rate over our investment horizon as semiconductors continue to become an increasingly larger part of the industrial complex.

Semiconductors in autos, for example, are expected to grow approximately 13% per year over the next four years. By contrast, semiconductors in PCs and servers started their decline last year, they're going to decline this year, and over the next four or five years they might overall increase around 5%.

So we found a much more attractive opportunity in **NXP** where its price declined nearly the same as a lot of the other semiconductor companies but with much better fundamentals.

You asked me what am I looking at in some of the sectors that I cover. I'll first start with what we do not find interesting, which is an important part of our process. Currently, I'm not a fan of consumer staples.

If you think about what's gone on in the market over the last 10 years, central banks around the world fought to keep interest rates at zero or below. A lot of sectors and industries became bond proxies as investors had to reach outside of traditional fixed income markets to get yield in the equity markets. The beneficiaries of that were mostly consumer staples and utilities. A lot of these companies are overpriced as a result, and a majority of them have very unattractive relative dividend yields with poor-to-fair fundamentals.

Last year's correction largely bypassed a lot of these sectors because investors held on to this belief that because they have in the past acted defensively during an economic slowdown, that they will so into the future. But we think this environment is a little different.

Because of high levels of inflation, a lot of these high-priced staples are struggling to pass through price increases without affecting volumes. Volumes are declining and we believe more is to come.

During the pandemic and the high level of retail concentration that occurred — you had a lot of bankruptcies, a lot of family businesses going out of business. Meanwhile, **Target** (NYSE:TGT), **Walmart** (NYSE:WMT), **Safeway** (NYSE:ACI) grocery stores all increased their market share and now have more ability to push their own private label products at the expense of branded products.

High valuations and poor-to-fair fundamentals do not create an attractive investment opportunity from our perspective. The relative dividend yields are not very attractive either, so we're staying away from a lot of the staples sector.

As mentioned, we try to stay away from companies that are overearning and overvalued. I much prefer companies that are underearning and undervalued, where you can find really good opportunities for above-average dividend yields at depressed prices. In autos, even before the supply chain was disrupted from the pandemic, the global auto market was already in decline due to the trade wars and the tariffs of the Trump-era economic policies. When the pandemic hit, auto manufacturers shut down manufacturing for several months and were not able to restart at levels that would match demand.

1-Year Daily Chart of NXP Semiconductors NV

Chart provided by www.BigCharts.com

We believe there's a good amount of pent-up demand for autos, which may be partially offset by higher interest rates and possibly higher prices. Having said that, the auto sector can firmly be placed in the underearning, not overearning bucket. Combine that with the near extreme low valuations and increasing dividends off the pandemic lows, we believe there are some attractive opportunities in this industry over our investment horizon.

Currently, we prefer the auto parts suppliers as the contracted price increases for inflation are beginning to kick in full force and are already beginning to restore margins back to pre-pandemic levels. While the OEM manufacturers like **Ford** (NYSE:F) and **GM** (NYSE:GM), on the other hand, have enjoyed higher prices due to lower inventories, and up until recently, they enjoyed the benefit of higher prices without associated costs because the contracts between suppliers and OEMs generally have about a one-year lag on them. So they're going to face lower prices for their vehicles as more supply comes into the market and higher costs.

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For this reason, we own the semiconductor manufacturers like **NXP** and **Texas Instruments** (NASDAQ:TXN), other sensor and connector manufacturers/distributors like **TE Connectivity** (NYSE:TEL), and electric wiring and battery harness and seating manufacturer **Lear** (NYSE:LEA).

"Governance tends to be a leading indicator, not a lagging indicator, of a company's interactions with the environment, their supply chains, and with social issues. Governance tends to drive these interactions, and so we focus on governance and simply try to avoid bad actors."

TWST: I want to switch gears, since the firm also runs an ESG portfolio and mutual fund. Tell us a bit about the strategy driving that portfolio and fund. And how you define "socially responsible"? Do you use positive or negative screens, or something else?

Mr. Segura: SKBA's Socially*Responsible* strategy was incepted in the year 2000. Unlike a lot of peers in this space, we have a long history, not just since strategy inception but nearly since the inception of the firm. I believe it was in 1990, we had a Catholic Diocese client that had specific requests as to what we could or couldn't invest in. And if you think about it, that's how the ESG industry started, with clients having unique needs and desires to include or exclude certain types of securities in their portfolios. So we had about 10 years of experience in managing portfolios for clients with these unique desires and needs.

In the late 1990s and early 2000s, we were looking at the overall ESG space, and in our opinion it did not seem like there were very many, if any, value strategies. They all, or mostly all, were growth, which is still true today. There are few diversification opportunities in ESG. Companies owned in these other strategies, and the kind of companies often considered to have positive ESG perceptions, tend not to be extractive industries like mining or energy. They tend to be more in the technology sector which tends to make the economy more productive. So, on the one hand it makes sense, but on the other hand, you end up seeing a huge crowding effect.

We did a short analysis in late 2021 looking at some of the different funds through Morningstar. Across the 10 largest ESG funds there was over 70% overlap in the top five holdings. In other words, they all owned the same companies, whereas we're very different. We're value. And that's why in 2000 we thought that we would formalize our process in terms of creating a value ESG strategy to help diversify away from this crowding effect that we witnessed. In addition, we already had developed perspectives given the 10 years of managing portfolios for clients with unique desires and needs.

We start off with the most commonly desirable screens, which is not really a part of the process. This just lowers the amount of investable companies in our universe. These include alcohol, tobacco, firearms, nuclear weapons, and a few others — your basic ESG screens. But what makes us unique in this strategy, we believe, is our focus on governance.

Governance tends to be a leading indicator, not a lagging indicator, of a company's interactions with the environment, their supply chains, and with social issues. Governance tends to drive these interactions, and so we focus on governance and simply try to avoid bad actors.

We don't necessarily exclude whole sectors. Industries like defense, yes, but not generally sectors. We do not have a large weight in technology at the moment, because as I previously mentioned, most technology stocks are in this overcrowded, overvalued, overearning bucket. Throughout time and depending on our investment opportunities and what we believe a company's overall ESG profile to be, that will affect how we're positioned.

I've been discussing the things that we don't want in our portfolio. But we also look at companies that can help. The climate is number one on most people's radar right now in terms of how we want to change the world, and some people think that through an investing framework they can help accomplish those goals. So we look for companies that can help get us there.

I mentioned previously we are attracted to autos, and **Aptiv** (NYSE:APTV) is the company in the auto supply chain that helps make cars more efficient. It helps enable this transition from the internal combustion engine to electric vehicles. They are the only company that can supply almost the entire end-to-end solution, including sensors, wire harnesses, and electric vehicle charging components to help move us beyond the internal combustion engine and hybrid vehicles as well.

1-Year Daily Chart of Aptiv PLC

Chart provided by www.BigCharts.com

So, yes, there are companies that we won't invest in due to our screens and what we believe would be higher risk profiles, with risk factors in their governance that would lead us to say, this is not really what we want to invest in. And there are some companies that we look to include in the portfolio that we think can help move the economy in a better direction.

TWST: Is there much overlap between the two portfolios?

Mr. Segura: There is some, but given the constrained universe in our Socially*Responsible* strategy, we don't just look at

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companies through the relative dividend yield framework. We also look at relative market cap for revenue, which is a fancy way of looking at price to sales. We also use other valuation metrics. In this strategy we relax the dividend constraint so that we don't limit the universe even more.

There are companies that we'd like to own in our Value*Plus* strategy, but they don't have a good or sustainable dividend policy, that we might own in the Socially*Responsible* strategy if we deemed it to fit our ESG mandate. On average, you might have 20% or so overlap at times, more or less.

TWST: Circling back to that topic of emphasizing dividends, investment strategies with a focus on dividends have been getting more attention lately. Do you think that will continue for the foreseeable future? What could change that? What are the broader investment market and economic factors that influence investor interest?

Mr. Segura: We believe that we're at the very beginning of a long unwinding of an asset bubble created by 10-plus years of zero interest rate policy here in the U.S., and even worse, the negative interest rate policy in the Eurozone. This was a global race towards free money supported by low inflation.

Few will remember Alan Greenspan's comment in 1996 about "irrational exuberance," but the preceding comments were that the ingredients for these market bubbles were low inflation and easy monetary policy. That's exactly what we've had again. The market preferred risk assets when you had low inflation and easy monetary policy, i.e., free money. That is now reversing and we think that's one of the big drivers of this prevalent shift.

Because of inflation and higher interest rates, money actually costs something. Investors are forced to make these decisions now. We think investors prefer companies with upfront cash flows that can pay dividends today, and have the ability to grow those dividends. This is important right now because bonds aren't going to grow. If you held a bond over the last year, your principal declined, and you are not getting compensated any more for that.

That's why investors in different asset classes are now preferring strategies that can grow dividends, because you don't get that with fixed income. Companies that pay dividends and have the ability to pass on that inflation in whatever service or product they are performing or making are very attractive right now.

Some of our biggest winners in the Value*Plus* strategy last year were from energy and basic materials, which was not by accident. We wrote a newsletter in early 2021 about how we thought inflation was going to appear and then persist, well before the Fed acknowledged that it was going to be a problem.

We began looking at companies who could pass along this inflation that would eventually become a major problem for the economy and for the market. A lot of those opportunities turned out to be in the energy and basic materials sectors. So we had pretty significant weights in both of those sectors along with companies that can pass through inflation, unlike consumer staples like I mentioned, without affecting volumes.

We think this environment is going to be here for a while, meaning we will continue to see elevated levels of inflation compared to the past 10 years. We may have passed peak inflation for the cycle but we don't think that it is going to go back down to where it was before. Similarly, we don't think the Fed's going to go back down to a zero interest rate policy.

For the next couple of years, the more likely economic scenario is stagflation — high levels of inflation combined with low levels of real GDP growth — with also a high risk of going into recession.

If the Fed continues to raise interest rates, that will eventually affect economic growth. So, either you stay in a stagflationary environment and the interest rates don't necessarily cause a recession right away, or the higher rates cause economic activity to slow down and we go into a recession. In either case, we don't think inflation needs to stay at 9% for this market preference to continue. But 4% inflation? Yes, we can see that lasting for a couple of years, to which we think the preference switch will last.

TWST: Any final thoughts to wrap up?

Mr. Segura: Every now and then we get these corrections where investors actually remember the value that active management can provide. Benchmarks can be risky; just take a look at the S&P 500 during the dot-com bubble burst, the great financial crisis, and again in 2022.

Moreover, we went back over these major market declines and tried to look for managers that had outperformed in every one of them; we couldn't really find many managers at all. We might be one of the few managers that outperformed in all three downturns, which the CEO of our company likes to call a "three-peat."

Benchmarks are not risk free, and active management can add value over a full market cycle. That's something that we think most investors ought to keep in mind.

TWST: Thank you. (MN)

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Wide Moat Linked to Ability to Sustain Dividends Over Time

AUSTIN R. KUMMER, FORT WASHINGTON INVESTMENT ADVISORS

AUSTIN R. KUMMER, CFA, is Vice President and Senior Portfolio Manager for Dividend Equity and Multi-Sector Fixed Income strategies at Fort Washington Investment Advisors, Inc. In this role, he is focused on the overall portfolio construction and management of client portfolios. He also contributes to the firm's asset allocation and macro positioning. Mr. Kummer joined Fort Washington in 2013. Prior to becoming a portfolio manager, he was primarily focused on investment-grade credit research and risk management functions. He received a BBA from Ohio University in finance and business economics, and an MBA in finance from Xavier University. He holds the Chartered Financial Analyst designation.

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SECTOR — GENERAL INVESTING

(AHV511) TWST: Let's start with a snapshot of Fort Washington, your overall business and overall approach to investment and asset management.

Mr. Kummer: Fort Washington is a wholly owned subsidiary of Western & Southern Financial Group, and we've been a registered investment adviser since 1990. We manage roughly $72 billion in assets as of year end for a diverse set of clients and valued partners through a wide range of investment solutions across the spectrum — private and public, equity and fixed income.

As a firm, we employ a consistent approach to asset management, with tenured and cohesive teams really focused on long-term investment results. Key to our approach is our steadfast focus on managing risk for our clients with a goal of generating top quartile returns.

TWST: You're part of the team that manages the Dividend Equity strategy, the Touchstone Dividend Equity mutual fund (TQCYX), and also the actively managed Touchstone Dividend Select ETF (DVND). What is the underlying philosophy and strategy for those investment vehicles?

Mr. Kummer: The overall objective for these funds is to generate a high level of income and income growth without sacrificing broad market exposure and capital appreciation. To achieve this, we built and designed our investment strategy to focus on elements supported by theory and evidence, and there are really four key ideas included there.

First, we believe dividend-paying stocks outperform over time. Second, we believe companies with high barriers to entry grow dividends at a higher rate. Third, the highest dividend yielding stocks often have unintentional exposures. And fourth, risk management is the foundation for investment success.

These four ideas — and again, the theory, the rationale is there, the evidence supports it — drive the overall process and portfolio construction of our strategy. We will get a little bit deeper into each of these as we go.

TWST: Yes. So, there are numerous dividend-oriented strategies and funds out there, but exactly what they focus on in terms of the dividend can differ. What specifically is your focus?

Mr. Kummer: This is a great question. We take a balanced approach. When we built this strategy, we found a lot of different risk and return characteristics for the two different approaches, whether just focusing on yield or just focusing on income growth. We believe the optimal approach of balancing the two really reduces investment risk in the portfolio.

As I mentioned, if you focus a little bit too much on yield, you're subject to potentially unintended sector exposures and potentially dividend cuts. But if you focus too much on just dividend growth, you might end up with a portfolio that actually yields less than the overall market, and you might not be getting all the benefits of investing in a dividend fund.

And so, we truly believe by balancing both of those, focusing on above-average yield and above-average growth, we can create a more consistent risk and return profile for investors.

TWST: Is there anything else you would point out in terms of how you might differ from other dividend strategies?

Mr. Kummer: Yes, we think our approach to portfolio construction and risk management differentiates us, and there are three key differentiators here. First, as it comes to risk management, we really seek to avoid the highest-dividend-yielding stocks, while also maintaining sector neutrality to the broad market.

If you look back at the 100 highest-yielding stocks in the S&P 500 in 2020, 30 of them cut their dividend yield. But if you look at the next 100, only eight cut it.

You also have potentially unintended sector exposures. Again, if you look at the highest yielding names in the S&P 500, the top 80, you end up with 40% in real estate, utilities and energy. If

you look at the broader market, it's only 10%. Add financials, you have 60% portfolio concentration.

"More specifically, we're looking for excess returns on capital, a company's ability to generate returns above and beyond their cost of capital. This excess profit can then be reinvested in the business for future value creation, or distributed to shareholders through the form of reliable growing dividends."

Sector exposures can add undue risk when you're chasing after yield, so we try to maintain sector neutrality compared to the broader market.

The second key differentiator is we drive decision-making down to our sector-focused analysts, who essentially operate as sector portfolio managers. We're really trying to drive and increase accountability and engagement at the analyst level, rather than having portfolio managers having all the decision-making at the end of the day.

And lastly, the third key differentiator is we link dividend capacity with barriers to entry. We believe this is a unique forward-looking assessment of a company's dividend, compared to many strategies that are focused more on trailing metrics such as payout ratios or annual increases. Going back to 2020 again, during the coronavirus pandemic, only seven wide-moat companies cut their dividend, while 33 no-moat companies cut their dividend.

TWST: What other key elements would you point out in terms of your stock selection, portfolio construction, and ongoing portfolio management?

Mr. Kummer: Security selection, that's key to the strategy. We look for high quality companies with four distinct characteristics. First, sustainable competitive advantages; second, high returns on capital; third, reliable and growing dividends; and fourth, reasonable valuations.

Briefly, the first, sustainable competitive advantage, is really companies with barriers to entry — structural features that help companies sustain excess profits over a long period of time. Examples are supply barriers, demand barriers, economies of scale, and government barriers.

Then we're looking for high returns on capital. More specifically, we're looking for excess returns on capital, a company's ability to generate returns above and beyond their cost of capital. This excess profit can then be reinvested in the business for future value creation, or distributed to shareholders through the form of reliable growing dividends.

And that gets us to the reliable and growing dividends — that's vital to a successful dividend strategy. We assess not only the historical track record, but their ability to grow and pay dividends in the future.

And then lastly, reasonable valuations. As we all know, equity valuations can be very sensitive to their inputs. Really what we're looking for is trying to avoid extreme valuations. One of my favorite quotes from Warren Buffett really summarizes our approach to valuation. He said, "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

To summarize, we're looking for high quality companies with sustainable competitive advantages and high returns on capital that should pay reliable, growing dividends at reasonable valuations.

TWST: Could you tell us about a few favorite investment ideas? What do you like about them and how do they meet those criteria?

Mr. Kummer: Over the past year we've added two names to the portfolio that have a pretty similar investment theme. These two names are **Stanley Black & Decker** (NYSE:SWK) and **Fortune Brands** (NYSE:FBIN). Stanley Black & Decker, maker of DeWalt, Craftsman, Black+Decker, and **Fortune Brands** with Moen in plumbing and Master Lock in security. The theme behind these two? These are both industrial products companies that have been impacted by the housing market slowdown and weakening in consumer demand over the last year, but despite these short-term headwinds, long-term prospects for both companies remain favorable.

I touched on the four key elements of our stock selection. Both companies have barriers to entry through the form of customer demand, where they enjoy pricing power due to their products that have high switching costs.

Both companies have long operating histories of generating above-average and consistent excess returns on capital, with both having products that are market share leaders in their respective segments.

1-Year Daily Chart of Stanley Black & Decker, Inc.

Chart provided by www.BigCharts.com

And when it comes to their dividend, both have generated above-average yields, and both have grown their dividend annually for the past 10 years. In the case of **Stanley Black & Decker**, they've increased their dividend annually for 55 years in a row now.

And then valuation, both names were priced with the assumption that this unfavorable near-term environment would last forever, which is highly unlikely. We'll get past the current economic downturn that we're experiencing here, and so, when and should earnings normalize over the coming years, both of these names have meaningful upside.

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So both names have strong barriers to entry, are market leaders in their respective segments, have high excess returns on capital, above-average yields with strong dividend growth, and favorable valuations. They really fit the mold of what we're trying to do within the strategy.

"That being said, there are benefits to dividends versus bond coupons, and the fact that dividends grow with inflation while coupons don't. If you look at our dividend strategy, the income has continued to grow over these past few years, where if you bought a fixed-income bond you're receiving that same amount of nominal income."

TWST: Where did you find your best performers last year, and are you expecting that to be similar this year, or do you find you're changing focus at all?

Mr. Kummer: Last year was a good year for dividend strategies, and we performed well relative, as well. The overall biggest theme really driving returns was outperformance of dividend-paying names and defensive stocks, and that was very much welcome following several years of underperformance by above-average-yielding stocks. But it was really punctuated by our strong security selection and positioning within the portfolio.

At the sector level, energy and health care were our best performing sectors, whereas real estate and technology were the worst performing. We benefited from this because we were increasing energy and health care toward the end of 2021 and actually reducing tech, so that shift in that positioning going into 2022 was beneficial for our portfolio.

At the security level, a key driver of returns was we were overweight defense companies going into 2022. **Lockheed Martin** (NYSE:LMT) and **Raytheon Technologies** (NYSE:RTX) were two outperformers during 2022. We increased these names toward the end of 2021 and they were top holdings in the portfolio entering 2022. Both names fit our style perfectly: market leaders with barriers to entry in their space, high profitability, and high-quality dividends with favorable valuations. These names outperformed during the year following the Russian invasion of Ukraine and the renewed focus on defense spending.

The overall theme of dividend stocks doing well influenced returns, but then our positioning heading into the year really emphasized that and allowed for even further outperformance due to our sector positioning and security selection.

TWST: In the macro landscape and potential impacts on the broader investment market, what are you most paying attention to these days?

Mr. Kummer: The primary question today is, are we going to go into a recession or not? At this point, the economic data is key. We really need inflation to continue to decline so the Fed stops the tightening cycle, which should hopefully lead to an easing in financial conditions. In order to keep inflation trending downward, the labor market probably needs to soften a bit, and that has yet to be seen. So we'll keep our eye on jobs data.

The positive here is the consumer has been extremely resilient till this point, but depleted savings and job cuts could lead to a broader slowdown in the economy and ultimately weigh on company earnings and valuations.

So the economic data, inflation continuing to roll over, jobs weak or softening a little bit — that's what we're watching, because that's what's going to influence what the Fed does, and that'll ultimately influence financial conditions, which, in part, will influence equity returns and earnings within the market.

TWST: Any further thoughts on the Fed's rate increases, especially how that affected the bond market last year and how that has sent some investors looking elsewhere for yield?

Mr. Kummer: I'll address that last part first. In regards to yield, yield is plentiful today. The pain the bond market experienced last year has resulted in the highest fixed-income yields in over a decade. The yield discussion that investors were having a year ago is drastically different today. We don't really see that stretch or that search for yield right now, because there is opportunity for yield across the different asset classes.

That being said, there are benefits to dividends versus bond coupons, and the fact that dividends grow with inflation while coupons don't. If you look at our dividend strategy, the income has continued to grow over these past few years, where if you bought a fixed-income bond you're receiving that same amount of nominal income. So that continues to favor dividend strategies over fixed income.

1-Year Daily Chart of Raytheon Technologies Corp.

Chart provided by www.BigCharts.com

And then you also get potential for capital appreciation within dividend strategies compared to the bond market. If you take a balanced approach like ours of higher yield, higher dividend growth, with a keen focus on risk management, over the long run it will reward investors.

With regards to the Fed, the Fed should be data dependent going forward. At the time of this interview, the market expects two more 25-basis-point hikes. I think that's aligned with the Fed, and we think that's reasonable. Now, if the inflation data over the next two months comes out above expectations, there could be a case

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that the Fed might hike another time, but right now I think two more 25 basis point hikes is reasonable, and we're in line with that.

TWST: Do you want to share some final thoughts on your outlook for the rest of the year and on why a focus on dividends is so important?

Mr. Kummer: When it comes to our outlook, it's a tough one, and it's the key conversation happening with all investors today. But our base case is we do think the Fed will be able to maneuver a soft landing and that the U.S. can avoid a severe recession.

Like I said, recent data is encouraging, and there's reason to believe inflation can continue to decelerate throughout the year. And although financial markets, stocks and bonds, will likely remain volatile throughout the year, ultimately we expect positive returns for most asset classes, especially as the economy heads toward a more normalized environment in 2024.

I think because of all this uncertainty in the market, in the economy, dividend strategies will continue to reward investors. You look at 2022 and dividend strategies outperformed by a wide margin. If you're looking at a dividend strategy focused on high-quality companies, it should be less volatile than the overall market, and they should continue to grow and pay out their dividends, which in the face of persistent inflation today, you want income that's going to rise with inflation compared to most other asset classes where it's more nominal yield.

Dividend strategies, after having a tough couple years with value and dividend underperforming, we think with the higher interest rates and the cheap money of low rates behind us, that should favor these higher-quality, more value-oriented dividend names going forward.

TWST: Thank you. (MN)

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MONEY MANAGER INTERVIEW

Strategy Screens for Annual Dividend Increases Over Five Years

MARY C. BROWN, CAMPBELL NEWMAN ASSET MANAGEMENT

MARY C. BROWN is President of Campbell Newman Asset Management, Inc., as well as a Portfolio Manager/Analyst at the firm. She has over 35 years' experience in the investment management industry. During that time, she has gained broad knowledge in securities analysis, portfolio construction, client service, human resource management, regulatory compliance, and strategic planning. Ms. Brown joined Campbell Newman in November 1986 as an equity analyst; in 1995 she was named Director of Research; and in May 2003, she was elected President. Ms. Brown graduated from Wheaton College in Norton, Mass., with a B.A. degree, and is a Chartered Financial Analyst charterholder. She is an active community volunteer, having served on the Board of Directors of Women Investment Professionals and Junior Achievement Women's Association, as well as Chairman on the Board of Advisors of the Digestive Disease Center at the Medical College of Wisconsin. She currently serves on the YPO Gold Wisconsin Board as Assistant Learning Officer.

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SECTOR — GENERAL INVESTING

(AHV506) TWST: Let's start with a snapshot of Campbell Newman's Large Cap Dividend Growth product. Would you tell us a bit about the overall strategy and, in particular, what "dividend growth" means for you?

Ms. Brown: Our Dividend Growth investment philosophy is that a company's dividend policy is tangible evidence of management's confidence in future earnings growth. Importantly, we're focused on dividend policy and not yield. We think a company's dividend policy is a signal from management that, because it's a cash payment out to shareholders, is more insightful than written or verbal commentary.

And importantly, in Dividend Growth we're seeking companies with growing earnings, and we think that the payment of a meaningful dividend, along with the expectation that it's going to be increased year after year, puts a really important discipline on management and their capital allocation policy — the capital allocation policy of shareholders' capital. We think that it makes them more shareholder friendly, we think it makes them more disciplined, and that then promotes more consistent and predictable earnings growth over time.

Also with our Dividend Growth, we start the bottom-up process with screening criteria that takes a roughly 7,000 stock universe down to about 150 to 175 stocks. The criteria that eliminates the most is the requirement of annual dividend increases over the last five years. Only about 4% — or 300 of that 7,000-stock universe — meet that.

We are truly looking for dividend growth, and what we found in our research is that once a company initiated a dividend, very few companies increased it the first year, the second year, the third year, the fourth year — but once a company got to five years of annualized dividend increases, it tended to become institutionalized. And you saw perpetuation of those dividend increases; again, that goes back to being an important component of management's capital allocation policy.

Why do we think that's important? Well, the Dividend Growth strategy was designed to participate in up markets and protect in down markets, to outperform over a market cycle, because you know that upside volatility and downside volatility don't cut equally.

If you can protect on the downside, and participate on the upside, over a market cycle, you should outperform at lower levels of volatility.

TWST: I was going to ask about what your investment analysis and portfolio construction process looks like, as well as what role the firm's broader investment philosophy plays. Is there anything else in particular, beyond the five years of dividend increases, that you would note?

Ms. Brown: Another thing that really sets us apart is our team. Campbell Newman was founded in 1977, but in many ways we look at ourselves as a new firm starting in 2003, because that's the year the current management group took over responsibility for all aspects of firm management, and it's also the year that we launched the Large Cap Dividend Growth strategy.

That strategy really grew out of our discussions with clients during the bear market of 2000 to 2003. Prior to that, we were known more as a high-quality, large-cap growth manager, a Russell 1000 growth manager.

“So, the three senior investment team members all have over 35 years of experience. We’ve worked at Campbell Newman together for almost 18 years. This is the team who created the strategy, that has managed it through multiple market cycles and environments, and have created the track record.”

During the bear market, our clients said, “We really like working with you, we believe in what you do, but we want higher levels of current income and lower levels of volatility.” And that caused Tom Bolgert and me to start to do the research into what dividends meant to total return, what they meant to dampening the volatility, and then, most importantly for us, is that signaling effect of dividend increases.

Requiring that dividend increase is also really important because, if a company, after decades, doesn’t increase the dividend or cuts the dividend, that’s also a really important signal that we pay attention to. We actually have hardwired sell disciplines — and a cut in the dividend is one of them — to protect our clients. We could get into some of the trades that we’ve made as a result of that, but it has been a very important sell discipline to reduce risk that’s worked over the almost 20 years that we’ve managed the strategy.

We have a tight-knit team here at Campbell Newman. Tom and I were the ones who did the original research in Dividend Growth. We had an existing client in April of 2003 give us a million dollars from his IRA to start Dividend Growth, and we’ve built it account by account, and Campbell Newman now has roughly $2.2 billion in assets under advisement, with the lion’s share, $2.1 billion, in the Large Cap Dividend Growth strategy.

In 2005, Rimas Milaitis joined our firm. He had been most recently at Strong Capital Management, where he ran a fund that was at the time a $1.3 billion fund approximately, that was growth and income. So, the three senior investment team members all have over 35 years of experience. We’ve worked at Campbell Newman together for almost 18 years. This is the team who created the strategy, that has managed it through multiple market cycles and environments, and have created the track record.

We think we do some things differently. First of all, we all act as portfolio manager/analysts, and we all act as generalists on the Dividend Growth strategy. We have a flat decision-making structure. We think that most effective decisions are made in a tight knit group with a flat decision-making structure. There’s nothing lost in translation between the analyst and the portfolio manager, we’re one and the same.

And we also require a unanimous vote to make changes in the portfolio, other than changes that are required due to hardwired sell disciplines. That would be the dividend cut, as I mentioned, price target met, and we also have a valuation metric that requires a stock to be at least trimmed if it meets a certain metric.

TWST: You mentioned you could discuss some trades based on that sell discipline. Please share an example or two.

Ms. Brown: A lot of times I use **Fannie Mae** (OTCMKTS:FNMA), it was back in 2005. In March of 2005, Fannie Mae cut their dividend after decades of annual dividend increases. The stock was $67 a share then, and we sold it all that day. That stock is under $1.00 per share now.

During the financial crisis, in the first part of 2008, when the 10-K for **US Bank** (NYSE:USB) came out, we noticed that in the back of the 10-K, in the notes discussing loan loss reserves, that loan loss reserves were at all-time low rates. We do our own bottom-up research, and we use primary resources: company filings, and we listen to conference calls, and we form our own opinion about a company, its business, its prospects. And then what we do is we don’t reinvent the wheel in terms of modeling; we use Wall Street consensus models, because these companies are well followed, and we don’t think we’ll add a lot to redo that. So we use the consensus models.

What we’re trying to do is ascertain whether or not these companies can meet or exceed consensus estimates. **US Bank** was our largest financial holding at the time. And when we looked at the earnings model, it was calling for 10% to 12% earnings per share growth over the next two to three years, and commensurate dividend growth, predicated, when you looked at the model, on loan loss reserves staying at these all-time low levels.

1-Year Daily Chart of ConocoPhillips

Chart provided by www.BigCharts.com

Well, this was early 2008. The subprime mortgage crisis was evolving. It had reared its ugly head. We certainly didn’t predict what would happen, but you have to believe in a little mean reversion — we have credit cycles, and things aren’t going to stay so great for so long.

So, what we did was we basically looked at the model, and we did a little stress testing, and said, if loan loss reserves just go back up to average historical levels, that tells us that earnings estimates are too high. And then, from our experience, the first thing we know about a bank is when they have to raise capital, they’re going to cut dividends. That told us that the dividend would be cut. So we preemptively sold **US Bank**, and then did the same sort of analysis on the other financials that we held.

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If you look back, in 2008 we were down, like the market, but we outperformed by over 10 percentage points that year, protecting client assets. That was our in-house bottom-up research and our experience used to protect client capital when we predicted dividends would be cut. And that doesn't happen all the time.

"In 2022, we initiated positions in energy. First we bought ConocoPhillips (NYSE:COP) in February of last year, and then we followed up with EOG (NYSE:EOG). And then we also, in October when the market had sold off, bought some Air Products and Chemicals (NYSE:APD)."

TWST: In terms of quarterly results, what are you looking for, or listening for in the tone and content of management comments during earnings calls, whether positive or negative?

Ms. Brown: What we look for is a well-articulated plan, and that you have a consistency that they're doing what they say they're going to do, and that it makes sense. Obviously all these companies have earnings, they're all profitable, all of them pay dividends. Our analysis is really grounded in a lot of rationality. And so, was it difficult to keep up in a zero interest rate environment when the market was rewarding what they now call long-duration stocks? Yes, but you stick to your knitting, knowing that this is going to work.

I think one of the important things that we really understand, and I learned this as a very young analyst looking at client portfolios and watching successful investors, is if you're lucky enough to pick a good stock and be able to have the company continue to do what they say they're going to do and grow and expand, one of the greatest things to happen is to have those dividend increases.

A lot of people will look at current yield, but another way to look at it is that yield on cost. If you look back at the holdings in our portfolio, and you look at clients who've been with us for quite a while and what they originally paid, since 2004, when we look at our growth in dividends, the portfolio's had a 13.7% average annual dividend increase versus the S&P at 7.7%. So, almost twice the dividend increase of the S&P 500. And you know, that really adds up.

So our goal is to outperform over the market cycle at lower than market volatility, provide higher-than-average current income, and growing streams of income over time.

TWST: Would you tell us about a few top holdings or favorite investments?

Ms. Brown: These aren't top holdings, but it's a change in the portfolio and a change in our thinking. We build portfolios on a bottom-up basis. We do not have to have exposure to all of the S&P economic sectors, and until recently, we did not have exposure to energy, materials, utilities, or consumer staples. In 2022, we initiated positions in energy. First we bought **ConocoPhillips** (NYSE:COP) in February of last year, and then we followed up with **EOG** (NYSE:EOG). And then we also, in October when the market had sold off, bought some **Air Products and Chemicals** (NYSE:APD).

Going back to energy, we hadn't had energy in the portfolio for quite a while, because the earnings predictability is tougher, because it's so dependent on the price of the underlying commodities. But with what's going on with these companies with ESG and the desire to lower carbon footprints, companies have made huge changes in the way that they're allocating shareholder capital. They're not investing as much in production in the same way that they have, or chasing price.

We think that that, ironically, is going to keep energy prices higher for longer. And then, what these companies are doing: Not only are they paying out good dividends, but they're also doing special return on capital and special dividends, so that makes them very attractive. As I said, we bought some **ConocoPhillips** in February, and then **EOG**, and when we bought **EOG** the yield with a special dividend was 8%, so very attractive. And they've been good stocks. **Air Products and Chemicals**, we liked that company. New management came in in 2014 and it really changed, because industrial chemicals can be cyclical, obviously, but what Air Products has done is they co-locate their production facilities next to the factories, and they have long-term contracts.

1-Year Daily Chart of Northrop Grumman Corp.

Chart provided by www.BigCharts.com

We're really looking for companies that have long-term contracts, better predictability, and with the market being down in October, we had been watching that stock and we found a really attractive purchase point for that.

In 2022 one of the reasons why we outperformed the way we did was our industrials exposure, and the major part of our industrials over the past several years has been in defense contractors. In 2022 our industrials were up 20.3%, when the S&P industrials were minus 5.5%.

Again, we had non-cyclical or less cyclical industrial companies. **Northrop Grumman** (NYSE:NOC) was up over 40% last year, **Raytheon Technologies** (NYSE:RTX) was up 20%, and **Honeywell** (NASDAQ:HON) was the other stock in that group for the year. And then in the fall we added **Deere & Company** (NYSE:DE). But it really was the defense contractors that have done so well for us for so long and, as you can see, in their relative performance.

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TWST: Are there any particular areas that you're really cautious about right now, or that just don't fit into your overall investment criteria?

Ms. Brown: I think that it's interesting, and it shows how we are more dividend growth than yield based, where we haven't owned utilities or consumer staples.

We have a valuation metric that we use, both as we're looking to buy stocks and also as a risk control metric to trim back or sell. We look at the next year's forward p/e over 20 years on an absolute basis, and if you graph it, what you see is like a sine wave. We want to buy low and sell high. So when we're looking to buy a company, we limit the valuation to 70% of that 20-year high. Then if it gets to 90% of that 20-year high, we have to trim it by at least a third, and, in order to keep any, we have to reassign an 18-month target price that implies a 20% total return.

So when you look at a lot of the staples companies and utilities, they are well outside of our valuation discipline to own. Also, staples companies are very slow growth. They've had a lot of problems with rising input costs and the ability to pass that along. And much slower dividend growth — and the portfolio has had almost double the dividend growth of the index.

When you talk about dividends and dividend increases, a company increasing its dividend by 13% is telling you something, versus those companies that increase in low single-digits or just a penny.

TWST: Obviously, that's a critical part of your strategy of 20 years now, but do you think it's something that too many investors or advisers have shortchanged in the past?

Ms. Brown: I think that with a focus on current yield, that could be true, yes. Also, our portfolio last year had about 7% turnover. The past five years, the average annual turnover was about 17%. Right now we own 32 stocks, and this is a high-conviction portfolio of carefully selected stocks with pretty low turnover.

Great investments develop over time. And, like I said, when I was a young analyst and I looked at people who, this stock, they've held it for a while, it's a company that's turned out well — we have holdings in the office that are getting multiples on the original investment and in current income. That's a good investment over time. In our Dividend Growth portfolio, right now the highest yield on cost is around 17%. That's pretty good.

TWST: Would you like to add any final thoughts to conclude?

Ms. Brown: I think Reg FD leveled the playing field. Everybody gets the same information at the same time. It's how you use that information to make decisions. With our 20-year track record, the same team using this flat decision-making process, we've shown that bottom-up stock picking is how we've created our alpha. This is a decision-maker's business, and we've shown that we have discipline and judgment, which creates results.

TWST: Thank you. (MN)

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MONEY MANAGER INTERVIEW

Balancing Dividend Growth and Earnings Growth to Produce Solid Returns

LAWRENCE J. PAVELEC AND MICHAEL L. SHELTON, NICHOLAS COMPANY

LAWRENCE J. PAVELEC, CFA, serves in a leadership position for Nicholas Company, Inc. as the Chief Operating Officer and head of product distribution. He also serves as an analyst and client portfolio manager for the separately managed account equity portfolios. Mr. Pavelec joined Nicholas Company in 2003 to serve as the Portfolio Manager for the Nicholas High Income Fund and lead the product distribution effort. His career as a credit analyst and portfolio manager began in 1984 with M&I Investment Management Corp., where he focused on investment-grade corporate bonds, asset-backed securities and mortgage-backed securities. Before joining Nicholas, he was with Brandes Investment Partners as the co-manager for Brandes Fixed Income Partners, serving as portfolio manager and head of marketing for the firm. Mr. Pavelec earned his B.S. in finance from the University of Wisconsin at La Crosse. He has served on various non-profit boards over the years, including the Mequon-Thiensville Education Foundation, North Shore Country Club, and the Peninsula School of Art. He has earned the right to use the CFA designation and is a member of the CFA Society Milwaukee.

MICHAEL L. SHELTON, CFA, joined Nicholas Company, Inc. in 2006. He serves as lead Portfolio Manager of Nicholas Equity Income Fund, co-Portfolio Manager of Nicholas Fund, and is a senior research analyst. Mr. Shelton has a depth of knowledge following years of covering the health care, technology and industrial sectors. Prior to joining Nicholas Company, Mr. Shelton worked for the Department of Defense Financing & Accounting Service as a financial analyst. He spent three years with Robert W. Baird as a research analyst, and at McDonald Investments for one year focusing on health care companies. Before starting his investment career, he worked with Ernst & Young as an auditor and tax consultant earning his CPA designation in 1995. Mr. Shelton graduated magna cum laude from Miami University in Oxford, Ohio, and obtained his MBA from Ohio State University. He has earned the right to use the CFA designation and is a member of the CFA Society Milwaukee.

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SECTOR — GENERAL INVESTING

(AHV507) TWST: Let's start with a short introduction to Nicholas Company and the Nicholas Funds — an overview of your business and your broader investment philosophy.

Mr. Pavelec: When you look at Nicholas Company, we have long-tenured investment staff, both from an industry standpoint and from Nicholas Company tenure. Dave Nicholas, who is the CEO, Chief Investment Officer, and a portfolio manager, has been

with the firm 37 years; 40 years in the industry. One of the other portfolio managers, Brian Janowski, 21 years; Ryan Bushman, 23 years; and Jeff Strong, 17 years in industry. Industry average is 20 years, and Nicholas Company tenure is 14. We feel strongly about our investment team and personnel.

"Companies that offer attractive dividend yields and have grown the dividends offer the best risk-adjusted returns over the long run. This is true especially in a lot of different types of markets such as high volatility, recessions and inflationary periods. Finally, dividends can also be a good indicator of a company's health."

We take a long-term approach to our investment philosophy and process. The Nicholas Company itself was founded in 1967 by Ab Nicholas. Ab was one of the early portfolio managers in the mutual fund industry, and he led the firm up until 2016. At that time, his son, Dave Nicholas, who was a portfolio manager for our mid-cap and small-cap, became the CEO and President. Dave continues in those roles today.

The firm is owned by the Nicholas family, Dave and his two sisters. Dave has majority voting share and control of the business. It has been a closely held family business since the beginning in 1967.

The history is interesting. Nicholas Company has weathered probably five of the six worst markets in history, outside of 1929. Ab was here during the 1970s, the oil crisis, the market fell by 40%; stagflation, high interest rates in the early 1980s, when the market fell 27% in 1982; and the tech bubble, the Nasdaq fell 77% in 2000.

Nicholas weathered the financial crisis, with the market down about 57%, and then more recently, COVID, which was a unique experience for everyone and changed the way we work to more of a flexible working environment.

All those events that occur test you as professionals. I think the one thing we all believe in is that in the long term, the economy and the markets will rebound, while the market decline creates opportunities. We're happy and proud that Nicholas Company has weathered all these different markets.

We really try to focus on the long term, and our main objective is to generate superior risk-adjusted returns over the long term. We do that by focusing on what we believe are higher-quality stocks, stocks that have superior balance sheets, consistent earnings, a sustainable business model, and sound management teams. All the characteristics that we believe are very important and equate to a higher-quality company that is equipped to grow their business, grow their earnings, and, if the occasion occurs, can weather market volatility like the recent COVID pandemic.

We believe in keeping our expenses low. We have some of the lowest expense ratios in the industry with our mutual funds, and we have some of the lowest turnover ratios as well. We really try to focus on these key elements of what makes a good investment, and then we try to be patient while using market volatility as an opportunity to trade around those positions to add value.

Lastly, our investment style allows us to participate in bull markets, but where we tend to not perform in line is the more aggressive or highly valued markets, where valuations are not considered as carefully as they should. We would put the zero interest rate policy over the last few years leading into 2022 as one of those periods where there's a lot more risk to stocks, when the valuations get rather extended. We're careful to look at that and to be mindful of all those characteristics that can leave our investors exposed to potential downside risk.

Being aware of downside risks and protecting in more difficult markets has always been a key element to our style. We believe security selection and the position of the portfolios provide a little bit more of a cushion than many of our competitors.

That philosophy/strategy goes across all the funds. Our other three funds are growth strategies. Mike is going to talk today about our Equity Income strategy, and that is focused on dividend-paying stocks across all market caps and trying to provide an attractive, competitive dividend stream as well as price appreciation.

TWST: That Equity Income Fund (NSEIX) was introduced 30 years ago this year. Why, in your and the firm's collective experience, is it important to emphasize dividends?

Mr. Shelton: There are several reasons why owning stocks that pay dividends is important and beneficial to the long-term performance and stability. Historically, dividends have accounted for a significant percent of total return. Since 1930, dividends have accounted for over 40% of total returns earned by common stocks. During high inflationary periods such as in the 1940s and the 1970s, dividends accounted for 67% and 73% of total return.

1-Year Daily Chart of Apple Inc.

Chart provided by www.BigCharts.com

Companies that offer attractive dividend yields and have grown the dividends offer the best risk-adjusted returns over the long run. This is true especially in a lot of different types of markets such as high volatility, recessions and inflationary periods. Finally, dividends can also be a good indicator of a company's health. Companies that pay dividends typically have a strong and consistent cash flow.

There is a lot of data that does back up the benefit of dividend payers. There's one study that measured the S&P 500 from 1973 to 2020, and it broke down all different kinds of categories: dividend growers, dividend payers, companies that didn't pay any

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dividends, companies that cut their dividend, and the equal weighted S&P. What's interesting is of all those categories, the dividend growers had the best returns and the lowest standard deviation.

"The Equity Income Fund's embedded dividend growth rate over the past three years is 7%, and for 2022, the fund's stocks have increased their dividends by 8%. That compares with the S&P 500's three-year CAGR dividend increase of 4.1% and a 2022 increase of 9.5%."

So when we think about an overarching view on dividends, the optimal performance is really achieved through a balance of growing dividend payouts and earnings growth. And to sustain the dividend growth, companies must have a reasonable payout ratio, because they need to be able to have sufficient capital to reinvest in the business. This is key, because to continue to raise that dividend, you have to reinvest in yourself.

Often people ask, what is the optimal dividend payout ratio? Are the highest dividend-paying stocks the best? It's been found that they are not, because their payout ratios are too high and as a result they don't have any free cash flow to reinvest in their business, which is needed to further drive growth.

And so, it's really a balance between those things that has proven, over long periods of time, to produce solid attractive risk-adjusted returns.

TWST: Walk us through the fund's investment process.

Mr. Shelton: The investment process starts with looking for companies that pay a yield greater than the S&P 500, have grown their dividend periodically, and have a reasonable payout ratio. Next, we assess whether the company has strong underlying fundamentals and possesses a strategic moat.

One differentiator of the Equity Income Fund is that we can own stocks of any market cap. A lot of dividend funds fall within the Morningstar category of large value. We have the freedom to own stocks across the market cap universe, and over time we've owned companies as small as $1 billion market cap all the way up to the largest market capitalization stocks, such as **Apple** (NASDAQ:AAPL). We think this flexibility gives the fund the opportunity to own some of the faster or more differentiated companies that pay dividends.

I can walk through our objective and philosophy as well as the characteristics that I'm looking for during stock selection. To reiterate, our investment objective is, first and foremost, to provide investors with a reasonable stream of income. Our secondary purpose is to provide moderate long-term growth of capital at an attractive total return.

Our investment philosophy is consistent across the other Nicholas funds. My focus is specific to dividend-paying stocks, but our investment philosophy has four elements. First, it's a traditional bottom-up process. I seek to invest in dividend-paying companies that I believe have high-quality characteristics and sustainable business models. We also focus on the long term, and to that end, the Equity Income Fund's turnover in 2022 was 18%.

We often find the best alpha-generating opportunities are situations where there's a dislocation between the fundamentals and market expectations. This often takes time to play out, thus taking a long view and having some patience provides the best return on individual stocks.

Of course, we try to seek to exploit short-term fluctuations and extreme market valuations. When COVID hit in March of 2020, that was probably one of my more active trading periods. From April 2020 through the summer, there were a lot of stocks that I had always wanted to own or had looked at, and during that period a lot of people were selling. Thus COVID and the market reaction offered some real good buying opportunities to own some great companies.

Finally, the last part of our philosophy is pulling together several elements, which includes security selection, diversification, and risk management. We believe as a result of this process our portfolio has greater price stability over time. As quoted by Morningstar, the Equity Income Fund's Sharpe ratios and standard deviation compares favorably over three, five and 10 years relative to our peers. Again, we really think about downside risk and stability, as we put together and manage the portfolio.

1-Year Daily Chart of American Tower Corp.

Chart provided by www.BigCharts.com

The selection process begins by evaluating nine investment characteristics of a company. The first three are very dividend specific. Buying a stock that has a dividend yield greater than the S&P 500. As of 12/31/22, the Equity Income Fund's SEC yield was 2.17%, versus 1.77% for the S&P 500.

The second characteristic relates to companies that have consistently raised their payout. The Equity Income Fund's embedded dividend growth rate over the past three years is 7%, and for 2022, the fund's stocks have increased their dividends by 8%. That compares with the S&P 500's three-year CAGR dividend increase of 4.1% and a 2022 increase of 9.5%.

The third characteristic of the fund is a reasonable payout ratio. We target below 60%, we feel that's ideal; the company has potential to raise its dividend but still has enough free cash flow to reinvest in the business. The Equity Income Fund payout ratio is 42%.

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The fourth characteristic I focus on is trying to identify a moat and a competitive advantage. Identifying a moat does describe a company's ability to maintain its competitive advantage and defend its long-term profitability. Possible moats include intangible assets, cost advantage, switching costs and network effects. Companies that don't possess a moat typically don't have pricing power. The inflationary environment we are in now tests the strength of the companies' moat.

"The tower business is very attractive, as wireless carriers enter long-term leases that include rent escalators, which really gives American Tower high visibility and stable revenue streams. These contracts are very long — seven, 10 years — and there are multiple renewals built in that, and so it gives them a lot of predictability."

The fifth characteristic focuses on the history of earnings growth and free cash flow generation. That's really important, because, as I said before, it's critical to be able to sustain and grow the company's dividend over time.

The sixth characteristic I look for are companies that generate returns on invested capital greater than their cost of capital. That's a very good measure of management teams' ability to make the right capital allocation decisions, and, typically, if you don't have a moat, you're not going to earn your cost of capital.

The next step in the selection process is evaluating the company's balance sheet. A strong balance sheet is important, as it provides optionality for the company and safety for the investor.

The eighth characteristic focuses on the management team. Is the company run by a competent management team and are their financial incentives aligned with shareholders? And what I mean by that is, trying to judge the management based on their strategic or capital allocation decisions they've made, but also, I always look at the proxies to see how the management team is compensated.

Over the years, you've seen management teams that were incentivized for the wrong reasons. We believe management teams play an important role in a company's success, and one way to evaluate them is to know if compensation is aligned with shareholders.

Finally, the last characteristic in the selection process is valuation. In terms of valuation, we are very valuation-sensitive here. I typically look at many of the traditional metrics: price to earnings multiple; PEG ratios; EV to EBITDA, which takes into consideration how much debt the company has; and the free cash flow yield.

Why free cash flow is important is because using the income statement in calculation valuation can lead you to get inaccurate conclusions since with earnings there's often a lot of adjustments that are made by the company to reach "adjusted earnings."

Free cash flow yield really is the cash that they generated divided by the market cap. It is a more pure way to assess valuation and the true value of the company as well as how it trades relative to its peers in the market.

TWST: With that in the backdrop, could you give us a couple examples of holdings?

Mr. Shelton: I have three I could talk about. One is our second largest holding, one is a recent purchase, and finally there is a mid-cap idea, which demonstrates the Fund's differentiating approach that we take in terms of security selection.

I can start off with the most recent purchase that we've made, a company called **American Tower** (NYSE:AMT). It's a little over $100 billion in market cap and generates roughly $11 billion in revenue. It was founded in 1995, and it's one of the largest global REITs and a leading owner of cell towers globally. They have towers all over the world, and their revenue is split evenly between North America and its international segment.

The tower business is very attractive, as wireless carriers enter long-term leases that include rent escalators, which really gives **American Tower** high visibility and stable revenue streams. These contracts are very long — seven, 10 years — and there are multiple renewals built in that, and so it gives them a lot of predictability.

Another attractive feature is they have significant operating leverage potential. Adding tenants to an existing tower really drives up the returns. If **American Tower** has a tower that Verizon is using, Verizon pays them, but then if T-Mobile and/or AT&T needs to build out their capacity they'll want to use that tower as well. If you're **American Tower**, you've already put the money into that location, and adding the new tenants really drives the returns.

1-Year Daily Chart of Crown Castle Inc.

Chart provided by www.BigCharts.com

It's quite compelling. One tenant, they make 3%. If they have a second tenant, they can make 13% returns. And if they have three tenants, they can make as much as 24%. So the returns can be significant depending on how many customers you have on there.

And there's obviously a big secular theme here, as data grows and networks get more stretched, upgrading equipment is really the primary solution for the carriers. Mobile data usage has grown at a 55% CAGR from 2007 to 2022, and I think it's safe to say that with 5G, autonomous driving, Internet of Things — there's just a tremendous need and appetite for reliable and fast networks, and **American Tower** is going to be well positioned to benefit from that.

One thing that does differentiate **American Tower** from other cell tower companies is their focus on the international market.

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They're in India, Brazil, Africa, Mexico — but what's interesting is that many of these international markets are about a decade behind the United States, they're just building their 4G networks now. And so that's where **American Tower** has focused, partly on the international market, because there's a very long runway for that.

"American Tower's dividend profile is very compelling. It has a 2.9% yield, which is higher than the S&P 500 at year-end of 1.77%. They've also grown their dividend over the past five years at a 19% CAGR, and that compares to the S&P growth rate of only 6.2%. American Tower's most recent increase was 12.5%."

When I bought this stock, I put it through the lens of our investment attributes approach. The first three have to do with the dividend. Is it greater than S&P 500? Have they raised it on a consistent basis? Do they have a reasonable payout ratio?

American Tower's dividend profile is very compelling. It has a 2.9% yield, which is higher than the S&P 500 at year-end of 1.77%. They've also grown their dividend over the past five years at a 19% CAGR, and that compares to the S&P growth rate of only 6.2%. **American Tower's** most recent increase was 12.5%. And they've raised it yearly since they initiated it nine years ago.

They have a low payout ratio of 60%, and relative to other companies that may seem high, but for REITs that's absolutely on the low side. Because it's low and they're growing cash flow, that's how they've been able to raise their dividend at such a high-double-digit rate.

The fourth investment attribute is making sure it has a moat and a competitive advantage. **American Tower** benefits from switching costs. First, because carriers own and are responsible for their equipment, they deploy the equipment on the towers, so it's the responsibility of AT&T or Verizon to put the equipment up on the tower.

For this reason there are high switching costs, since if a carrier wants to use a different tower, they have to take it down themselves, and it can cost up to $40,000 to remove equipment from a tower. It's very expensive. And so, it's unlikely that they're going to find a deal or another tower company that's going to offer them such a low price that it's going to make it worth their while to switch.

Furthermore, carriers don't want to cause any disruptions, so they don't like changing towers, and therefore, tower churn or turnover in customers is 1% to 2%. It just doesn't happen for those reasons.

They have a strong history of growth. Their AFFO — Adjusted Funds From Operations — per share has grown over the past 10 years at 14% CAGR. In terms of return on invested capital, **American Tower** has consistently generated a 10% return over the past decade. Given the critical nature of these towers and the need for mobile data and lack of substitutes at this point, I feel confident that they should be able to earn excess returns for the foreseeable future.

The next step in the process, I analyze **American Tower's** balance sheet and debt serviceability. Though their leverage is high at 5.5, REITs typically do carry high amounts of debt relative to their cash flow. Their debt is rated investment grade. One way to measure their ability to service debt is looking at their fixed charge ratio, and **American Tower's** is 3.8 times covered, which is better than its closest competitor, **Crown Castle** (NYSE:CCI), which is at 3.4, and then nearly double **SBA Communications** (NASDAQ:SBAC), which is the other U.S. tower company. There are three U.S. publicly traded tower companies, so they're in the best relative position when it comes to its ability to service their debt.

Looking at the management team, one way to evaluate their decision-making is determining if the company is generating excess returns on capital, which they do. The other component of assessing management is examining the proxy statement. To that end, their compensation is tied to their AFFO growth and return on invested capital over a trailing three-year period. I always like to see management's compensation tied to return on invested capital, or at least some portion of their compensation, because it really forces them to be thoughtful in how they utilize and spend the capital.

Finally, the last step is looking at valuation. It's 21 times next 12 months. Its five-year average is 24 times, down from its 5-year high of 31 times, and they're expected to grow about 9% from 2022 to 2025.

We bought the stock in the fall, so it's a very recent purchase. Given that interest rates had increased so fast and so high, a lot of the REITs had really underperformed. Given **American Tower's** numerous attractive characteristics coupled with a material correction, we felt it was a great opportunity to take an initial position.

1-Year Daily Chart of SBA Communications Corp.

Chart provided by www.BigCharts.com

TWST: And you said you had two other examples you'd like to discuss. One is a top holding?

Mr. Shelton: The second largest holding in the Equity Income Fund is a company called **Analog Devices** (NASDAQ:ADI). It's a $93 billion market cap company and does a little over $12 billion in revenue. It was founded in 1965 in Cambridge, Mass., and it's the world's second largest analog chipmaker. The company is well positioned to benefit from more advanced and higher-priced semiconductor content in automobiles, 5G wireless equipment, industrial applications, and factory automation.

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Analog chips are different than a lot of other microprocessors, such as Intel. Analog chips are used to convert real world signals such as sound, temperature and pressure into digital signals that can be used in a wide array of electronic equipment. What's interesting about this part of the semiconductor industry is it can never be replaced, because there will always need to be a way to convert a physical characteristic into a digital signal, and this is the technology that does it.

"ADI's analog expertise tends to come from intangible assets associated with proprietary chip designs. These take many iterations, and so it's very difficult for a startup or another competitor to get into the industry, given the complicated chip designs. And they benefit from switching costs as well."

ADI's two key markets are industrial and automotive, which represents about 60% of revenue, and their business is characterized by very long product cycles, highly sticky customer relationships, and strong operating margins, which topped over 50% in the most recent fiscal year end.

ADI has a dividend yield of 1.9%, slightly above the S&P 500. They've grown their dividend 10% on an annual basis over the past 10 years, and that compares to the S&P 500 of 8%. They've raised the dividend 19 years in a row, and their payout ratio is only 32%. So we think it's well positioned to drive double-digit dividend increases for the foreseeable future.

Another key component of the investment selection process is identifying an economic moat and competitive advantages. **ADI's** impressive margins are supported by two moat sources: intangible assets and switching costs. **ADI's** analog expertise tends to come from intangible assets associated with proprietary chip designs. These take many iterations, and so it's very difficult for a startup or another competitor to get into the industry, given the complicated chip designs.

And they benefit from switching costs as well. Often, these analog chips can be as cheap as $1 or $2, but they're a very key part in a car or in a medical device for example. It serves a function that has to be done, and so once you're designed in, you can stay there for quite a long time. Fifty percent of **Analog Devices'** revenue is derived from products that are over 10 years old. Some things for the military, it could be the same product for 20 years, and it makes no economic sense for those customers to switch out. So it's a great business from that standpoint.

They have a great history of earnings growth and free cash generation. Over the past 10 years, they've grown EPS at a CAGR of 16%, and free cash flow at 17%; quite impressive numbers. Their return on invested capital is below their cost of capital. However, they've spent $35 billion on two acquisitions over the past five years.

Usually what happens is that, in the near period, your returns on invested capital don't look as good, but prior to the acquisitions they were earning double-digit returns on invested capital. I have a lot of confidence that they'll get back to earning double-digit returns.

They also have an excellent balance sheet. They're less than one times levered, and that gives them a lot of options. They've made some excellent acquisitions in the past, and what they don't spend, they return to shareholders. They distribute 100% of their free cash flow, either through dividends or buybacks.

We believe they have an excellent management team, and they're very well aligned with shareholders. They've made excellent capital allocation decisions. Over the past five years, the whole semiconductor industry has consolidated. Ten, 15, 20 years ago, people were very fearful of owning semiconductors for very long because they were very volatile. There has been tremendous consolidation across the whole semiconductor space, and the result is higher margins for everybody, and less price cyclicality versus the past. Over 90% of the management team's compensation is tied to performance metrics, including revenue growth, margins, and stock performance.

And then finally, their valuation is attractive, it's 16.5 times the next 12 months earnings, and that's below the five-year average of 20 times and well below the five-year high of 28 times. We assess the long-term earnings and free cash flow potential is quite attractive, and, given their strong moat, we believe that the stock does warrant a much higher multiple. That's a stock we've owned since 2017, and it's just a tremendous company all around.

1-Year Daily Chart of Analog Devices, Inc.

Chart provided by www.BigCharts.com

TWST: And then your third example is a mid-cap name?

Mr. Shelton: Yes, it's **Lincoln Electric Holdings** (NASDAQ:LECO). It's about a $10 billion market cap company with a little under $4 billion in revenue. This company was founded in 1895 and is a manufacturer of welding equipment and consumables. **Lincoln Electric** has the leading market share of 17% in a very large $22 billion industry. The industry is expected to grow 3% to 4% annually. Demand is correlated to general industrial production and GDP growth, and they do sell into some cyclical end markets such as construction, the auto industry, energy, and general fabrication.

On the good side, nearly 60% of the revenue is from consumables — you have the equipment, but then you also need the consumables. You're welding things together, and those

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consumables help provide a recurring nature to the business, which does lessen the volatility of the results.

“Lincoln Electric has made a big push into automation, and welding automation is growing twice as fast as traditional manufacturing. This has been driven by a shortage of skilled workers, capacity constraints, and manufacturers are reshoring operations to drive efficiencies.”

Additionally, the market is incredibly fragmented. They have leading market share and there are only two other companies that provide both consumables and equipment. Having a complete offering has aided **Lincoln Electric’s** track record of picking up market share. Additionally, the $1.2 trillion Infrastructure Investment and Jobs Act should also provide some nice growth opportunities over the next several years.

I’ll walk you through the investment attributes, and really **Lincoln Electric** checks nearly all the boxes of what I am looking for. The yield is 1.8%. Their dividend growth CAGR for the past 10 years is 13%, which compares favorably to the S&P 500, which is only 8%. Their most recent increase was 14%, and they’ve raised their dividend 27 years in a row, and their payout ratio is only 31%. They have a great track record of growing the dividend and, with that low payout ratio, are well positioned to be able to invest in their business but also raise the dividend at a healthy rate.

Can I identify an economic moat and competitive advantage? **Lincoln** really benefits from two moat sources, intangible assets and switching costs. **Lincoln Electric’s** intangible asset rests on its reputation for quality. They have a host of patents, and they have very strong relationships with distributors. Brand loyalty is extremely high in welding, and customers tend to stick with one manufacturer.

One thing that **Lincoln Electric** does well is they work with welding schools to help provide some training, and so when those students graduate and start to work, they’re already familiar with **Lincoln Electric** products. Again, once they start using a product, they typically don’t switch to another manufacturer.

Also, **Lincoln Electric’s** other moat is switching costs. There are only three companies in the world that provide both the equipment and the consumables, and most welding companies and welders just want to deal with a one-stop shop. This has really helped them take market share from smaller competitors.

Their history of growth and free cash generation has been great, as well. They’ve grown EPS 10.5% (CAGR) over the past 10 years and free cash flow at 10%. And when it comes to returns on invested capital, this is where they shine. They’ve averaged over 20% returns on invested capital over the last decade. Their balance sheet is in tremendous position. They only have one times debt to EBITDA, which gives them a lot of flexibility. They do make acquisitions.

They have an incredibly competent management team. Return on invested capital is one of the main ways that the management team is measured and compensated. In total, 85% of CEO compensation is tied to performance. Again, we like to see the management team aligned with shareholders, and in this case, we feel very confident they are.

Also, as part of the characteristic of trying to identify something unique, I like to ask myself, are they benefiting from secular growth opportunities? **Lincoln Electric** has made a big push into automation, and welding automation is growing twice as fast as traditional manufacturing. This has been driven by a shortage of skilled workers, capacity constraints, and manufacturers are reshoring operations to drive efficiencies. Almost 25% of their business, on a run rate, is now in automation, and the auto industry is very keen on utilizing this, and that’s where **Lincoln Electric** has had some early success.

Valuation is attractive as well, 17 times, which is below its five-year high of 28 times and below its five-year average of 19 times. Free cash yield is 6.8%, which compares favorably to the S&P 500 of 5.1%. So, all around, we think it’s a unique pure play within the welding industry and they are a true compounder. I define a compounder as a company that has outperformed the market over three, five, 10 and 15-year periods.

1-Year Daily Chart of Lincoln Electric Holdings Inc.

Chart provided by www.BigCharts.com

TWST: Taking a look at the broader investment market and the macroeconomic landscape, what is top of mind for you in terms of your outlook for the rest of the year?

Mr. Shelton: I’m cautious regarding 2023. I do believe we’re heading into recession. Is it a deep recession or a mild recession? I think a recession, nonetheless. Inflation has been a significant challenge for the Federal Reserve. It has proved to be much stickier than they originally forecasted. And while inflation is slowing, it continues to be well ahead of the Federal Reserve’s target of 2%. The December reading was 6.5%, which is below the cycle peak of 9.1% recorded in June of 2022, but it’s still a long way off from a stable pricing environment.

We hear stories every day that underpinning the inflation challenge is a very strong labor market. The unemployment rate is 3.4%, and businesses have had to give raises to attract and keep workers, and while the wage pressures may be waning a little bit, they’re still having this upward push on inflation.

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We believe the Fed is going to continue to raise rates and hold them there until inflation is well under control. In his press conference the other day, Powell made it very clear that he doesn't want to cut too early, because if you cut too early and inflation comes back, then it becomes more entrenched, and you will have a bigger problem and may end up leading to a more severe recession.

There's been historical precedent for this. This is exactly what happened back in the early 1970s: They raised rates, inflation started to cool, they then backed off and cut rates, and subsequently inflation accelerated again and it really became a problem and didn't get fixed until they raised interest rates to quite high levels. Powell is really concerned about not making that mistake, and so we believe that he's going to keep rates high until he's got a lot of conviction.

Regarding the market, we do have the most conviction in, at least, an earnings recession in 2023. We've already begun to see this in the most recent reporting season; 4Q 2022 S&P 500 earnings were down 5%, and if you exclude energy, earnings were down 9%. 2023 earnings have continued to come down, and right now represent only 3% growth. If you go back six, nine months, they were much higher.

As we move through the first half of the year, I would expect earnings to continue to decline, given the lag effects of the Fed rate hikes, because it could take up to 18 months for those rate hikes to take full effect. As things get repriced, it could be a headwind to the economy. On average, historically, recessions have resulted in earnings contracting 24%, and so I feel like with the backdrop that we're having now, it's hard to imagine we're going to have 3% growth next year. I think it's going to be a lot less.

With continued inflation, Fed policy, and the beginning signs of a weakening consumer, we're very cautious about the market, especially since the market isn't cheap — it's 18 times earnings. With a backdrop of slowing earnings and high inflation, the 10-year average S&P 500 multiple is 17.5x, so it's close to the current multiple of 18. But that multiple was during a time when inflation averaged 2.6% over that 10-year period, and we're in a much higher inflationary market at this point, and so frankly, a lower multiple than 18 is justified, in my opinion.

However, given the large market selloff last year — the S&P was down 18% — there are some opportunities that are beginning to present themselves, again, taking a long-term approach. The way the Equity Income Fund is put together, earnings of the fund are slated to grow 6% in 2023, and coupled with a 2% dividend yield, thus you have the potential for 8% total return. That would compare to the S&P 500 of 4.8%, 3% earnings growth and 1.8% yield.

So we are optimistic about the Equity Income's return relative to the market for this year, and we've been adding some new names in the last three months. We're barred by the 60-day rule in terms of disclosing recent ideas, but there are opportunities. I believe the market selloff and the inflation headwind which hasn't been tamed yet will provide excellent opportunities to buy great companies at attractive prices.

In terms of sector positioning the biggest sector weighting in the Equity Income Fund is health care. The sector has been a solid long-term performer because it's really a combination of both defensive and companies that do have growth, and so that area of the market can really offer some growth at reasonable valuations.

My second largest sector weighting is technology at 16%, with semiconductors representing over 7% of the Equity Income Fund in total. I feel strongly that there are just so many secular growth themes out there — automation, 5G, AI, electric vehicles, cloud computing — which could provide tremendous opportunity over time. The ones I own all have excellent dividend growth, earnings growth, and reasonable payout ratios.

So, again, cautious about 2023, but have been adding and buying some new companies, and if the market does sell off, I look forward to upgrading the portfolio. I have about 6.5% cash. We believe these are the times, when you have the most volatility, that can really present the best opportunities, if you have a long enough horizon to take advantage of it.

TWST: Do you want to wrap up with some final thoughts?

Mr. Pavelec: We appreciate the opportunity to tell our story and to give some insight as to how we view dividend-paying stocks and how we approach the Equity Income Fund, which we think is a great investment alternative for individuals. We have foundations and endowments in this, and also have it as an option in certain retirement plans.

For individuals that are looking for an income component to their equity strategy, and they want to be a little bit more defensive because of their concerns over the market, it really fits in well. Over the long term, the returns have been very strong.

Over 15 years, the fund is ranked in Morningstar at 4% at end of January. We think it has a proven track record, and Mike has had the reins here for a number of years, and so a good part of this record is his. We feel very strongly this is a great option for shareholders and future investors.

TWST: Thank you. (MN)

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MONEY MANAGER INTERVIEW

Powerful Metrics: Growing Free Cash Flow and a Strong Balance Sheet

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SECTOR — GENERAL INVESTING

(AHV510) TWST: We're focusing our conversation on the Invesco Diversified Dividend Fund (LCEAX). Would you give us an overview of the fund and its investment philosophy and strategy?

Mr. Santoro: We view dividend income investing as a comprehensive strategy rather than a single investment factor or a style box. We don't simply screen for companies with the highest yields because it says nothing about the ability to pay a dividend, and certainly nothing about the ability to grow that dividend over time. In contrast, we believe that focusing on companies with growing free cash flow, strong balance sheets and good capital discipline is a better way to gauge the value of a company and importantly its ability to pay and grow dividends, which is an essential part of the total return strategy that we implement in managing the Diversified Dividend Fund.

TWST: Tell us more about what the stock selection, as well as the ongoing portfolio management process, look like.

Mr. Santoro: We believe portfolio construction is just as important as picking stocks. In addition to our free cash flow and balance sheet analysis, we spend a lot of time focusing on portfolio construction. We stress diversification and look to avoid large sector concentrations that may result in undesired elevated portfolio volatility or extreme factor bets.

As I mentioned, instead of looking for the highest dividend yields, we believe investors should focus on quality companies with growing free cash flow, strong balance sheets, and capital discipline, and we believe we can find attractive ideas across all the sectors. We think this approach potentially leads to better risk-adjusted returns and less volatility in turbulent markets, which is what most of our dividend clients are seeking.

TWST: Is there anything else you'd note that you feel differentiates this fund and your portfolio management team's approach from other dividend-oriented mutual funds?

Mr. Santoro: Yes, and it's something I'm very excited about. One of the advantages of making free cash flow generation central to our investment process is that it opens the aperture of our investment universe. It allows us to evolve as value investors by identifying companies with exposure to exciting secular growth trends. I think that's what differentiates us: We can tap into many different secular trends by focusing on projected free cash flow.

Sometimes when you think of a dividend strategy, you're thinking solely of old, unexciting and completely mature companies. We don't need to be pigeonholed into that — we can actually evolve the portfolio as our universe expands when we focus on projected free cash flow.

TWST: So, are you finding better opportunities in certain sectors or segments of the market right now? And is that differing so far this year as compared to 2022?

Mr. Santoro: I don't know if it's more about the calendar year turning over, but clearly some of the factors that were working really well in 2022 dovetailed into what we do, if you think about free cash flow metrics, quality, focus, strong balance sheets. We're going to stick to our discipline, because I think that when you look at the fundamentals of the companies and analyze those balance sheets and projected free cash flows, I think that will still be rewarded over a market cycle.

So I'm hesitant to jump into the one month of this year versus last year, but in general, I do think that over a market cycle free cash flow metrics work. We think that free cash flow plus strong balance sheets is one plus one equals three. So there's power in both of those metrics together.

In the backdrop of a challenging year for the market last year, we identified a couple of companies that we thought were benefiting from long-term secular growth tailwinds and were also very well positioned in their industries.

One of the names that we purchased is **Thermo Fisher Scientific** (NYSE:TMO). This is a company that has strong franchises in medical innovation, including large molecule research. As innovation happens within the biotech and health care industries, **Thermo Fisher** is right at the forefront of that revolution.

"In addition to benefitting from a number of long-term secular growth tailwinds, Microsoft has an extremely strong balance sheet, healthy projected free cash flows, and a management team that remains committed to strong capital discipline and returns to shareholders."

In addition, the company benefits from high recurring revenue streams, consistent pricing power, and a very strong balance sheet. Importantly, we project free cash flow to have healthy growth, and this should allow the company to increase the dividend yield over time.

Thermo Fisher is a name that probably wouldn't be found in a ton of other dividend strategies. We used the general market weakness to accumulate a position at prices we found particularly attractive.

TWST: Could you give us another example or two from your top 10 holdings, and again, how they illustrate your investment criteria?

Mr. Santoro: We are flexible, and we go where the opportunity set takes us. As an example, we started increasing exposure to the energy sector in 2022 even though the sector had been out of favor for many years. Three of our top 10 holdings are in the energy sector: **ConocoPhillips** (NYSE:COP), **Chevron** (NYSE:CVX) and **Exxon** (XOM). These companies have found capital discipline, they've improved their balance sheets, and they've focused on returning capital to shareholders. That was a big change for energy companies, and that shift made them attractive investment candidates.

From a fundamental perspective, we believe the oil supply/demand relationship can tighten further, with China demand coming back and supply growth still very muted. We think that it's fair to say that energy stocks are also discounting a lower oil price than present in the market today.

While energy is a space that we weren't as attracted to a few years ago because of the lack of capital discipline or the leverage on their balance sheets, these companies have become much more attractive because many of them have clearly changed their stripes.

As I mentioned, we are always open to find new ideas across a wide range of sectors, so I'll touch on two more companies. One of them is aerospace and defense holding **Raytheon** (NYSE:RTX), which has an underappreciated commercial aircraft division that's still operating below pre-COVID levels. They've had supply chain issues that have constrained their business, but we see evidence that those issues are improving. And we love the fact that they have very good visibility into the next few years, versus other industrial companies that are likely more exposed to cyclical headwinds.

Raytheon also has a leading defense business that should be a big beneficiary of the elevated level of geopolitical risk that is likely to persist in the years to come.

One other stock I can highlight is software and technology products maker **Microsoft** (NASDAQ:MSFT). We hadn't owned **Microsoft** for a long time in this fund, but we found **Microsoft** to get much more attractive as the tech selloff happened last year. Quite simply, we believe **Microsoft** has a great diversified portfolio of products at the forefront of emerging critical technology needs.

In addition to benefitting from a number of long-term secular growth tailwinds, **Microsoft** has an extremely strong balance sheet, healthy projected free cash flows, and a management team that remains committed to strong capital discipline and returns to shareholders.

While these stock examples are spread across multiple sectors, they have the attributes we look for in all of our holdings: strong free cash flow projections, healthy or improving balance sheets, and then companies that are in the right secular spots. This last element is important, because we believe in innovation, and we believe in being at the forefront of finding that innovation within our process and framework. I think that's what differentiates us.

TWST: Describe your sell discipline and exit strategy, and if you can, give us an example or two.

Mr. Santoro: Broadly speaking, we buy our portfolio every day. I think that's one of the important things in investment management — to analyze the fundamentals and the risk/reward of your portfolio every day.

1-Year Daily Chart of Thermo Fisher Scientific Inc.

Chart provided by www.BigCharts.com

Our sell discipline is multifaceted. I mentioned before that free cash flow projections and strong or improving balance sheets are very important to us, and then also a strong fundamental story. As a result, if we see a deterioration of that free cash flow, additional leverage on the balance sheet to a point that we're not comfortable with, or we believe the secular advantages that we were excited about in a company are no longer there — those are all part of our overall sell discipline.

We also look at valuation metrics, and we do have target prices on all our stocks. Sometimes a stock simply reaches our target

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price, and we have better ideas on our bench that we'd rather buy. So there's a myriad of reasons why we may exit a position. But from a fundamental standpoint, free cash flow, balance sheet, and then company positioning or the company advantages that we liked are no longer there, are the big drivers of why we'd exit a position — and then the fun part is when it hits our target price and we get to move on.

"We do believe we're entering a period where dividends will once again play a key role in a portfolio, in an environment characterized by high uncertainty and the possibility of more muted or even negative returns, which is something that we haven't talked about in the market for a long time."

In a portfolio where we buy our portfolio every day, we're always analyzing the risk/reward of each of our portfolio holdings. And obviously, we have a bench of names that we've worked on. I've been doing this for a long time; it's also looking at what are the alternatives. So I think it's important, when you think of sell discipline, it gets back to my original point of how portfolio construction is equally as important as stock selection. You need to put that all in context when you're fitting the pieces of the puzzle of your portfolio together.

TWST: There have been a number of recent articles about dividend-focused strategies; a recent Morningstar headline referred to stock dividend funds as "today's investment darlings." What are your thoughts about the attention and the overall performance — is it just a reaction to last year's stock and bond markets or is this a longer-term shift in investor focus?

Mr. Santoro: It's a great question, and I believe it's certainly warranted. I mentioned previously that from a very high level, investors are rediscovering the potential benefits of dividend-paying stocks in a market that has begun, really last year, to favor stability and income over some of the riskier growth companies that are extraordinarily expensive. We do believe we're entering a period where dividends will once again play a key role in a portfolio, in an environment characterized by high uncertainty and the possibility of more muted or even negative returns, which is something that we haven't talked about in the market for a long time. Investors should and will likely place an increased emphasis on companies with stable dividends.

It's important to remember that dividends are an important component of total return. If you go back even to the 1930s, compounded dividends have equaled around 40% of the total return of the S&P 500. In an environment where capital appreciation is not the only way to get total return, dividends have been and will continue to be a vital part of the equity markets' total return.

I believe we're going into a period of more normalized returns, so dividend income will be a much larger portion of that total return. The timing is right. If you look back over the past decade, dividends were clearly not 40% of the total return of the market. Now when you think of more normalized returns, that extra income you get from dividends is a much more powerful part of the equation.

I mentioned a little bit about geopolitical risks. There are things in the marketplace, and things in the world, where it's clear that the risk premium has expanded. Therefore, I believe companies that are well positioned and not relying on the capital markets or relying on other factors to drive their growth, but are more self-sufficient, generating their own free cash flow and having strong balance sheets — these are the type of companies that will likely be rewarded. And most of those companies pay dividends.

I think the time is right. I think the exposure that dividend stocks are getting is warranted. And I think this is not a short-term fad. I go back to the first question you asked: What is our strategy? It's a strategy, it's not a style box. I think the strategy to own dividends is a long-term winning strategy, and should be a core part of anyone's portfolio.

The last thing I'll say is that our population is aging, people are living longer and they need to have steady income streams for much longer time periods than previous generations. Dividends can play a unique role to help solve that problem.

In short, dividends not only provide current income, but companies that pay dividends typically hold up better in down markets and have lower volatility relative to the broad stock market. All of these characteristics should be very attractive to these investors who seek some capital appreciation, additional income from dividends, but also some downside protection in turbulent markets.

1-Year Daily Chart of Chevron Corporation

Chart provided by www.BigCharts.com

TWST: You mentioned the geopolitical risks. What else in the macro environment are you keeping your eyes on most closely these days?

Mr. Santoro: There were a number of significant macroeconomic headwinds at play during 2022, including record inflation levels, rising interest rates, as well as the Russian invasion of Ukraine These are all macro issues that creep into each and every one of our stocks. Our job is to treat those as more of a mosaic, and to understand how those factors may affect each individual company.

But I go back to my comments on the importance of portfolio construction to our investment process. What we're aiming to do is to be balanced with a lot of those risks, and to avoid taking large macro, sector or factor bets. We then seek to drive as much of the return from our individual stock selection as possible.

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So, while we keep an eye on all those macro issues, it's more in aggregate as part of the mosaic of how we're picking stocks and constructing the portfolio.

TWST: And the broader investment markets — what are you focused on tracking this year?

Mr. Santoro: We are focused on a lot of different things as we enter 2023. In my view, the big debate is whether we're going into a recession. Will it be a short-term recession, will we have a hard or soft landing, will there be a recession at all? What effect will the Fed have in driving that? What effect will the geopolitical risks we talked about have? What will the reopening in China mean for the markets?

When I take a step back, I believe a lot of these issues balance each other out. I think there are as many positives as negatives, and we're trying to retain that balance in our portfolio.

From a very high level, our team is focused on our individual companies and their ability to generate a lot of free cash flow and maintain strong balance sheets. I think that some of the earnings projections are a little high. I think they're a little optimistic.

We'd rather own companies that have more of a self-help opportunity, or more of a self-funding opportunity. These companies often don't need to access capital markets to refinance debt, they're self-sufficient in their business models, and typically they're not so exposed to extreme macro events. These are the type of companies we want to own in our portfolio.

When I think macro, I get back to the same word: balanced. We're trying to make sure we have a portfolio that's balanced to a lot of those factors, and we are working to pick the best stocks that fit our process within that.

Our strategy is just not very macro driven. We're paying a little bit of attention to all of them, and make sure that in aggregate, we're not exposed in any extreme way to any of those big macro factors.

TWST: Do you want to wrap up with some final thoughts or advice on the importance of investing in dividend paying stocks, both in general and in the current market environment in particular?

Mr. Santoro: When it comes to investing in dividend paying stocks, one of the most important elements is to make sure you're not just looking for the highest paying dividend yields. As I mentioned earlier, I believe it's important to focus on quality companies with growing free cash flow, strong balance sheets and capital discipline, because yield itself doesn't tell you anything. It doesn't tell you the company's ability to pay that yield. It doesn't tell you the company's ability to grow the dividend. It's just a number on a piece of paper.

So do the bottom-up work, do the analysis, figure out the free cash flow generation potential of that company, focus on balance sheet strength and capital discipline. Those quality characteristics make the best dividend-paying investments. Furthermore, portfolio construction is equally as important as picking stocks and striving for diversification across your holdings.

TWST: Thank you. (MN)

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Uncovering Bargains: Neglected Stocks with Positive Momentum

DONALD J. NESBITT, ZCM

DONALD J. NESBITT, CFA, is the Chief Investment Officer and Senior Portfolio Manager for Large Cap Core and Value Equities at ZCM. He joined the firm in early 2002 after having spent nearly four years at Qwest Communications' pension plan in Denver, Colorado, where he managed $6 billion of equities using quantitative approaches that exploit behavioral anomalies. Prior to joining Qwest, Mr. Nesbitt spent nine years at the Illinois Teachers' Retirement System where, as Chief Investment Officer, he was responsible for the management of $20 billion across various asset classes. Mr. Nesbitt instructs investment courses at the University of Wisconsin–Milwaukee and has spoken at numerous industry conferences on the topics of enhanced equity management and derivative investment strategies. He received his M.S. in financial analysis from the University of Wisconsin-Milwaukee, and holds a B.S. in economics from Saint Cloud State University. He is a CFA charter holder and a member of CFA Institute and CFA Society Wisconsin.

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SECTOR — GENERAL INVESTING

(AHV512) TWST: Let's start with an introduction to ZCM. Would you give us an overview of your business and overall investment philosophy?

Mr. Nesbitt: We develop and manage a diversified slate of investment strategies designed to increase the resilience of our clients' investment portfolios, while providing strategic opportunities for attractive returns across the risk spectrum.

We're headquartered in Chicago, although we do have teams and products managed by those teams across the country. In all, the firm is about $8 billion in AUM, and we run that over U.S.-based strategies in fixed income and equity. Fixed income is about $5 billion of that, and equity is about $3 billion of that. We have a staff of about 63 employees. As I said, we run equity strategies, fixed income, some mutual funds, and sustainable ESG strategies.

As for myself, I've been here at ZCM coming up on 21 years. I'm in charge of the Chicago equity group, which is basically large-cap and value products. Prior to being here, I spent the first part of my career on the buy side working for pension funds. I worked at the Illinois Teachers' Retirement System, and also the Qwest fund at CenturyLink, now out of Denver; originally, it was U S WEST.

So I made a move from being on the buy side and interviewing some of the best managers in the world. When you have hundreds of millions of dollars to give out in management mandates, they'll come to your door and tell you exactly how they do things. So I've tried to take a lot of the things I learned there and put it into what kind of product would work here being on the sell side now.

TWST: We're going to talk in more detail about the High Dividend Equity strategy. What's the overall investment thesis?

Mr. Nesbitt: This is obviously, as the name says, focused on dividends. We are in the large-cap value box of the Morningstar grid, so we benchmark it to the Russell 1000 Value. That probably is the closest benchmark that would reflect us. Beyond that, we have a very heavy dividend yield bias. That's an overwhelming factor in here. We can only invest in dividend-paying stocks. In that we're operating in that square, our primary goal is to beat the Russell 1000 Value Index over time, on both an absolute and a risk-adjusted basis.

But we also have a secondary objective, which is to out-yield that index. We set a soft target there, about a 50% yield pickup relative to the benchmark. That has moved in and out over the years, depending on how we see the market and where we view opportunity. It's been as high as maybe twice the benchmark yield, and as low as maybe 20% of a yield pickup against the benchmark.

Incidentally, that low watermark was attained back in the financial crisis, when a lot of stocks were selling off but they hadn't cut their dividends, but we focused on quality and didn't want to go chasing dividend yield at that time. A lot of funds in strategies that target just getting a high yield — you can run into problems with that.

We've been in this space, as I said, for over 20 years. ZCM's motto, if you will, is resilience in capital management, and we've been that. We've been resilient. We've been one of the major players in this space. We recognize that the dividend factor is important, as it accounts for anywhere between 30% to 40% of total return when you look back through history.

I came here right during the break of the tech bubble, and we wanted to focus on a strategy that would provide more stability, more consistency, be more resilient throughout market cycles. Companies that pay consistent dividends are generally superior companies in nature, have higher-quality earnings, fiscally healthy balance sheets, and the market usually rewards them over time for that higher quality.

"What we look for in our first screen is an overreaction to the past. We line up all the stocks in our investable universe, those paying a dividend, and we promote them relative to valuation. Basically, you get a higher score if you have a lower price-to-cash flow, or flip that around, higher cash flow-to-price. So we're looking for basically value-oriented names."

TWST: Is there anything you'd add in terms of what you look for in the dividend component? Do you look for a history of growing dividends, or yield of a certain number?

Mr. Nesbitt: I can talk about screens in a minute here, but one thing, in order to get that 50% or so yield advantage in the portfolio, is we look sector by sector. For example, we know that a sector like information technology is not going to pay a high dividend overall, but what we try to do there is we use our screens to find stocks that are attractively valued, and the second part of that is to pick up a stock with a yield that's higher than the average of its sector in the Russell 1000 Value.

Obviously utilities, staples, real estate have higher yields; health care, industrials, information technology are going to have lower yields. But if we are able to look across all the sectors and get a stock in there with above-average yield, then that's how we're going to try to hit that 50% yield advantage objective.

TWST: Let's talk a bit more about the investment and portfolio construction process. What does that look like overall? What are the other attributes or metrics that you focus on?

Mr. Nesbitt: I mentioned the screens, that's where it starts. One of the things I bring to the shop, I like to say I was one of the original behavioral quants. People ask, "Are you growth or are you value?" I'm a behavioral quant.

When I'd answer that 15, 20 years ago, people would look at me and say, "What the heck is that?" Of course, now behavioral science has made it into the CFA curriculum, everybody knows it. Everybody's got strong quant capabilities and are able to crunch the data a million different ways. Our advantage, I think, is we use that in a different way. Our screens have a two-step process, instead of lining up a whole bunch of different factors.

What we look for in our first screen is an overreaction to the past. We line up all the stocks in our investable universe, those paying a dividend, and we promote them relative to valuation. Basically, you get a higher score if you have a lower price-to-cash flow, or flip that around, higher cash flow-to-price. So we're looking for basically value-oriented names.

The second variable that we rank on is historical sales growth, and we actually penalize stocks with higher sales growth, which is inverse to what a lot of managers think. In a perfect world, you want cheap stocks that have great growth rates. The problem is they don't really exist, because the market focuses on one or the other. We're focused on the value proposition.

We rank the stocks in our universe, some 1,200 stocks, based on these two factors. On the one side, you've got neglected stocks. These stocks have become neglected by investors because something bad has probably happened, whether it's to the industry, the sector, the company itself, and so their prices have been knocked down to the point where they are trading very attractively to the cash flows that they throw off.

On the other side, you have the popular stocks. These stocks have had the great growth over the past five years or so, but they've been priced for it. Many times, they're priced to perfection. So we're basically trying to fish in that neglected end and find neglected stocks that look really attractive and still have their business intact. The business model is not broken, it's just had troubles.

And then the second part of our screening process looks within these stocks and uses what we call momentum measures, which is basically saying, we know this company is cheap, what's turning it around? We use three different kinds of measures from three different agents of information.

One is what the market itself is telling us via price momentum. Is it moving up, is it breaking down? The second is, what does the company report when it reports its earnings? Does it meet expectations, beat expectations, or disappoint? And the third agent of information is what are the analysts doing with their earnings estimates? Are they ratcheting them up, ratcheting them down, or leaving the same?

1-Year Daily Chart of Wells Fargo & Co.

Chart provided by www.BigCharts.com

So the ideal stock for us is a neglected stock that is attractively valued, the business is still intact, and it's showing positive momentum in terms of these three variables. Then we'll basically follow that up with a fundamental analysis, get to know the company, understand it, understand why it was broken and what's turning it around now.

TWST: Could you give us a few examples of holdings in the portfolio?

Mr. Nesbitt: A recent one that we added was **Wells Fargo** (NYSE:WFC). If you recall, it was back almost 10 years ago

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that it was actually occurring, but it came to light a few years later, the issue they were having with their retail customers — some issues in disclosure, maybe improper fee usage, and so on. That was the event that really knocked **Wells Fargo** out of favor. The price went down. The regulatory agencies got involved. And nobody really wanted to touch **Wells Fargo** for many years.

"Another best performer for us in 2022 was AbbVie (NYSE:ABBV), the health care medical company. It had fallen out of favor because its primary drug, HUMIRA, was coming off patent, getting competition, that sort of thing, so the market has not treated it very well."

What are the catalysts that we've seen recently? In 2019 they brought in Charles Scharf, the new CEO. This is one of the things we like to see in a broken company — they bring in new management, that's usually a catalyst. And the bank has slowly been climbing itself back to respectability.

We are hoping, and this could be the other catalyst, that the regulatory caps finish winding down this year and they're then able to move back towards running their business as usual. Meantime, though, this is a very cheap stock. It's trading at nine times its 2023 earnings. As I said, if these regulations come off, a further catalyst would be that they could start buying back their stock again, they could start raising their dividends even more, and so on and so forth.

Right now it has an attractive 2.8% dividend yield. It's not the highest yielding stock we have, but you're at about 2.3% yield for the financial sector in the Russell 1000, so it meets our above-average yield criteria.

One other one is **Bath & Body Works** (NYSE:BBWI), which we bought back in March of 2022, so it's been in there a little while longer. That was the old **L Brands** that broke up and basically spun off **Victoria's Secret** (NYSE:VSCO), which is probably the more popular business. The other one is **Bath & Body Works**, and they brought in a new CEO there. The market, we believe, has now recognized the growth potential there. Again, it's selling at a very attractive multiple in terms of its potential growth moving forward.

So, these are two what we saw as bargain stocks — neglected, out-of-favor stocks that we think are turning around.

TWST: What were your best performers and biggest detractors last year?

Mr. Nesbitt: We were overweight energy basically all year, which helped us. One of the names in the portfolio is **Diamondback Energy** (NASDAQ:FANG). We own currently in our portfolio four different energy holdings. There's **FANG**, there's **EOG** (NYSE:EOG); those are two upstream energy providers, the E&P plays, and they're what we call the high beta play in the portfolio.

One of the things we're always looking at doing goes back to how we manage in terms of how, once we construct the portfolio, we manage the risk factors of this portfolio. Also, we're looking at it closely against the Russell 1000 Value, trying to either match or understand our overweights and underweights to the factors.

We know we're very exposed to the dividend yield. But we decided a little over a year ago that with oil prices low, and it looked like the oil industry was going to be making a comeback, that we wanted to put some higher beta names in there.

To balance that off we've got a stalwart that's been in there for some time, **Chevron Corporation** (NYSE:CVX), a diversified energy play there, lower beta, that's kind of a bread-and-butter in the area and gives us the higher yield. And then the last one rounding it out is a refiner. And so, we've got a pretty well diversified play within the energy sector itself.

As I said, we've been overweight there, and we've been carrying a little bit of a higher beta with the **EOG** and **Diamondback** holdings, and they've been paying off for us very well.

Another best performer for us in 2022 was **AbbVie** (NYSE:ABBV), the health care medical company. It had fallen out of favor because its primary drug, HUMIRA, was coming off patent, getting competition, that sort of thing, so the market has not treated it very well. It's treated as basically a value bargain stock. I talked about our criteria, that these stocks are neglected but have positive momentum in terms of the three areas I talked about. Those are our bargain stocks.

1-Year Daily Chart of Bath & Body Works Inc.

Chart provided by www.BigCharts.com

We're trying to stay away from value traps, because we recognize that there are a lot of cheap stocks out there that are going to remain cheap; those are the attractively priced stocks that are having their prices stay broken down or are not moving up, the market's telling us it hasn't discovered it yet, earnings estimates are staying flat or down, and when they report, they either miss or they just meet expectations. We try to stay away from those stocks.

AbbVie, though, was a bargain stock, several years ago we added it and now it's a great growth story. It's not even in our benchmark, the Russell 1000 Value. Because it still has growth, its pipeline remains robust, and it's been increasing its earnings at a steady pace, it's one of the higher yielders in the portfolio. Right now, it has almost a 3.9% yield. So to get that kind of growth, that kind of yield, is something we really are looking for.

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A name we like and hold in the tech area, but has experienced recent underperformance, is the chipmaker **Qualcomm** (NASDAQ:QCOM), which I believe has been under fire and underappreciated by the market because of their relationship with **Apple** (NASDAQ:AAPL). But it's still a strong company and doing well, and is at about a 2.3% yield in a sector that is very low. If we look at the tech sector, it has an average yield of about 1.6%. So that fits our criteria.

"When you look at utilities, these are bond proxies, there's not a lot of growth there, the typical route of growth for a utility is basically demographics, their population market increasing, but NRG has recognized that we can move beyond this and take advantage of market participants' interest in ESG by being in companies that enable energy efficiency."

Over the last couple of years we've been putting more towards a growth component. When we look at dividends in general, we recognize that all dividends aren't created equal. There's what we call the bond proxies on one end of the spectrum — as you can imagine, a lot of the utility stocks, the staples, those kinds of companies you think of as paying a high dividend, but they don't have a lot of growth — and then on the other end are the growers like **AbbVie**, like **Qualcomm**.

We've been tilted more towards growth over the last several years. This has helped our product stay up. Even though growth strategies have trounced the market over the past decade or so, it keeps us hanging in there. If we see an advantage to moving back towards the bond proxies, we'll do that.

That's why I say, you can see that that yield pickup over time has moved anywhere from a 20% yield advantage to almost a double. I think it was back in 2010 when we had almost a double yield advantage, and that's where we were able to get a lot more bond proxies into the portfolio. So, again, all dividend yielders aren't equal. We want to balance out the portfolio, but we are aware of where we put the biases and why we're putting those biases in place.

To finish up on your question, what was the worst performer last year for us? Texas-based utility **NRG** (NYSE:NRG). **NRG** was knocked down in the fourth quarter. We had bought it the year before, when, if you recall, Texas had all those power outages, and the market didn't treat the stock very kindly. Although their service is across a wide swath of the country, by being Texas-based I think it got lumped in there and hurt by investors who sold it off.

It was doing very well for us until the fourth quarter, and it basically got hit again, because it announced its acquisition of **Vivint Smart Home** (NYSE:VVNT), which is basically a do-it-for-me type of smart home service provider. The market said, "you overpaid for that, we're worried about that," and knocked it down. But we're still holding on to it. We even took the opportunity to add a little bit to that.

When you look at utilities, these are bond proxies, there's not a lot of growth there, the typical route of growth for a utility is basically demographics, their population market increasing, but **NRG** has recognized that we can move beyond this and take advantage of market participants' interest in ESG by being in companies that enable energy efficiency. So, building this into their product line, where they can deliver the energy and help its customers become more energy efficient with their home — we see that as a real smart move and an opportunity for growth moving forward.

We've seen a pickup off the lows over the last couple of weeks, and we expect that to continue. But that's what we look at — when we get a situation like that, do we jettison it from the portfolio, or do we stick with it? In that case, we felt that the market overreacted, and the business is not broken, and as a matter of fact, it has underreacted to the prospects that there's going to be future growth here and reacted short term to the idea that they may have overpaid for that entity.

TWST: Do you find you're shifting your focus at all so far this year due to any particular themes?

Mr. Nesbitt: I think we stay overweight to the energy sector, although I will preface that by saying we're a bottom-up strategy, so we're looking for the names that we find are neglected but attractive bargain stocks. But second, we are very portfolio aware and benchmark aware. For example, the two areas that represent the best value are still energy, even though they've had this huge run over the last year, year and a half, and financials.

But we don't want to build a whole portfolio of financials and energy. As a matter of fact, we're going to stick pretty close to what the weightings are in the benchmark. Financials are actually the largest part of the Russell 1000 Value at about 20.5%, and we're sitting at about 20%, so a slight underweight there. Energy right now is about 8.2% in the benchmark, and we're at 8.5%. So, no real big benchmark bets; even though we find lots of stocks in each sector, we don't want to take those big sector bets.

1-Year Daily Chart of EOG Resources Inc.

Chart provided by www.BigCharts.com

Energy, in particular, is one that we don't want to run too far out of the lines — 1% one way or the other — because of the volatile nature of oil. While we're big ESG proponents, we recognize that fossil fuels are still going to meet 80% of our energy needs and they're not going away anytime soon. But the market really discounted them in terms of ESG, in terms of some of the things that were going on in the supply and, in the pandemic, in

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terms of demand, and even though they had this big run, they came from a very undervalued point of view.

"Going back to Wells Fargo, we think that it's the most asset sensitive of large banks and benefits the most from a steepening yield curve. We have started seeing that yield curve steepen, but banks still have a ways to catch up there, and there are still a lot of good values in that sector."

Banks in general, that's something that hasn't really come around yet. They're usually late-cycle performers and they benefit from a steeper yield curve. Going back to **Wells Fargo**, we think that it's the most asset sensitive of large banks and benefits the most from a steepening yield curve. We have started seeing that yield curve steepen, but banks still have a ways to catch up there, and there are still a lot of good values in that sector.

Going back to your original question about themes, you have the environmental, which I think is incorporated in the **NRG** example, where we try to understand the move towards more environmentally friendly companies.

Also, reshoring, the turnaround in globalization. As globalization contracts a little bit, or it certainly is not expanding at the clip it did in the past decade or so, we think that plays into a holding like we have in **Eaton** (NYSE:ETN) in the industrials. We're actually a little bit overweight in the industrial sector with names like **Eaton** and **Snap-on** (NYSE:SNA). These are going to be beneficiaries of this reshoring policy that we see coming up.

On top of that we own a couple of defense names, **Northrop Grumman** (NYSE:NOC) and **Raytheon Technologies** (NYSE:RTX). This is interesting because these stocks were really neglected a little over a year ago. In the fourth quarter of 2021, we put these in the portfolio because they were showing up as very cheap stocks.

We had no inclination that Putin was going to invade Ukraine in February of the following year. These just turned out to be really cheap stocks, they were beating the estimates, showing some price improvement, and analysts were starting to recognize them. So we put those in, and they've done very well, too.

We think that trend goes forward, so we're holding on to those stocks. Just this last week with all this spy balloon business, it further underscores the fact that geopolitical tensions across the world seem to be increasing, that it was another great lull, or a peace dividend that we've been living off of the last decade, and we may not be assured of such an environment going forward.

The other theme that keeps us awake and kind of scratching our heads, and I think this is true for the whole market, is will the Fed create a recession here as it raises rates? And if so, how long and how deep will that recession be?

We were prepared for these interest rate rises over the last year, and the portfolio did very well on a relative basis. Now it becomes a little bit sketchier. It seems like the Fed is nearing the top of its rate increases, but the market has been interesting to watch over the past year, because we put the best names we have in there, and they've all done pretty well, but on top of that you're running against this Fed pivot.

Several times over the last year, when we've seen these market rallies — just like the rally we're in now — the market is saying, "Well, the Fed is going to pivot, therefore, let's go back to the environment we had over the last decade of high growth stocks."

As I said, we're benchmark aware, and in this last Russell rebalance, several names came out of growth — names like **Meta Platforms** (NASDAQ:META), **Google** (NASDAQ:GOOG), **Netflix** (NASDAQ:NFLX) — and we can't own those stocks because they don't pay a dividend.

We were doing great over the last year overall, other than times like in early summer, when the market was rallying before the Jackson Hole Federal Reserve Symposium put a quash on that, and then at the end of the year the Fed again put a quash on it, though the market was rallying before that December meeting. When the market rallies like that, it's difficult for us to keep up with glamorous growth stocks, so we're trying to figure out what this is going to look like on the other side, when the Fed is done.

Another thing we're scratching our head about is the discount rate that the market is applying. I'm looking at this in the terms of the S&P 500, and if you look at that over the past five years, the market has been trading at a multiple of about 20 p/e. If you break that down at a discount rate, that is about a 2% real growth rate and a 3% risk premium put in there. There hasn't been inflation, so inflation was zero; that's why you could have a 5% discount and a 20-times multiple. If you add just a 2% inflation onto that 2% real growth and 3% risk premium, you're at 7%. A 7% discount gives you about a 14 multiple on p/e.

1-Year Daily Chart of AbbVie Inc.

Chart provided by www.BigCharts.com

So we think it's going to be a rockier road moving forward. But this strategy is basically made for that kind of an outlook. If you look historically at any three-year trailing period over our 20 years of running this, you can see that we outperform whenever the market returns a three-year return of about 6% or less. When it moves higher, like we've had in the last couple of years with 20% returns, we're 50/50; sometimes we'll outperform, sometimes we'll underperform, depending on what kinds of stocks outperform versus underperform.

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So we're looking at this on the other side, once we get done, and think that we're going to go back to an environment that has a higher discount rate. It's going to be looking for stocks that trade on reasonable multiples to their cash flows produced, not these glamorous stocks with high pie-in-the-sky estimates, and we think that bodes well for both the strategy and active management overall.

TWST: What are you cautious about these days?

Mr. Nesbitt: The hardest thing to manage to is when the market has this irrational exuberance over pivots coming, and when these stocks that we can't own or don't own outperform. We're going to trail there. But as I said, over the long run, we still think that we come back to more of a normal reckoning. Unless for some reason we go back to a zero interest rate policy and an easy money policy on the other side of this Fed tightening, what drove stock returns in the past decade is not going to be driving them this year.

And, as I mentioned, if you're looking at lower-single-digit returns, this type of strategy is going to outperform in that type of an environment versus some of these high-growth strategies that prevailed over the previous decade.

But it's a rough road getting there. Of course, we run a well-diversified portfolio so that we can weather some of the shots we take, like with our **NRG** holding.

TWST: What other advice would you offer to investors?

Mr. Nesbitt: I think the focus is back to what old timers like me were brought up on: Cash flow becomes important, and understanding the consistency, the quality, the resilience of those cash flows, and buying companies that are able to consistently grow those cash flows and pay them out in a dividend or buybacks over time.

Going back to our first level of screens, on the one end, we have the neglected bucket. On the popular bucket, we recognize that there are some stocks that are good growers; **Apple**, **Google**, they've been great growers over the past 15, 20 years. But it's going to be tough to grow those trillion-dollar companies at that kind of a rate. As a matter of fact, it just can't sustain. And so, you have a greater risk that those do not perform up to expectations, versus getting into names like I told you that we own in our portfolio.

The zero money made it easier to buy those type of things, so you had all kinds of bubbles going on with cryptocurrency, a lot of these tech stocks, the communication service stocks that were basically just a great story that attracted a lot of money.

All that's going to unwind, and I think investors are going to be looking for a real return on their investments, looking at the real cash flows to support those returns, and that's going to be what drives us going forward. This type of strategy, and the high-quality, cash-flow-growing types of businesses, is where you want to be. I know I'm talking my book, but I believe it.

TWST: Thank you. (MN)

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MONEY MANAGER INTERVIEW

Portfolio Benefits from Dividend-Paying Global Multinationals

DENNIS SABO, BLUE CURRENT PORTFOLIOS

DENNIS SABO, CFA, is a Co-Portfolio Manager of the Blue Current Global Dividend mutual fund and separately managed account strategy, and the Portfolio Manager of the firm's US Dividend Growth Strategy. He graduated from the University of Miami with a B.S. in electrical engineering and was a member of the electrical and computer engineering honor society Eta Kappa Nu. Following college, he worked in the telecommunications industry as an engineer and project manager with Harris Corporation in Florida and later at Cisco (formerly Scientific-Atlanta). In 2002, Mr. Sabo transitioned his career to the investments industry and graduated from the University of Georgia with an MBA. He then spent several years as a sell-side equity analyst, first with Robinson Humphrey of Suntrust covering software technology, and later with the Credit Suisse Global Media Team where he was responsible for the U.S. media sector. Mr. Sabo subsequently joined an emerging hedge fund, Jodocus Capital, where he was a sector generalist and focused on high-quality, small-cap companies. He joined Blue Current in 2010 and has worked on the Global Dividend strategy with Harry Jones since. Mr. Sabo is a CFA charterholder and a member of the Atlanta Society of Finance and Investment Professionals.

SECTOR — GENERAL INVESTING

(AHV513) TWST: Please tell us a bit about Edge Capital Group and Blue Current Portfolios before we get into more specifics.

Mr. Sabo: Edge Capital Group is an independent Registered Investment Adviser, otherwise known as an RIA. We're headquartered in Atlanta, Georgia. I would say our point of emphasis is solving financial problems for ultra high net worth families and individuals.

In order to do that, we have a variety of different arrows in the quiver, so we can be helpful in financial planning, we can be helpful in investment management. We have experience in offering a variety of different investment solutions for our clients, one of which we've developed really since the inception of the firm, which is offering creative income solutions for families and individuals.

Within our broader Edge Capital corporation is the Blue Current Asset Management division, and within Blue Current we specialize, again, on creating income-generating solutions for our clients.

I've been working in that capacity since 2010 with the firm, but bring about 22 years of experience in selecting individual equity securities and managing equity portfolios for individuals and families and some institutions. Within Blue Current Asset Management, we have a team of four individuals working closely together to manage the portfolio and select stocks. I'm the lead Portfolio Manager but work closely with one of my partners, Harry Jones, who originally incepted the strategy.

TWST: The two strategies at Blue Current portfolios are both dividend oriented, one global, the other U.S. focused. Would you describe the overarching investment approach and philosophy?

Mr. Sabo: Our oldest strategy, which is our Global Dividend Growth Strategy, dates back to 2009. It's the first strategy that we launched, and the investment philosophy that underpins all of the strategies that we offer and all the different flavors that we offer is emphasizing the importance of dividend growth. We believe dividend growth is one of the best areas of the overall market to invest in over the long term. For us it is not only buying companies that pay dividends, but more importantly companies that are committed to growing that dividend over time.

In our Global Strategy, which is the easy one to speak about given the longevity of the track record, the average annualized dividend growth rate is about 11%. If you think about the idea of buying a stock, that stock is paying you a dividend each quarter, semi-annually, annually, however often it pays out, but having that income grow annually over a long period of time creates another lever to compounding growth that we think is often overlooked.

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We think our emphasis in that area is a little bit unique in the overall investment universe. A lot of firms have dividend yielding strategies, but I've yet to find, or if I do find them they're very few, that have this focus on owning companies that are rewarding investors through growing that dividend each and every year, and at an above-average rate. It's also very helpful if you think about the importance of a rising income stream in an inflationary environment.

"But if you zoom out and look over the last 50 or 60 years, you'll find that these periods, like the period of the last 10 years, are abnormal in the longer historical perspective. In fact, it's more typical that the multiple is less, there's a lower contribution to your total return, and therefore dividends have made up a bigger part of an investor's total return over time."

When we started the strategy back in 2009, we would have thought that inflation would be a bigger problem, given how the Fed really manipulated interest rates and, obviously, we went down to a near-zero rate policy for a long, long time, but we really didn't see a lot of inflation. It wasn't until more recently — we've had the pandemic, and then all the related dislocations that has generated, and there are many, but all of those have now contributed to this above-average rate of inflation, which is creating challenges for clients in terms of having enough income to meet their lifestyle and growing expenses.

If you have a portfolio of stocks where your income is growing 10% per year, you can easily see that, even if you adjust for inflation, you're still earning a positive rate of growth in the dividends. So it's a very timely strategy to have, given the backdrop that we're seeing right now.

TWST: You may have answered this, at least in part, but could you talk more about the importance of dividends in terms of results and performance and how that plays out both short and long term?

Mr. Sabo: It's been underappreciated. If you look back at the last 10 years, we've had a prolonged period where growth has done very well for investors, and I mean growth like stocks that are growing earnings at an above-average pace and you have an opportunity for their multiple to expand.

If you dissect that, a lot of the multiple growth that's happened has been because of rates. As interest rates have come down, investors have been willing to pay more and more for equity risk or long-duration equity assets, and that's led to multiple expansion broadly in the market.

I think we can all look back now and say there were a lot of businesses that were on life support for the last 10 years because of easy liquidity and easy monetary conditions. So the dividend's contribution to your total return over the last 10 years has been small. It hasn't made that much of a difference. What's made the biggest difference is the multiple going up.

But if you zoom out and look over the last 50 or 60 years, you'll find that these periods, like the period of the last 10 years, are abnormal in the longer historical perspective. In fact, it's more typical that the multiple is less, there's a lower contribution to your total return, and therefore dividends have made up a bigger part of an investor's total return over time.

So, the drivers of return are the multiple, earnings growth and dividend growth, and again going back a long period of time, the dividend yield has been maybe a third or a fourth of your total return in any given year. If the market returns 7% or 8%, the dividend could be 2% or 3% and earnings growth would have been the other 4% or 5%, and you use the sum of those parts and you get to around 8%. That's typical of what you see over a long period of time.

We think we'll probably be getting back to that, where returns are a little bit more subdued going forward. Certainly, multiples are elevated right now, and we can get into the reason why that is. But I think there's a base case to be made that multiples have a high probability of either staying where they're at or even coming down in the next couple years. And so, we think the dividend component of your total return is going to be more important in the next decade than it has been in the prior for all the reasons I just laid out.

TWST: What does the portfolio and investment selection process look like for the Global Dividend Strategy and mutual fund?

Mr. Sabo: The idea behind Global was that we wanted to provide one portfolio that would search for opportunities around the globe. And I need to clarify that our definition of global is really developed markets. We're not looking in emerging markets, so there are no portfolio positions that are based in China, Brazil, Russia, India. I think those markets require their own expertise and subject matter experts.

1-Year Daily Chart of AstraZeneca plc

Chart provided by www.BigCharts.com

Our focus within Global has always been developed markets, and examples of that are, clearly, the U.S., but then also broader Europe, the United Kingdom, Canada, Japan, and there are some other pockets around the globe that we would also include in our definition. Again, the idea was to have a single portfolio that looked for the best ideas around the world and alleviated you from the responsibility of having to move your assets from the U.S. to maybe Europe, or to try to find the hotter asset class, which requires a lot of work.

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If we could solve that for you and offer you one portfolio that's flexible enough to move capital to where we think the better opportunities are, then it should add value for investors. And that's how we've operated the fund since inception in 2009.

"It's a very diversified portfolio globally. We generally own about 40 stocks, so it's meant to be a reasonably concentrated portfolio. We want to be distinct from the index and provide active management and hopefully have stock selection be the largest contribution to performance over time."

In general, the portfolio tends to be 50% to 60% in the U.S., and there have been great opportunities in the U.S. That's also one of the deepest markets. The other 40% to 50% is going to be invested away from the U.S. and in the other countries that I mentioned earlier.

Today is actually an interesting point in time; we actually have more capital outside the U.S. than we do in the U.S., which I think is the first time in five or six years we've been positioned that way. That's because we think the valuations are just a little bit more compelling across Europe, the United Kingdom, other places, than they are in the United States at the moment.

It's a very diversified portfolio globally. We generally own about 40 stocks, so it's meant to be a reasonably concentrated portfolio. We want to be distinct from the index and provide active management and hopefully have stock selection be the largest contribution to performance over time. We feel that number 40 is about right.

It also allows us the ability to identify those companies that are delivering that 10%, 11%, 12% growth rate in dividend, and those are hard to find, there are not hundreds of companies growing their income at that rate. I think if we got too big or had too many names we'd dilute that growth rate, which is certainly not our intent; we want to keep it as elevated as possible.

TWST: Are there some examples of holdings you can tell us about?

Mr. Sabo: Yes. These are in no order of preference. I can walk you through some of the core portfolio holdings. Keep in mind, a lot of our holdings are global multinationals that, if you were just running a U.S. portfolio with U.S.-based companies, you would miss some of these names, which is why we think global is so important.

Look at a name like **AstraZeneca** (NASDAQ:AZN), a big giant pharmaceutical company that most people, if you asked them, wouldn't know where it was based or may even think it's a U.S. company, but in truth it's domiciled in the United Kingdom. It's been a name that we've owned for a number of years, and it's one of our top five holdings in the portfolio.

We've had the view that it has been undervalued in terms of a price-to-earnings multiple, given the strength of its drug pipeline, the level of innovation that's happening within **AstraZeneca**, and it's one of those opportunities where we knew early on it would have a chance for multiple expansion and really attractive earnings growth, which has been in the double-digits. More recently, the company has started growing its dividend again. This is a great example of a non-U.S. company that has produced attractive returns.

Another name that is more timely today would be **British Petroleum** (NYSE:BP) in the energy sector. We think energy stocks, even with the rally we saw last year, remain undervalued, especially if oil prices stay anywhere north of $70 a barrel. Obviously, the domicile is in the name of the company, but another global multinational that just happens to be based abroad.

It recently reported a fantastic quarter. I'd say the free cash flow yield, using that as a valuation proxy, is almost 20%. The company is buying back stock, and it has a great dividend yield that's growing as they produce more and more cash flow. So that's another name that's outside of the United States and doing very well for us this year.

If I pivot to look at the United States, we own **Raytheon Technologies** (NYSE:RTX), which is another mega-cap company. It is really focused on defense, as well as commercial aerospace, and those are two levers that we think will continue to do very well for years ahead.

Clearly, defense got a big boost with the unfortunate war in Ukraine that seems to be carrying on. As a result of that, we see a lot of countries are starting to accelerate their spending on defense. Not to mention that there's been a lot of armory headed to Ukraine over the last 12 months provided by the United States and our other partners to help with the war against Russia, and so there is a restocking that's inevitably going to happen.

1-Year Daily Chart of BP plc

Chart provided by www.BigCharts.com

Also, commercial aerospace travel, although it's come back a lot we think it still has a ways to go before we even get back to 2019 levels of travel, and we think demand will continue to be strong for the next several years for travel.

They have exposures to both of those areas that we think have good secular growth trends. It's also another name that has a very reasonable valuation, growing its dividend and a good dividend yield, and that's also been a core holding of ours for some time.

So those are three examples of names that fit our profile: good balance sheets, secular growth drivers for all three of the companies, and paying really good dividend yields and growing those yields over time.

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TWST: And the US Dividend Growth portfolio, besides obviously geography, is there anything that differentiates this strategy?

Mr. Sabo: As I mentioned, we launched the Global Strategy in 2009, but within four or five years we started getting requests for a U.S.-only version of that strategy. Some clients, for whatever reason, have an aversion to owning assets outside the United States and really just want to focus their investment dollars in the U.S. That certainly has been the better decision in the last 10 years, as the U.S. markets have done so well.

“Semiconductors and digital content play such a big role in our lives today and will continue to play a bigger role as we move forward in time, and there are so many new innovative technologies coming to market, the biggest being artificial intelligence. AI will be a big driver of semiconductor demand for the next couple of years.”

In 2014, we launched a U.S. version of our Global Strategy, which is essentially taking the U.S. names that are in Global, call that 20 or 25 stocks, and then adding another 10 to 15 to get to a 35 to 40 stock portfolio.

It has the same characteristics as what we’re doing in Global, which is looking for companies that have secular growth drivers and use their excess cash flow to pay dividends, grow dividends, and buy back stock. So it’s the same drivers, and there’s a fair bit of overlap between our Global and our U.S. strategies.

And then two years ago we launched an International-only strategy, which is taking 15 or 20 stocks in Global and then adding another 10 or so names, and it really just emphasizes international markets.

We feel between the three strategies we have a solution for different types of investors. But again, the process underpinning all of our stock selection is the emphasis on dividend growth and dividend yield, so we’re certainly staying within our lane and keeping the philosophy consistent across all three of those strategies. There’s not much difference in terms of philosophy and strategy, the biggest difference is going to be where we are trying to source ideas from.

As a result, what you typically find is that the International strategy probably has the highest yield, Global would be the second highest, and the U.S. strategy would have the lower yielding of the three, and that’s just because valuations are higher in the U.S. versus abroad. Same thing with the price-to-earnings or the valuation of portfolios; U.S. tends to be a little bit higher, and International today is around 13 times forward earnings, which is really an attractively priced portfolio.

TWST: Do you see any particular trends or themes offering better opportunities right now?

Mr. Sabo: That’s a crystal ball question as to where we see opportunities in the next several quarters and years. I think one area that we own consistently across the portfolios is exposure to semiconductors, a sector that had a challenging 2022 for all the reasons we know, the biggest probably being supply chain issues.

Sourcing has certainly been a problem for the space, and what’s happened in China has also been an issue. We found ourselves with probably a little bit too much inventory and slower demand in 2022, but we think that’s going to be pretty short lived.

Semiconductors and digital content play such a big role in our lives today and will continue to play a bigger role as we move forward in time, and there are so many new innovative technologies coming to market, the biggest being artificial intelligence. AI will be a big driver of semiconductor demand for the next couple of years.

And so, we think that industry ultimately comes back very quickly. We think the multiples on semi stocks, with the re-rating that occurred last year, are very attractive. So we think there’s an opportunity for multiple expansion, a lot of free cash flow, and rising dividends and stock buybacks — all the things that we like.

From that sector, **Qualcomm** (NASDAQ:QCOM) has been a core holding of ours. **Broadcom** (NASDAQ:AVGO), another semiconductor company, has been a core holding for a long, long time. And we’ve done well, but we still think there’s tremendous upside there.

Another area of the market that could be attractive, and we’ll see, is consumer discretionary stocks. There’s a lot of worry about the recession coming. Maybe it comes in the second half of 2023; some people believe maybe it’s the beginning of 2024. We’ll see. Everybody has a different opinion. But as we sit here today, a lot of the consumer information still continues to look very resilient, and a lot of that is driven by continuing to create jobs in the United States and abroad.

1-Year Daily Chart of Broadcom Inc.

Chart provided by www.BigCharts.com

And so, if the consumer has a job and wages are rising, then the consumer should continue to manage their lifestyle expenses. There may be some tailwinds there that last longer than anybody thinks as of right now. So we think consumer spending, if it remains resilient, is going to be a very attractive area of the market, and considerably if you drill down even more.

We think autos are going to be a really interesting place to be for the next couple of years. Some of those stocks are trading at really depressed multiples. Some of that is hangover from 2022 and

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the auto manufacturers not being able to get cars on lots and being in short supply, and a lot of the components and a lot of the parts that go into the auto manufacturing business do come from Eastern Europe and Asia and other places that have been slow to recover or dealing with geopolitical headwinds, like Ukraine.

"And then I think you have to pick your spots in some of the more defensive sectors like staples, which did well last year, and so high multiples. I think you've got to be careful what you pay for some of those companies, given the fickleness of consumers and where they are going to spend their dollars."

There have been some really strong headwinds, but those headwinds resulted in multiples being fairly low, and as they work themselves out, which they inevitably will, you may see auto sales start to accelerate and continue to remain high.

If you look just at the United States, we were averaging 17 million, 18 million new cars sold every year, and that dropped to 13 million or 14 million cars in the last year or two. We think that's probably too low, and so we think there's going to be a rebound in new car sales the next couple of years.

And we like some of the European auto manufacturers as part of that investment, and some of the parts and components suppliers as well, that we think could have some good secular growth trends.

And of course there's a lot of innovation happening in autos, whether it be electrification, autonomous driving, and infotainment. Cars are becoming computers in a way, which is also driving semiconductor content, so those two themes are reinforcing one another.

But we think autos will be a great place to put some capital to work. You can't put too much because it's a volatile sector, but it's an area that we've been picking our spots in and putting some dollars to work, alongside the semis that I mentioned earlier.

And then more broadly, you can see some other consumer stocks do well. We own **Target** (NYSE:TGT) in our U.S. portfolio. We do like **Walmart** (NYSE:WMT). We think shopping trends, even if the consumer proves to be a little bit weaker than expected, those two brands should do very well as consumers perhaps trade down if they need to. So we think there's some good opportunity there as well.

TWST: What are you staying away from or cautious about?

Mr. Sabo: One area that maybe we've been wrong on, but the industrial stocks are priced — I'm not going to say to perfection, but they're carrying some pretty lofty multiples right now. And so we're avoiding some of the more classic industrial manufacturers — that could be anything from filters, pumps, short cycle companies, that we think are priced pretty high at the moment. Those stocks have done very well this year, so we'll see if we're wrong about that. Those have done better than we would have thought, and multiples are high, so we're not chasing them, we're avoiding them for right now.

Technology, I mentioned some areas that we find attractive, but there's a wide dispersion in multiples in technology stocks. There are a lot of companies that are trading at very high multiples after the rally we've seen, which really began in Q4 and carried over into January. Some of those multiples have come right back, and so there are pockets of the technology sector, like software in particular, that we think is expensive.

Microsoft (NASDAQ:MSFT) went from being a very expensive stock — we did sell some in our Global Portfolio a year ago — and then the stock price came all the way back down to where we thought the valuation was interesting again. And then it shot up again, very unexpectedly, in the last month or two, to where it's trading at a high multiple again.

So software, we think, is an expensive place to be, so we've been avoiding that.

And then I think you have to pick your spots in some of the more defensive sectors like staples, which did well last year, and so high multiples. I think you've got to be careful what you pay for some of those companies, given the fickleness of consumers and where they are going to spend their dollars. I think active management is going to be key in that area to avoid overpaying for some businesses that may give up market share volume.

So, those are the areas we're a little bit more cautious on in the near term.

1-Year Daily Chart of Walmart Inc.

Chart provided by www.BigCharts.com

TWST: To conclude, do you have any additional advice to offer investors, especially in the context of your expectations and outlook for the rest of the year?

Mr. Sabo: It's a really interesting time. With where Fed policy is at today, with where inflation is at, and against the backdrop of having high multiples in the market today and uncertainty around the consumer and growth — and I'm not even mentioning all the geopolitical uncertainty that's going on in the world today — I have a hard time not believing that being defensive is the right place to be in your investment portfolio.

We think all that's going to translate to investor preference for owning high-quality businesses that are undervalued and are generating a lot of cash flow and have some secular drivers that can push them through some of these challenges that could be in front of us for the next year or two.

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The dividend trade and the quality trade did great last year; those were the places to be last year. Aside from this brief rally we're seeing now, we think investors will go back to that space, like they did in 2022, and want to own those dividend payers and dividend growers.

Inflation could very well remain above this 2% imaginary target that the Fed has, and if that's the case, I think the dividend contribution to your total return is going to be high. You're going to want to own stocks that are going to pay dividends, because multiples are just not going to expand in the next couple of years and so.

If the expectation is a return of 7% or 8% from equities, which would be a long-term average, dividends could be 3% or even 4% of that. That's a pretty nice place to be, we think, given all the uncertainty around all those variables I mentioned a minute ago.

It's hard to believe that the Fed is going to start cutting rates, and inflation is going to come down to 2%, and all of the tech stocks are going to come roaring back, and investors are going to sell all their quality and their value. We just think the probability of that happening on a sustainable basis is going to be really low in the next couple of years.

The other point I'll make is that international equities, a place that investors have avoided for the last decade, really are interesting here. Valuations are low. These are multinationals that we're buying, so less dependent on local economies and more dependent on global growth, including emerging markets, which, through some of these companies we own that are domiciled in other places, we pick up that tailwind of global emerging market growth.

We think those types of businesses could continue to be really attractive, especially if the dollar — and you have to have a view on currency if you're going to invest abroad — starts to weaken or is weak because of all the issues that we mentioned earlier. Then you're going to want to own assets in foreign currencies. So owning non-U.S. assets, owning quality, and owning dividend-growing businesses in your portfolio, we think, is going to make a lot of sense in the next couple of years.

TWST: Thank you. (MN)

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Dividends Signal Company Health and Commitment to Shareholders

ERICH M. PATTEN, CUTLER INVESTMENT GROUP

ERICH M. PATTEN is the President and Chief Investment Officer of Cutler Investment Group. He also serves as a Portfolio Manager of the Cutler Equity Fund (DIVHX), and serves as President of the Cutler Trust, which provides oversight of the Cutler Equity Fund. Mr. Patten received his Bachelor of Science in Economics from the University of Pennsylvania, and was awarded his Masters in Public Policy from the University of Chicago. He is a member of the Bellevue Rotary Club and a Cub Scout leader. Mr. Patten and his brother, Chief Executive Officer Matthew C. Patten, have managed the firm's investment strategies since 2003.

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SECTOR — GENERAL INVESTING

(AHV508) TWST: Let's start, if you wouldn't mind, with a brief introduction to Cutler Investment Group.

Mr. Patten: Cutler Investment Group is based out of Southern Oregon — Jacksonville, Oregon — and we have five offices across the West Coast and Alaska. We manage approximately $1 billion in client assets, and have a history of dividend investing. We've been investing in dividends from our inception. The core of our firm's philosophical belief stems from our years of market observations, forming our view that investing for current income leads to solid investment returns.

We manage dividend strategies as separate accounts, as well as a mutual fund. And we believe that dividends are really an important part of investors' total return profile, but most importantly, we believe that dividends are a great way to identify and manage risk. After all, if a company can afford to pay out dividends their business is, in our view, viable and healthy. So that's the lens with which we view the dividend space.

TWST: Is there anything you'd add there in terms of that underlying philosophy and the importance for returns and risk profile?

Mr. Patten: I would mention our Equity Income strategy is managed by myself, Erich Patten, as well as Matthew Patten, my brother, and it's an investment strategy that was developed by our grandfather, Ken Cutler, who is our firm's namesake.

He really built that strategy upon his belief that a dividend was the best indicator for a company's prospects and its commitment to shareholders, going back to even his experiences growing up in the Great Depression and the viability of companies that were able to make it through that tumultuous economic period without cutting their dividend. He always felt that if a company could make it through that type of environment, that it was a great long-term investment.

And we've seen a lot of different time periods where there's economic stress, and companies oftentimes will cut their dividends. The sustainability of that dividend and the continuation of that dividend is something that is really important to us. Every company we look at for the Cutler strategy has at least a 10-year history of dividends without a cut, the equivalent of making it through what we see as a full business cycle.

It used to be that we'd see these economic downturns perhaps once a decade. But in the past 20 years or so, we seem to have economic downturns, or market crises you could call them, a little more often than that. But if a company is able to make it through those periods without cutting their dividend, in our view, they have a business that's built for the long term. And as long-term focused investors, that's something we take a great deal of confidence in.

TWST: So is it that history of dividends that you look for, versus growing dividends or an absolute yield?

Mr. Patten: Yes, the history to us is most important, so that is really where we will make our deepest cut when analyzing dividend stocks out there in the marketplace. Once we have done that, obviously growing dividends is icing on the cake, but it's not something that's a prerequisite for us.

Depending on what industry or what type of business they are running, some companies are more focused on growing dividends than others. And, we will look for relative yields in terms of analyzing stocks and the attractiveness of that cash flow the dividend is producing, but we don't necessarily make it a prerequisite to have that company growing their dividends over the time period that we are analyzing.

TWST: What else factors into your investment selection, portfolio construction, and ongoing risk management process?

Mr. Patten: It's interesting in the dividend space, because by default, most dividend managers are value managers. That's what the universe looks like, and that's the pool of stocks that dividend managers make selections from. Our view is that value is definitely important, but not necessarily the be-all and end-all of our investment thesis, especially since we start with a very value-biased universe of stocks.

So we're looking for companies that do have the ability to grow their earnings, and we'll apply those value metrics relative to their peers and to other stocks that are available within our universe. But as you can imagine, when we start with a filter that's comprised of at least 10 years of dividends without a cut, that universe gets winnowed down.

"What we really like to focus on are what I would call out-of-favor blue chip stocks. So companies that have great long-term prospects, great branding, very wide economic moat, but might, for one reason or another based on the current trading environment or market environment, really be out of favor."

We cut this list even further, using screens such as industry or lawsuit risk. For example we eliminate the tobacco and firearms industries. Our job as portfolio managers is to identify what we view as the best total return opportunities within that very select universe of stocks.

We are benchmarking to the S&P 500, and really looking to construct a portfolio to keep up with the benchmark on the upside and, importantly, suffer less capital loss during times of market decline. The consistent dividend payout serves to protect investors and reduces the overall risk of the portfolio.

TWST: Could you tell us about a few examples of holdings, whether they're top holdings or something you've been buying or adding to recently?

Mr. Patten: Our philosophy is very low turnover, so it's a high-conviction approach to dividend investing. We will make changes to our portfolio when we feel very strongly about those changes.

The current market that we've seen over the last year has presented some exciting opportunities within the dividend space. What we really like to focus on are what I would call out-of-favor blue chip stocks. So companies that have great long-term prospects, great branding, very wide economic moat, but might, for one reason or another based on the current trading environment or market environment, really be out of favor.

Last year, a company that fit that profile for us was **Nike** (NYSE:NKE). We felt that the supply chain issues that **Nike** was struggling with, and that the market had really punished that stock price for, would be resolved by management, and that opening a position in that stock presented an attractive opportunity.

There's always been a philosophy within our portfolio of not creating too many adjustments for the sake of making adjustments. What that results in is a portfolio where our largest positions are typically the ones that have grown into being the largest positions, and our smallest positions are the ones that have underperformed and really lagged the overall portfolio performance. So when we look at our highest-conviction stocks within our portfolio, oftentimes those look like the companies that have recently done the best, because they've grown into those larger positions within our strategy.

TWST: In addition to Nike, is there another example from the Equity Income strategy and mutual fund that you could cite?

Mr. Patten: It's funny, because I mentioned we have a very low turnover portfolio and we don't make changes very often to our list of held securities. But when I look at the current environment — and maybe less so as we enter into 2023 and we've seen a recovery in the equity markets — but definitely in times of turmoil and in a bear market environment, you see very high-quality companies out there that are well off their highs, that are trading at relative discounts to their historical valuation, and that's when we think the opportunity to make a change to your investment lineup is most advantageous.

So, as we enter into 2023, we'll be looking for any sort of volatility that might create some of those opportunities for us. We don't have any name at the top of our list at any given time, and if I did, we would be buying it right now. Instead, our process weans down the broader stock market to an approved list, and we look at that approved list for opportunities, really mining that list for valuation, as well as comparing it with the value of the stocks in our portfolio.

There are 33 stocks currently in our portfolio. The largest is just over 5%, and the smallest is just over 1%, so a pretty big delta in terms of the influence our largest holdings have on our portfolio. I can tell you, **John Deere** (NYSE:DE) is at the top of our list in terms of size within the portfolio. Other dividend stocks that make that top five are companies like **Microsoft** (NASDAQ:MSFT), and **Microsoft** is a company that has also suffered over the last year with the entire tech sector, but we believe that that company has diversified businesses.

1-Year Daily Chart of Nike Inc.

Chart provided by www.BigCharts.com

I mentioned earlier the term "economic moat." **Microsoft** has a very wide moat stock in terms of their business, and that's been a long-term holding for us, and it's something we're continuing owning as one of our largest positions today.

TWST: Do you see any particular themes or trends, or expect to, in terms of where the best opportunities might be? And on the flip side, are there any areas that you're particularly cautious about right now?

Mr. Patten: When you look at the dividend space, and especially if you apply that long-term dividend-payer lens, you end

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up gravitating toward more mature industries, and that creates a handicap in an environment that is a risk-seeking or growth-oriented environment. As we look forward over the next decade, I already mentioned **Microsoft**, but a lot of these technology companies are maturing into dividend-paying companies and companies that might transition from a growth company into more of a value metric and something that might get picked up by income-focused investors.

I'm really excited about that opportunity for dividend investors. I think it presents a lot more diversification for them within the opportunities that are out there to capture both dividends as well as some capital appreciation or growth-focused companies in their portfolio. So that's a trend that we're very much focused on. It's not a short-term trend. It's definitely a long-term trend.

If you look at the short-term trends, our view of the current economy is that the market is anticipating much lower rates, and we're skeptical that rates will achieve the current market expectations. So, what that means is, companies that are either benefiting from the current period of surprising economic strength — which has also been supportive of this higher inflationary environment — I think of energy companies as a space where there's great dividend yields, but also economic growth really contributes to that stock price.

And we've seen a huge rally in energy in 2022, and the question in the short term for investors is, does that rally continue to have legs? We wouldn't abandon that sector as of yet. We would continue with our current positioning there.

Other sectors that we think might be beneficial in this current environment — and again, these are short-term statements, and we would like to take a long-term view of equity market investing — but I mentioned earlier the trend of growing dividends in the technology space. And we've seen a rapid rally in technology thus far in 2023, but for the most part, that rally has not been focused on dividend-paying companies. I think it's still beneficial to be looking for technology and dividend overlaps in places where investors can get, again, some of those out-of-favor companies that have sold off over the last year but might have a nice dividend yield.

So, that's two opportunities, I think, in the current market as we get started on 2023 and head into this very uncertain year when it comes to interest rates, inflation, and the Fed.

TWST: My next question was going to be on the macroeconomic environment. What do you keep a close eye on generally, and especially in the current environment?

Mr. Patten: One thing that definitely caught our attention as dividend investors over the last year was the rotation out of growth and into value. In our view, the higher rate environment favors value versus growth. If you think about discounting those future cash flows, a growth company has cash flows way off in the future, whereas a dividend-paying company has cash flows much closer to the present day, and so your discounting has a much bigger effect on the growth sector than it does the value sector.

Given our thoughts that interest rates are going to remain higher than the market is anticipating, we think that that value versus growth tradeoff can continue as this year progresses. So we would maintain that value bias currently, and look for companies that have those traditional value metrics, dividend yield being one of them, but also those traditionally lower price-to-earnings types of companies, companies that, in our view, are blue chip companies but maybe slower growing companies. I think the macro environment could play out to really favor those.

The first part of 2023 definitely has not. It has been a bounce-back rally that we've seen some of the worst-performing stocks from last year become the best-performing stocks of this year, and the pendulum might have swung too far last year in terms of overselling some sectors. We wouldn't chase that performance, and we would stay diligent and look for those really value, quality companies that we think can generate shareholder value beyond just the next six months, but really looking down the road for the long term.

TWST: would you like to share any final words of advice to wrap up?

Mr. Patten: I will just say that dividend investing is hard, and the reason that I believe it's hard is not because it's difficult to find dividend-paying companies, but it's difficult to maintain that discipline of each dividend payment is a small contribution to the long-term compounding value of your portfolio.

Most investors do not have the patience to continue with a dividend-based strategy for the long term, and this leads them toward looking for stocks with more volatility. But I think that people who maintain their diligence will be rewarded by those consistent cash flows adding up every quarter — and really creating long-term value.

So my advice to any dividend investor would be to stick with it, not worry about the short-term fluctuations in the market, but focus on their cash flows, focus on their income, and continue to build their portfolios with that mindset.

TWST: Thank you. (MN)

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Bank Fund to Provide Capital to Disadvantaged Communities

FRED CUMMINGS, ELIZABETH PARK CAPITAL MANAGEMENT

FRED CUMMINGS is the President and Founder of Elizabeth Park Capital Management. He serves as Portfolio Manager for the privately held, alternative asset management firm focused on long/short equity, event-driven, and customized investment opportunities in the banking sector. The firm supports community bank technology investment through a partnership with Strandview Capital and the Btech Consortium Fund. The firm is the investment manager for the Mission Driven Bank Fund. Mr. Cummings serves on the firm's investment committee for the Btech Consortium Fund and the Mission Driven Bank Fund. Mr. Cummings is an investment and banking portfolio manager with 30+ years' industry experience leading disciplined, client-focused investment practices. Prior to founding Elizabeth Park, Mr. Cummings achieved a distinguished 17-year career at KeyBanc Capital Markets as one of the sell-side's foremost Senior Analysts covering the banking sector. He additionally served as a Senior Analyst for FSI Group, a financial services hedge fund. He launched his career at McDonald & Co. as a sell-side Junior Analyst. Mr. Cummings earned his B.A. in Economics with honors from Oberlin College. He was named 2017's *Crain's Cleveland Business* Who's Who and Cleveland.com's People to Watch in 2015. As an industry expert, he has been featured on various media outlets, including *The Wall Street Journal*, *INC Magazine*, *Crain's Cleveland Business*, CNN Money, and was a cited expert in the recently published book by Wiley called *Bank Investing, a Practitioners Field Guide*. Mr. Cummings lives in the Cleveland area with his wife.

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SECTOR — GENERAL INVESTING

(AHV502) TWST: Could you please introduce Elizabeth Park and tell us about your role there and what motivated you to establish the firm?

Mr. Cummings: Elizabeth Park is a bank-focused alternative asset manager based in Cleveland, Ohio. We were founded in February of 2008. After I had experienced a great 15-year or 16-year career on the sales side, I decided to start my own firm in the throes of the recession of February 2008, which was an interesting time to start investing in bank stocks — of course, those were the early stages of the financial crisis. And fortunately, I'd been steeped in credit analysis over the last 15 years while I was a sell-side analyst, which prepared me for an economic downturn.

So those were exciting times. We started with $3 million under management and have grown over time. And we now sit somewhere around $300 million of assets under management, excluding this new venture with the Mission Driven Bank Fund, which we're very excited about.

TWST: Before we take a closer look at the Mission Driven Bank Fund, do you believe that we're currently in a crisis? Have you seen anything like it before? And how does the current environment impact your investment approach strategy and what you aim to offer investors?

Mr. Cummings: We don't believe we are in a financial crisis. We think the current economic conditions are vastly better than what they were entering the last economic downturn. Most notably, we just don't have the same kind of excesses in any asset classes that would really negatively impact banks.

And so, of course, in this economic cycle, we did see some excesses in the digital asset sector. And we've seen a big correction in Bitcoin and other digital asset prices. Banks don't have a lot of direct exposure to that asset class, particularly on the lending side. They have some deposit relationships, but not real lending relationships.

The second area of great growth during this upturn in the economy has been in private equity and venture capital, particularly as it relates to technology investments and technology valuations.

And we've seen a correction in technology stocks in the public markets, and more importantly, we've seen a correction in their valuations in the private markets. And there, too, the banking sector doesn't have a lot of direct balance sheet exposure to those technology companies. And so that's a positive for the sector.

"And that impact will be measured in a variety of means. But notably, the focus is on job creation, increasing homeownership, increasing the number of businesses in these markets, and hopefully increasing the average household income and net worth of individuals in these markets over time."

Our banks do have some exposure, and there has been a lot of growth with the leveraged lending sector, which really entails these private equity companies; buying businesses and using debt to finance the purchase of those businesses. That has been a fast-growing area. But notably, the non-bank competitors have taken market share away from the banks in that business line. And so that's why we feel comfortable with banks' credit exposure. And leveraged lending banks do have some — particularly with superregional and the money center banks — they have exposure to that, but it's at manageable levels.

And then, the consumer's balance sheet is still in relatively good shape underpinned by strong debt-to-income levels. And of course, unemployment is still relatively low. And importantly, the housing market is in a much better place this cycle.

In the previous cycle, we had a lot of concerns about excess supply in terms of overbuilding and construction, and frankly, some of it was speculative construction lending in the housing market. Now, we don't have that. In this cycle, there's more demand than there is supply.

Prices, of course, ran up very aggressively over the last couple of years, and we see prices moderating. But we don't see a crash, a housing market crash like what was experienced from 2008-2010 where we had a sharp contraction in home prices due to excess supply.

So, overall, we think the economy is in a much better place. And if we do have a recession we're likely to have a mild recession, based on some of the factors I've discussed. And frankly, when we talk to the banks, they're in touch with their customers and still seeing pretty good loan demand.

And so, while the economy is expected to slow, banks are optimistic about loan demand being relatively good in 2023. And more importantly, they're optimistic that their net charge-offs will remain below or at normalized level. And so, they are not seeing early signs of any credit weakness.

TWST: Give us a closer look at the Mission Driven Bank Fund. Tell us about its structure, mission, and strategy.

Mr. Cummings: The Mission Driven Bank Fund was an idea encouraged by the FDIC. **Microsoft** and **Truist** got together to anchor the fund, issued a competitive RFP, and we were fortunate to be awarded as the investment adviser last quarter. Our co-manager, Calvert Impact, is a blue-chip impact investor.

And currently, we're in the process of finalizing the fund documents and marketing materials. So we expect to initiate fundraising activities hopefully sometime in the first quarter. Our target first close is $350 million and the fund could be as large as $1 billion. The anchor and lead investors have great support toward the mission and have committed $135 million.

We will partner with Calvert Impact and Strategic Value Bank Partners, creating a world-class team. Calvert has long-standing roots over many decades in impact investing and they've also been active in the MDI and CDFI space. Strategic Value Bank Partners has expertise in working with CDFIs, investing in private banks, and they also bring operational expertise. We bring bank-specific private and public equity investing with a highly experienced and deep investment team.

We will invest in community development financial institutions and minority depository institutions. Many of these institutions are smaller in size and historically have not had access to capital. The fund will be a means to give these institutions broader access to capital to help them grow their businesses.

TWST: Who are your targeted investors? What do you aim to offer investors in terms of return on investment?

Mr. Cummings: We will target institutional investors, such as endowments, foundations, and commercial banks. In particular, many commercial banks are mission-aligned, and many are interested in the CRA credit this fund should provide. So some of Truist's peers, whether it'd be Bank of America, JPMorgan, could be Keybanc, could be U.S. Bank, Wells Fargo, Comerica, and others. So any U.S. commercial bank could be a potential investor in the fund.

In addition, we will call on corporate investors like Microsoft, who are interested in this area. And so, any mission-aligned corporation might choose to invest. And then, of course, because most corporations have a strong interest in ESG and making a social impact, we think a wide range of corporate investors will have an interest in the fund.

And then finally, there is a huge segment of foundations that have an interest in this subject matter. So we have a wide range of potential investors whom we're going to be marketing this fund to. And our value proposition is, most importantly, we want to generate impact in the communities that these banks serve.

And that impact will be measured in a variety of means. But notably, the focus is on job creation, increasing homeownership, increasing the number of businesses in these markets, and hopefully increasing the average household income and net worth of individuals in these markets over time. And so, we're looking at the return of capital. We want to make sure that our investors don't lose money.

And then, the third priority would be return on capital. And we're targeting a return somewhere in the range of, say, 2%-4% net. That's what we're in discussions about with potential investors.

But the most important goal is to have impact. So investors are not going to invest in this fund with the primary purpose of generating financial returns. They are the investors who really want to have an impact on the communities that these banks serve.

TWST: How exactly will the fund improve certain racial gaps, enable greater home ownership, and possibly improve access to needed capital?

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Mr. Cummings: Our goal here is to partner with these banks and provide them the capital, whether it'd be equity or whether it'd be subordinated debt; it could be common equity, preferred equity. And even, in some cases, we might provide some deposits. But our job is to give them the capital, and then their job is to allocate that capital to consumers and businesses in their marketplace. And that's the real key to wealth creation here in America; it's access to capital.

In the past, many individuals, for different reasons, have not had equal access to capital. And we hope to bridge that gap and address that issue. So the banks themselves will be looking at the credit opportunities and assessing those opportunities that come before them. And then, hopefully, there'll be people who want to buy homes, people who may want to become real estate investors, and people who want to own a small business in the markets they serve. And the banks will have the capital to lend to those individuals. So that's how we anticipate it working.

But very importantly, we will also be providing — and this is what is somewhat unique about the fund — we will provide technical services to help make the banks better banks for the long term.

For example, we may help them improve their technology inside the bank to allow them to better, or more easily originate loans. And to allow them to develop digital banking products more easily, which have become very popular across America for people who want to bank on their phones. And we're also going to help them with legal advice if they need that. We're going to try and frankly help them recruit talent that they might need and even in underwriting — improving their underwriting capabilities on the operating side.

And so, this technical assistance aspect will fundamentally be to help improve how they run the bank in a customized way. And that's a big challenge for many small banks. Many of them just don't have the financial strength to attract the type of people they need to allow them to become more profitable, and to allow them to grow the way they want to grow.

And so, we're going to be providing that technical assistance and introducing them to deposits, the sources, and also bringing in consultants to help them better manage their business. And I think that's a key point of differentiation for us.

TWST: Any sort of technologies that are most notably needed that you will enable these banks to have access to?

Mr. Cummings: Well, we're, right now, in the early stages of assessing those needs. For example, some of the banks we've spoken to indicate they need help with their loan origination platform, deposit gathering — mobile deposit gathering technology. But we're going to be speaking with as many banks as we can, so that we can best understand the needs that they might have.

So those have been some of the early indications of where there is a need, but I think the need will broaden. And as we speak with more banks — we've really started speaking with banks this month. We're in the process of better understanding where they are, what their needs are, and what type of capital they might desire to support their growth rates. And so, three months from now we'll have spoken to many more banks.

TWST: Looking into 2023, what are the headwinds that worry you most about the fund? For example, what about rising interest rates and inflation — will those be big headwinds?

Mr. Cummings: Rising interest rates are a headwind, and another one is many of the banks have high capital levels. About 30% of the banks received capital from the U.S. government-sponsored Emergency Capital Investment Program, mostly in low-cost preferred equity.

But their big challenge is two-fold: One is very consistent with what's going on now in the banking sector, and that is attracting low-cost deposits to lend. That's how you really leverage your capital.

What is needed is to leverage capital 10-to-1 by getting deposits. And it's very challenging for all banks right now to raise deposits, or track deposits, because, one, it's very competitive, and two, the Fed is reducing the amount of cash in the system. And so that's our biggest concern: How do we help these banks find and access reasonably well-priced deposits?

And these banks are no different from all of the bigger banks in the marketplace. That's the biggest issue. And that's our biggest concern.

The second concern would be a potential slowdown in the economy. And we do know that the Fed's rate is rising. The tightening campaign has had an impact on the economy. So, if the economy is slowing, that means loan demand will slow. So even though you have the capital and even if you can attract new deposits, the question is what kind of demand will there be from businesses and consumers, because loan demand is expected to slow.

So those would be two of our biggest concerns; a slowing economy and attracting low-cost deposits, especially in low- to moderate-income neighborhoods with little wealth.

And so that's a big, big challenge. And that's a longer-term challenge, to find different sources of deposits. It is on the deposit side, and then the potential slowdown in loan demand whether it relates to a just a slowing economy.

TWST: Any silver linings to all this? Any potential tailwinds that will enable you to achieve your mission?

Mr. Cummings: Yes, the biggest is that the banks are in a good financial situation based on the ease of cash infusion that many of them receive. So they have very strong balance sheets and they can have staying power. And so, to the extent that the economy does slow, and they aren't as profitable as they thought they would be, they still have the capital to get them through an economic downturn. So that is very positive.

And the second tailwind is that there's been increased focus on this area over the last few years from corporations. And then given how important ESG is in corporate America, more corporations are just interested in supporting an initiative like this. We think that's a tailwind and that should help us to meet our fundraising goals. There's just a broader range of interest in this topic because it does relate to ESG. And ESG is top of mind in many boardrooms across the country.

TWST: Thank you. (VSB)

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SMID-Cap Fund Integrates Quantitative and Fundamental Approaches

DAVID CORRIS, T. ROWE PRICE

DAVID CORRIS, CFA, is a co-portfolio manager and co-chair of the Investment Advisory Committees of the Integrated U.S. Small-Mid Cap Core Equity, Integrated U.S. Value Equity, Integrated U.S. Large Cap Growth Equity, U.S. Low Volatility Equity, and Integrated Global Equity strategies in T. Rowe Price's Global Equity Division. In addition, he is a member of the Investment Advisory Committees of the U.S. Large-Cap Value Equity and U.S. Large-Cap Equity Income strategies. Mr. Corris is also a vice president of T. Rowe Price Group, Inc. Mr. Corris's investment experience began in 2003, and he has been with T. Rowe Price since 2021, beginning in the Quantitative Equity team (since named the Integrated Equity team) of the firm's Global Equity Division. Prior to joining T. Rowe Price, Mr. Corris was employed by Bank of Montreal Global Asset Management, where he was the head of the hybrid quant and fundamental platform and was responsible for launching and managing numerous products and client solutions. Mr. Corris also was employed by Northern Trust, where he developed investment products, led research, and was a senior portfolio manager on the Global Equity Strategy. Mr. Corris earned a B.S. in mathematics and quantitative economics from the University of Wisconsin and an MBA from Harvard Business School. Mr. Corris also has earned the Chartered Financial Analyst designation. In addition, he is a member of the Chicago Quantitative Alliance.

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SECTOR — GENERAL INVESTING

(AHV503) TWST: Let's begin with an introduction to your role at T. Rowe Price and an overview of the funds you manage.

Mr. Corris: I'm a portfolio manager on the T. Rowe Price Integrated Equity Team. The Integrated Equity Team manages a suite of strategies that combine insights from T. Rowe Price's quantitative and fundamental research platforms. T. Rowe Price has one of the deepest fundamental research platforms in the industry, and we also have a quantitative equity capability that dates back to the 1990s. Our team believes that we can add significant value for clients by integrating insights from the two platforms.

Our team manages strategies that include U.S. large cap value and growth, U.S. small- and mid-cap (SMID) core and small-cap growth, U.S. low volatility, as well as international and global strategies.

My role as portfolio manager is to provide attractive risk-adjusted returns for our clients, which involves overseeing and implementing all areas of the investment process, including quantitative research, alpha generation, portfolio construction and risk management.

TWST: Our focus will be on the T. Rowe Price Integrated U.S. Small-Mid Cap Core Equity Fund. And I believe you have an upcoming name change. What was behind the name change? Why is your group now being called Integrated Equity?

Mr. Corris: We're changing the names of all of our team's strategies to be consistent with that word "integrated." There's nothing about the philosophy or process or team that's changing. The decision to change the name from QM, standing for "quantitative management," to "integrated" is simply to better reflect our investment approach which integrates the insights from our quantitative and fundamental investment platforms.

TWST: Can you give us a closer look at your quantitative approach? And anything else you can tell us about the fund's structure, composition, and your strategy?

Mr. Corris: Our quantitative approach aims to identify the same drivers of stocks that a fundamental manager would identify, but in a somewhat different way. Whereas a fundamental manager typically will go deep on individual stocks and meet with company management and do a deep dive on individual company strategies, our integrated approach looks at characteristics of stocks that have

outperformed over time and captures the types of fundamentals that we think are important in a systematic way. We do this by screening large universes of stocks with the same approach every day.

“First, our research has shown that the intersection of fundamentally and quantitatively attractive stocks tends to outperform over time. In other words, stocks that are viewed attractively by both our fundamental platform and our quantitative models tend to outperform over time.”

We use a core approach that invests in high-quality, profitable, growing stocks that are trading at attractive valuations. Whereas large-cap investors often need to choose between growth and value, our approach delivers both styles in the same fund. Within SMID cap, you can identify durable growth stocks that haven’t yet been recognized by the market and therefore are not priced expensively.

Finally, our research shows the quantitative and fundamental approaches are complementary. In particular, we add value in SMID cap in two ways. First, our research has shown that the intersection of fundamentally and quantitatively attractive stocks tends to outperform over time. In other words, stocks that are viewed attractively by both our fundamental platform and our quantitative models tend to outperform over time.

Second, stocks that are not covered by the fundamental platform but are attractive in our quantitative models also tend to outperform. T. Rowe has one of the deepest fundamental platforms in the industry, so when we don’t cover a stock, most likely there’s going to be very low industry coverage of that stock, and so these stocks tend to be more inefficient. But because our quantitative models rank everything in the universe, our models tend to work very well within those types of stocks.

TWST: Could you explain how this model and the quantitative process works, and how it relates to your investment choices and composition of the fund?

Mr. Corris: We have a number of different quantitative tools that we use to analyze stocks. First, we have a quantitative stock selection model that scores an entire investable universe of stocks on metrics like valuation, profitability, earnings quality, growth, capital usage, and sentiment. The output of that model is stocks that we believe are fundamentally attractive and are also undervalued relative to those fundamentals.

We then supplement that model with a couple of other things. One is a market surveillance platform that highlights structural dislocations in the market. So, for example, we will look for groups of stocks that have become cheap or expensive relative to history, or that might appear to be unusually risky. This is a part of the process that was really helpful in our SMID portfolio last year because it highlighted a dislocation in the market that we were able to take advantage of, which I’ll discuss later.

Finally, we also talk to our fundamental analysts and are aware of their views on sectors, industries and individual stocks. We have discussions with them thematically about what they see going on in the market. We sit in meetings together and discuss our views on stocks, both from our quantitative approach and their fundamental approach, and we look for areas where we agree.

We think the best ideas in the funds tend to come from areas where our models highlight an attractive opportunity and the fundamental research corroborates the opportunity.

TWST: Looking back over 2022, which were the headwinds that most impacted the fund and/or particular spaces in the fund? And what were the tailwinds?

Mr. Corris: 2022 was a really strong year for the fund, which outperformed its benchmark by over 500 basis points. The most important trend of 2022 was the impact of rising interest rates on the equity market.

Over the past few years, historically low interest rates led to outsized valuation for long-duration assets. For the market as a whole, this trend was manifested most within technology. Within this particular SMID-cap fund, it was manifested in speculative stocks and non-earning stocks, many of which were in health care and information technology.

Our research shows that these stocks had become historically expensive because their cost of capital was artificially low and speculative behavior in the market was too high. As inflation picked up and the Fed started raising rates, these speculative stocks and non-earners corrected significantly.

1-Year Daily Chart of Essent Group Ltd.

Chart provided by www.BigCharts.com

While we’re typically underweight this group because we have a quality bias, our research on their historic overpricing led us to eliminate most of our weight in this cohort, and that was a key driver of our outperformance last year. More specifically, the U.S. SMID fund outperformed by more than 500 basis points last year and most can be attributed to our stock selection model with the focus on high-quality and reasonable valuations.

TWST: Can you share particular sectors and subsectors that were strongest? And what do you see ahead into 2023?

Mr. Corris: We don’t take significant sector exposures in the portfolio. Our approach is to be close to the benchmark in terms of sector and industry weights, and to primarily add value through stock selection. So the effect we had last year was mostly

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the effect of avoiding expensive and non-earning and speculative companies throughout different parts of the market. In SMID cap, a lot of that exposure is within technology and health care, such as biotech and early-stage software.

“When the Fed started raising interest rates, that brought valuation rationality back to the market. That has been a significant tailwind for us because we focus on quality and value, and typically avoid more aggressive areas of the market.”

Looking forward, we’ve been focusing on parts of the market where investors might be pricing in a more significant economic slowdown, leading to asymmetric risk. One area we’ve seen that is with mortgage insurers, where one of the stocks we own is **Essent Group** (NYSE:ESNT).

On the basis of our quantitative models, speaking with the fundamental platform, and joining a management call, we formed a thesis that many investors are worried about mortgage insurance due to declining home prices and potential credit concerns as interest rates rise. However, the data show that the majority of outstanding mortgages have been taken out or refinanced in the last few years at low interest rates. And following the GFC, lending standards have been tighter.

So as a result, we think this is one area where the market may be mistaken in thinking that mortgage insurance is riskier than it actually is.

Another area we focus on is durable growth stocks trading at a reasonable valuation. We developed a model that identifies durable growth stocks that can sustainably grow their top and bottom lines. One holding with this profile is **PTC** (NASDAQ:PTC), a computer design and product lifecycle management software stock. It ranks highly in our durable growth metric, focuses on high-growth markets such as the industrial Internet of Things, and we think it’s an attractive SMID growth stock at 30 times earnings.

TWST: Anything more about tailwinds the fund has captured?

Mr. Corris: I think the biggest tailwind for our investment process has been the Fed increasing interest rates and restoring a valuation focus in the market. Our view is that artificially low interest rates and cost of capital led to speculative behavior, and a lot of companies were overvalued relative to their fundamentals.

When the Fed started raising interest rates, that brought valuation rationality back to the market. That has been a significant tailwind for us because we focus on quality and value, and typically avoid more aggressive areas of the market.

TWST: What are the risks that you see going forward? And how does the fund mitigate against risk?

Mr. Corris: We see two big risks going forward. The biggest macro risk is whether the Fed is going to be able to engineer a soft landing or not. We think the market has largely been pricing in a soft landing over the last few months. If the Fed is able to engineer that soft landing, the market could see sporadic periods of risk-taking and speculation return. That happened in January, which was a historically strong month for highly shorted, negative-momentum stocks.

We are a little more cautious. We think that there’s still a reasonable risk of a slowdown and are focused on some leading indicators that suggest the market may still be a little bit too optimistic. We think the market may still be a little complacent. If we’re right, that would be a risk to the market, but probably a tailwind to our relative performance.

The second big risk we see is what we call “COVID Camouflage,” second-order effects where COVID distortions on the economy are less obvious. For example, in many areas nominal revenues have been strong and have led firms to over-hire; however, as inflation recedes these firms are going to be left with lower revenues alongside inflated cost bases, and will need to cut costs or face margin compression.

Another example would be stock-based compensation, which we think is a big risk for growth firms that was temporarily masked by COVID.

TWST: What’s your view of current investor sentiment? How important to your approach are geopolitical tensions like current troubles with China and the Ukraine?

Mr. Corris: We do a lot of risk management in the fund. We have a number of tools that we use to manage risk along a variety of dimensions including individual stocks, sectors, and systematic factors including macroeconomic factors. As a result, we don’t have a strong tilt on macro themes.

1-Year Daily Chart of PTC Inc.

Chart provided by www.BigCharts.com

In terms of my general view on speculation in the market, it seems that when interest rates were very low, there was a lot of speculation that has since come back somewhat since the Fed raised rates. But it doesn’t look like it’s been squeezed out of the market entirely.

In January, we saw a number of the meme stocks and highly shorted, lower-quality stocks that rallied significantly, and it still seems like there’s more of a buy-the-dip mentality. It still seems like there has not been capitulation, and if you look at the overall market multiple relative to consensus earnings, it’s still rather full, suggesting a lack of fear in the market.

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TWST: Do you consider factors related to clean energy investing? Is ESG something you look at?

Mr. Corris: ESG is one among many factors we consider. The U.S. Small-Mid Cap Core Equity Fund is not an ESG fund, and we do not use ESG to make the final buy or sell decision on stocks. But we do consider ESG as part of our decision making, particularly when it presents an outsized risk to the fundamentals of a stock.

TWST: In summary, what's your best advice to investors now?

Mr. Corris: I'll start with some high-level advice on what investors should be doing right now. My top concern is that investors seem to be complacent about potential downside risk. That doesn't mean that it will necessarily happen, but a soft landing is certainly plausible. I think the market has priced in a soft landing, and some more caution is warranted.

Relatedly, I would highlight the importance of recognizing when there's a change in the market — for example, the environment we've been in for the last 10 years may not be the same one we go into for the next 10 years. We've come out of an environment with historically low interest rates and leadership by high-duration growth stocks, and we're now moving into a world where interest rates and inflation are going to be higher. In that world, shorter duration may be more attractive than longer duration, and value stocks may be relatively more attractive than high-growth stocks.

My third big picture view is a defense of active management. We think that over the last decade, artificially low interest rates led to a strong stock market, and it was both easy and profitable to buy and hold an index. Lower-quality and overpriced stocks performed well because a rising tide lifted all ships. I think that one of the changes we're going to see in this higher interest rate environment is that speculative behavior and elevated valuations will continue coming out of the market, so there will be more differentiation between winners and losers.

In that environment, active managers should add more value than they have over the last decade. Going forward, it's going to be more important to choose good active managers and recognize that just buying a passive index won't have the same value proposition that it did over the last decade.

TWST: Thank you. (VSB)

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China Focuses on Economic Reboot Post Pandemic Restrictions

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MAN WING CHUNG joined Value Partners Group Limited in 2017, and is the lead manager of the Asia ex-Japan and All-China Equity UCITS strategies. He currently manages US$1.1 billion of ALL China, Greater China and Asia ex-Japan equities portfolios for institutional and intermediary clients. He started his career with East Asia Hamon in Hong Kong in 1992, before joining HSBC AM in 1993, where he was ultimately promoted to CIO for Far East ex-Japan equities. He then spent five years at Jardine Fleming AM/JP Morgan AM as Head of the Greater China Team, before leaving in 2005 to co-found HindSight IM and co-manage its Asia Pacific multi-strategy hedge fund. In 2009, he co-founded JTM Capital Partners and managed a Greater China hedge fund, before joining Ellis Brady Management in 2012, where he was responsible for Greater China equities. He graduated from the University of Hong Kong with an MBA and the University of Pennsylvania (U.S.) with a bachelor's degree in Economics.

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SECTOR — GENERAL INVESTING

(AHV504) TWST: Let's start with an introduction to your role at Value Partners.

Mr. Chung: Sure. I am an equity portfolio manager with Value Partners based in Hong Kong. I focus on the all-China equity region and also Asia ex-Japan equities portfolios. All of these are long-only strategies.

TWST: Since we spoke about a year ago, any notable changes to the fund?

Mr. Chung: No. In terms of our investment philosophy, investment process, and approach, it's been very consistent over the years. So no material change in that sense.

TWST: And what is the approach and structure of the fund?

Mr. Chung: The portfolio is guided with an actively managed, bottom-up-driven approach. And the capital size of that particular portfolio is about $30 million with about four years of history. Alongside that public fund, we also have different sorts of similar mandates managed in house. The unaudited AUM of our group as of 31 December 2022 was approximately US$6.1 billion.

We don't really have a particular country or sector bias. It's really up to the bottom-up opportunities that we come across in this Asia ex-Japan region. Historically, and even up to date, given the structure of the Asia ex-Japan region as a whole, it's a portfolio that's heavily featured with exposure to, for example, financials and information technology, and of course, the big consumption consumer sector in Asia ex-Japan.

TWST: Looking back over 2022, what were the most impactful headwinds that affected the fund?

Mr. Chung: As a quick recap of what happened in 2022, one could argue that Asia, in general, was hit by a perfect storm: external volatility, worries about global inflation, stagflation, a tense geopolitical environment that is apparently affecting all kinds of equities. And also within Asia, of course, we all remember, in particular China, had been hit by COVID and the resulting zero-COVID restrictions that had affected not just economic and business activities in China, but also the rest of Asia.

So these are probably one or two important issues that we have to learn from and draw lessons from last year.

TWST: What is the economic picture like in the region, compared to the inflation and recessionary scenario happening in the U.S.?

Mr. Chung: To start with China, the economic environment is still very fluid. As we all know, China just came out from the zero-COVID lockdown environment and the Chinese government has very recently decided to lift all the restrictions, virtually all of the restrictions. So this is the exact time that the decision makers and financial investors are focusing on the long-term growth and sustainable development of the overall Chinese economy. And as I said, the situation is still very fluid.

We did see some business and economic disruption right after China lifted its pandemic restrictions, as there was a sudden outbreak of the pandemic. However, that has peaked earlier this year and now we are seeing some recovery in the economy, especially as seen during the CNY — Chinese New Year — holidays, where domestic traveling and consumption were nearly at the pre-COVID levels of 2019.

Meanwhile, looking at inflation — inflation is quite different from what we understand in the U.S., i.e., yes, we are also hit by, for example, rising material costs and the effect of the previous lockdowns and pressure on logistics and so on. But overall, inflation pressures are now very manageable. And that is not just in China, but also in the rest of Asia.

"And we expect that the Chinese government will soon continue to roll out more policy support and administrative measures to stimulate domestic consumption. And gradual recovery in China-oriented trade and travel, to the normal level. Then there will be a spill-over effect on similar types of companies and businesses in the rest of Asia."

TWST: What about geopolitical issues? Recently, unfortunately balloons were spotted floating over the U.S. Do things like that impact the fund?

Mr. Chung: Yes, geopolitical concerns definitely are here. And the kind of competition between the U.S. and China definitely is an issue that we look at and we monitor every day. In our view, when we took a somewhat backseat and looked at the overall situation, on one hand, the external geopolitical tension is still here. But we are more pleased to say that especially with China lifting its anti-pandemic measures, clearly, within China and therefore within the rest of Asia, the focus is back on economic growth and almost like a reboot of investment and domestic consumption.

So in terms of portfolio positioning, we are more positioned toward a gradual recovery in investment and also consumer confidence, especially in domestic China.

TWST: Is there a regulatory reset happening in China? If so, how would that impact the fund?

Mr. Chung: Actually, it was a major market overhang, especially from a couple of years ago when a handful of the large private business platforms in China were "regulated" by the Chinese government. But there are recent developments, that alongside with the refocus on growth and future development by the Chinese government itself, there are some signals that the focus now is more on cooperation between the state and the private sector in China.

So the underlying tone is that everyone now is more than willing to move forward and to secure growth and development and definitely trying to instill more confidence in consumers, so that the economy can be rebooted and driven forward and upward.

TWST: Looking back over 2022, are there any particular specific names that did best? And what do you see ahead in 2023? Where might you be lightening up, or selling some names? Tell us the story there.

Mr. Chung: I guess from a macro or thematic point of view, I'd say that overall 2022 was a bad year for markets in this part of the world. Now anything, everything, in terms of performance can be described as relative, right? And relatively speaking, we have seen stronger performance, especially in China, from selective themes such as renewable energy, advanced manufacturing and domestic consumption. And we do think these themes and sectors are still on a very visible secular growth trajectory.

So going forward, main sectors like advanced manufacturing, big consumption and financials, we think will continue to drive the market, at least in the coming few months. Therefore, maybe trading from a technical point of view, big internet, e-commerce, business portals in China have been under pressure for the last 18, 24 months until the recent rebound in the fourth quarter.

And the same with the refocus back to growth and development. The rebound in this particular area looks to be having another leg. So we think the near-term rebound should continue.

On the flip side, if you like to look at it that way in the near term, with a tactical perspective, there are things that we might want to reduce in order to fund our upcoming purchases. We might be lighting up our exposure to, for example, utilities and telecom.

It's not saying that these are bad businesses or bad companies. But just positioning from a technical point of view — they have done well in the last year. And from a rotation point of view, we might be taking some money off the table from these areas. And then to increase our exposure to more growth areas.

TWST: Can you give us a closer look at some of those higher growth areas that you might be going into upcoming?

Mr. Chung: Clearly, consumer discretionary will be one area that we are doing more and more homework on. And that applies to not just the companies in China, but also throughout Asia. For example, in the very near term, most market participants are looking at the China reopening development.

And at least from a thematic point of view, we see the Chinese consumer in a trend toward what we see as pent-up demand from being locked up for the last two and a half years.

And we expect that the Chinese government will soon continue to roll out more policy support and administrative measures to stimulate domestic consumption. And gradual recovery in China-oriented trade and travel, to the normal level.

Then there will be a spill-over effect on similar types of companies and businesses in the rest of Asia. So they will also benefit. And so themes like tourism-related businesses in Southeast Asia. And Southeast Asia is a favorite travel destination for Chinese travelers, so that clearly will lead us to do more work on that area too.

TWST: As you look further into 2023, what worries you? What are your top concerns? And what is your strategy for mitigating against risk?

Mr. Chung: One risk factor probably more externally driven is the geopolitical situation. Everyone will agree that the relations between China and the West need to calm down. And it's still a very fluid situation. And from time to time, this may cause volatility to the markets.

Domestically within Asia, the risk premium has already come down quite a bit, especially helped by the Chinese government's decision to open up and remove the COVID-related restrictions.

Hence, in the near term, we expect the risks that may affect Asia are more associated with external factors, particularly geopolitical risks and the slowing down of demand from the West.

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For example, export-heavy economies, such as Taiwan and Korea, are more likely to be impacted by the low growth global environment.

TWST: In 2021, your fund received a five-star rating from Morningstar. Congratulations on that. To what do you attribute this success? And what's your current outlook? What do you see ahead in 2023?

Mr. Chung: Off the top of my head, I would think the favorable performance back then was driven by our team's efforts to pick good stocks. In particular, in that period, our domestic Asia and also China stock selection was quite satisfactory. And another factor that helped the performance in that period, and actually up to today was, again, our selection, not just in China, but also in Southeast Asia. So for example, our selection in certain areas are still prevailing, i.e., consumption in Southeast Asia for example, and financials, and good manufacturing and industrial stocks in Southeast Asia as well.

So I think these are still sort of secular themes that we are still sticking with and will continue to try to extract more alpha along these areas.

TWST: Can you share your best advice to investors who would like to participate in the ex-Japan market? Beyond buying your fund, can you recommend any companies, and countries, that look attractive now?

Mr. Chung: We recommend diversifying, at least along countries and along sectors. And that will continue, in our view, to be the best strategy to tackle the whole Asia ex-Japan universe. So, for example, everyone talking about deglobalization will definitely, on the surface, cause some concerns about the attraction of Asia. But if this is the case, then there will be winners that will capitalize on this deglobalization trend.

And some of the companies have been long established in China and the rest of Asia. And it's a matter of doing more homework and getting to know their business models better to uncover opportunities.

TWST: Do you see correlation between rising geopolitical tensions between the U.S. and China and investor sentiment? What specifically do you see as the financial impacts of current tensions?

Mr. Chung: Well, in terms of sentiment, yes, definitely, there is correlation. And the area is still widely perceived as part of the emerging markets. And so market volatility often will be affected by short-term or temporary concerns. Geopolitical tensions can be one, and what's happening with U.S. interest rates, as well as the war in Ukraine from time to time. So yes, we'll continue to see some pressure on sentiment.

In terms of financial impact, definitely different kinds of industries, different companies will be affected to various degrees. But despite the uncertain macro environment, there are still some companies that remain resilient and can still provide earnings visibility, such as industry leaders in some sectors or those that have strong pricing power. And as long as the corporate managers do a good job.

And when we come across these strong companies, we actually like volatility that causes short-term share price volatility. We use it to increase our exposure to these areas.

TWST: Any other thoughts you'd like to share before we conclude?

Mr. Chung: Well, from our experience in this part of the world, Asia ex- Japan should continue to feature in a global equity portfolio for the diversification and for the long-term growth prospects. And even after the rebound in the fourth quarter, many good quality Asian companies are still trading at very attractive valuations, especially against the similar peer group in the developed markets. So at least from that diversification point of view, Asia is looking very, very good if you have a longer-term investment horizon.

TWST: Thank you. (VSB)

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