Second Quarter 2018 Commentary **Carol M. Lippman, CFA**

Why We Stick with High Quality, Financially Solid Companies

Since the stock market troughed in March of 2009, the economy and stock market have generally charted a slow, steady upward path. Much economic and market commentary has centered around generally moderate but optimistic growth expectations, and the Federal Reserve's course for returning the level of interest rates from the zero interest rate policy to historically more normal levels.

On June 13, 2018 the Federal Reserve voted unanimously to raise their benchmark federal-funds rate by a quarter-percentage point to a range between 1.75% and 2%, their second rate increase so far this year. From the Wall Street Journal that day:

> "The decision you see today is another sign that the U.S. economy is in great shape," said Fed Chairman Jerome Powell at a press conference following the Fed's two-day policy meeting. "Growth is strong. Labor markets are strong. Inflation is close to target."
> Eight of 15 Fed officials now expect at least four rate increases will be needed this year, up from seven in March and four in December. Stocks fell as investors calculated higher borrowing costs could weigh on earnings.[1]

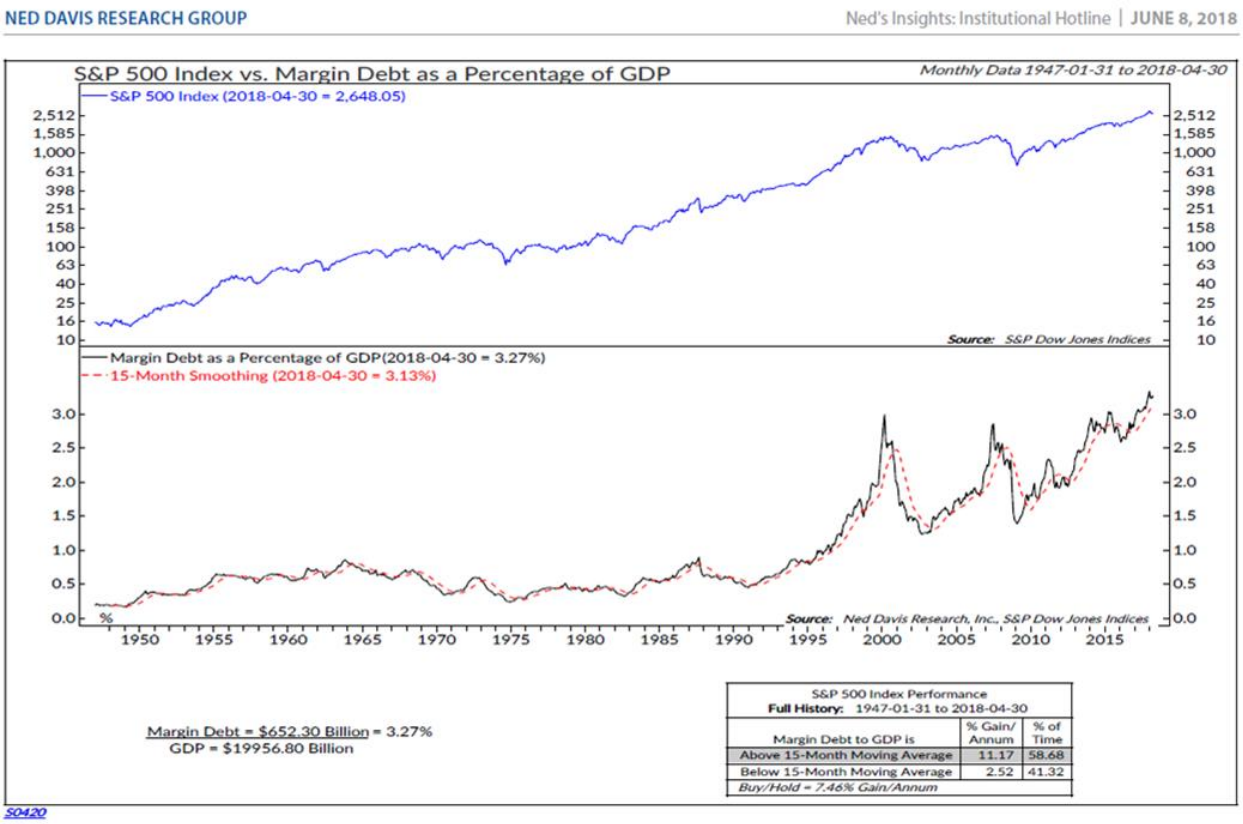
Recently, several articles (two of which are excerpted below) have been written that express concerns about the economy and the markets, frequently citing the significant amounts of debt that have built up throughout households, corporations, and governments.

***Q1 2018 Quarterly Debt and Savings Update* - Ned Davis Research**

> **Debt and Savings Theme**: (Ned Davis's) debt theme for the economy is the same one (he) uses for supply/demand analysis in the stock market. Ample savings (cash reserves), and low debt suggest a lot of potential buying power. Also, when savings are depleted and debt is high, the market is at high risk for a big correction.
>
> The debt theme for the economy is just as simple. Debt represents consumption today at the expense of future consumption. Thus, excessive debt is a burden on growth through: (1) debt service; (2) repayments; (3) low credit scores (people less "credit worthy"); and (4) anxiety of being trapped by debt. Now, we don't think all debt is bad. If it is used for productive investment, be it in machines, or education and training, it can actually help growth. The investment can pay off in higher income in the future. Unfortunately, (Ned Davis) thinks most of the debt has been used for consumption.
>
> The rate of real GDP growth at high levels of debt has historically been about half the rate at low debt levels. (Ned Davis's) real problem with corporate debt is that profits have been good enough that there was really no need to borrow. (Ned Davis) wonders if the big cash pile that corporations have is really just from borrowing at near zero percent interest rates. (Ned Davis) also worries that the borrowings have not been used for new investment, but rather for buy-backs of stock. Good for stock investors – not so good for the economy. The good news is that debt/GDP is still rising, showing a growing confidence by speculators in S0420. In conclusion, (Ned Davis) still thinks debt is a longer-term problem, but it looks manageable at these interest rates, for now.[2]

[1] Timiraos, Nick. "Fed Raises Interest Rates, Sets Stage for Two More Increases in 2018." The Wall Street Journal. June 14, 2018.
[2] Davis, Ned. "Q1 2018 Quarterly Debt and Savings Update," Ned Davis Research Group. June 8, 2018.

Ned Davis Research Graph SO420 Margin debt has never been higher since the end of WWII:



Excerpt from John Mauldin's 5/25/18 *Thoughts from the Frontline--High Yield Train Wreck*

> The landscape is littered with similarly tenuous corporate borrowers. It is the inevitable consequence of a free-cash decade. Here's Grant Williams again.
>
> *Ten years into the ongoing laboratory experiment being conducted by the world's central banks, everywhere you look there are multiple examples of the kind of lunacy those policies have fomented by reducing the cost of capital to virtually zero and forcing investors to take risks they would ordinarily avoid in order to find some kind of return*[3].

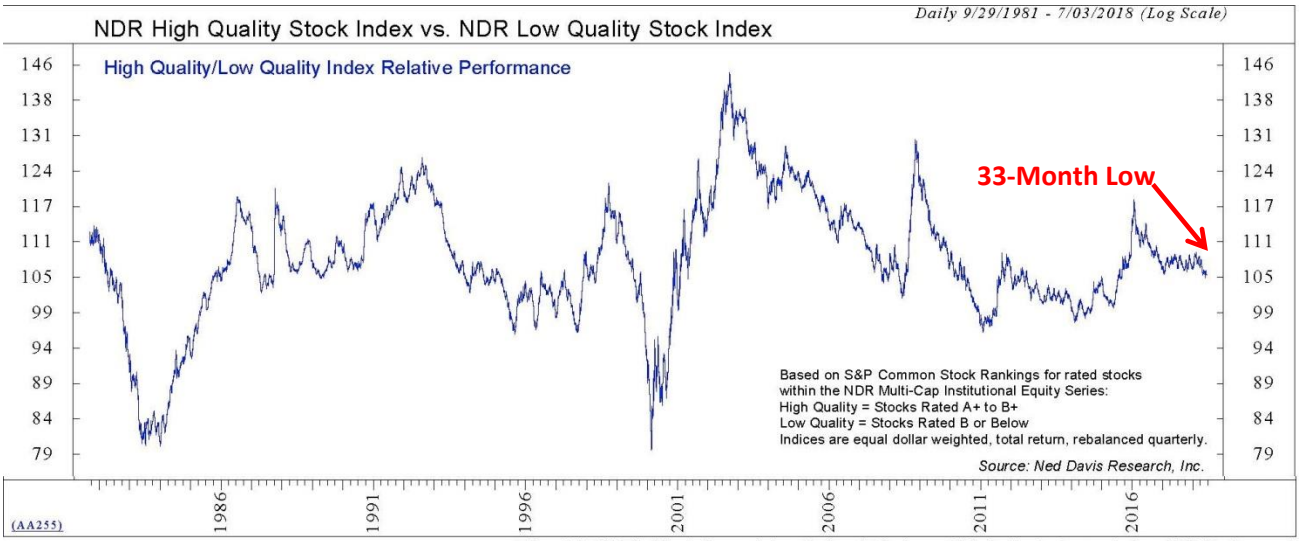
When one holds substantial debt and the unforeseen comes along, the debt holder does not have control; the debt issuer has the control. Such a situation creates vulnerability for the debt holder. We work hard to try to *reduce* vulnerability in our portfolios. Among the ways we attempt to reduce vulnerability are by including what we consider high quality companies with fundamentally strong balance sheets with reasonable levels of well-covered, investment grade debt, as well as strong cash flow generation potential. We believe that financially solid companies should be able to hold up if the unforeseen comes along.

Yet, Stocks of High Quality, Dividend-Paying Companies Have Lagged

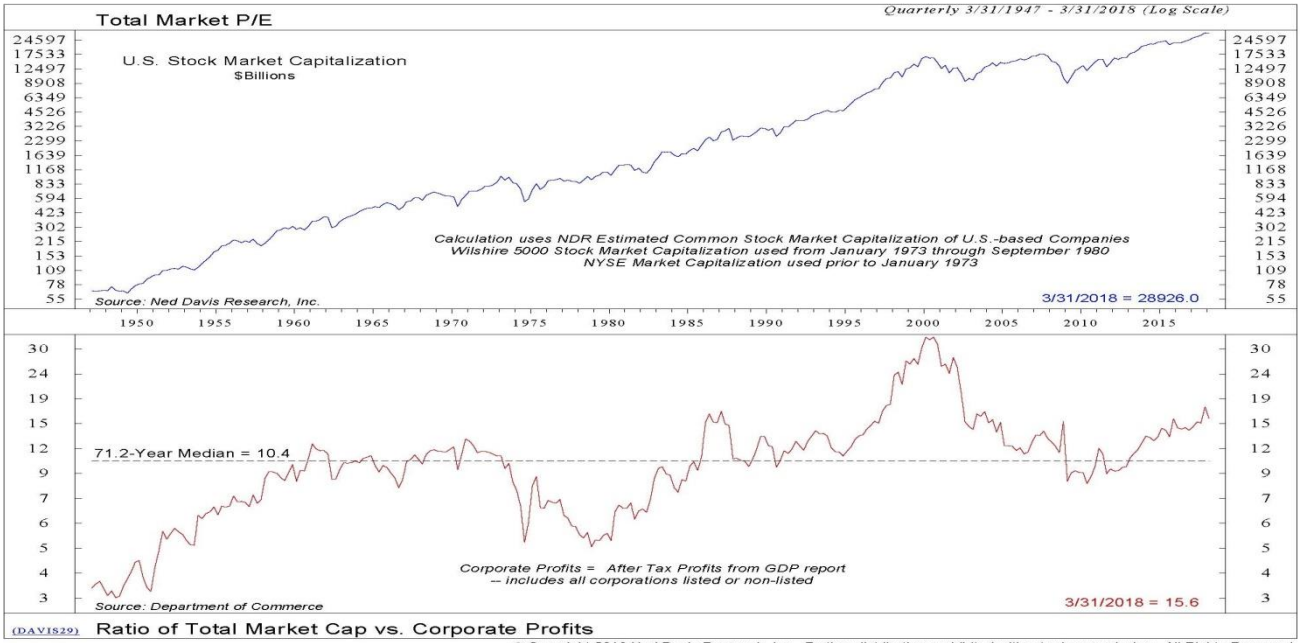
[3] Mauldin, John. "High Yield Train Wreck." MauldinEconomics.com. March 25, 2018.

Despite so many warnings urging caution about too much debt, according to a May 29, 2018 Ned Davis Research note:

> The stock market's lackluster start to 2018 should support higher quality names that tend to have lower betas. Yet the NDR High Quality Index has fallen to a 33-month low relative to the NDR Low Quality Index (Davis chart AA255).



At the same time, valuations for the broad market as measured by the S&P 500 are near historic highs (Davis29 below). In our opinion, this spells potential vulnerability.

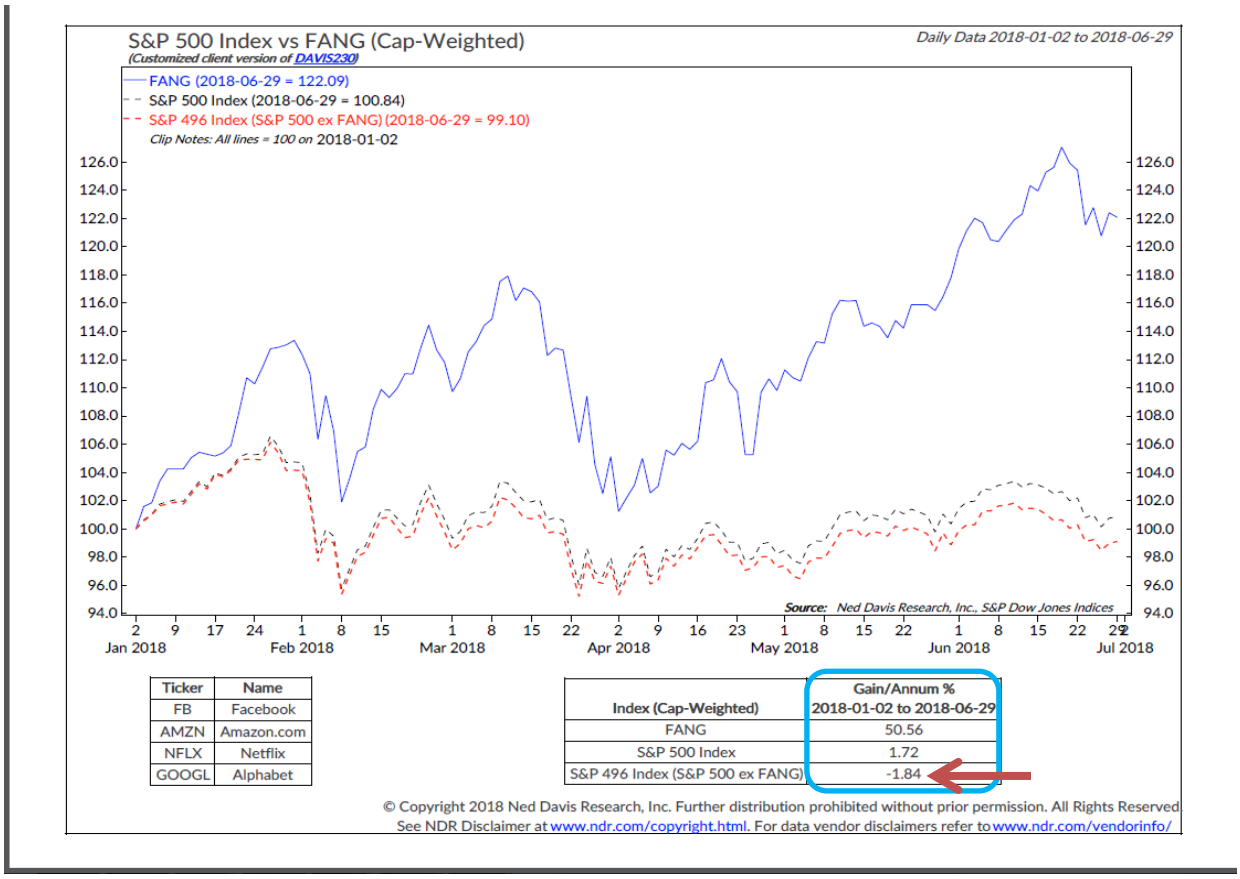


We are not endorsing any of these views or making any predictions about the stock market. We are, however, taking the analysis of third-party "experts" to show that high quality, dividend-paying strategies, such as ours, have been lagging the benchmark and other higher-risk strategies for quite some time. After all, 33 months is almost three years!

We do understand that it is difficult when the investments one holds are not performing in line with stocks that are frequently in the news or the popular S&P 500 benchmark. In the first half of 2018, the return of the benchmark S&P500 Index would have been negative were it not for the turbo-boost from the four non-

dividend-paying FANG stocks: Facebook, Amazon, Netflix, and Google. The first half 2018 gross before fees performance of both of our SMAs lagged the benchmark, but the results were positive, not negative, and can be seen on the following page.

First Half 2018 Benchmark Performance Was Negative Without FANG Stocks



Our strategy is designed to hold up for the long term. If the unforeseen ever does occur and has a negative effect on the stock market, it is our hope that our disciplined approach to stock selection and portfolio management will allow our portfolios to hold up. Furthermore, we would expect each company in our portfolios to continue to pay dividends and increase them over time.

"Big Down Days" Update

There were five days in the second quarter and 16 days in the first half of 2018 on which the S&P 500 declined more than 1%. Both Dearborn Partners Rising Dividend SMA portfolios outperformed the benchmark (i.e., declined less than 1%) on each of those 16 days. Our generally conservative, defensive strategy tends to hold up better than the benchmark on what we call "big down days" when the S&P 500 declines 1% or more.

Since we launched our Rising Dividend Strategy in September 2011, only 146 or 8.5% of the total number of days have been "big down days." This update shows that on days when the S&P 500 has declined 1% or more, roughly 90% of the time, our two Rising Dividend SMA portfolios have outperformed the broad market. Although past performance cannot assure future results, if any of the concerns we presented above should ever affect markets, it is our hope that the power of rising dividends would continue to generally cushion the fall of stock prices and thereby provide respectable total returns. There are certainly no guarantees, of course.

Big down days from inception (September 30, 2011) through June 30, 2018:

Total Days	1,708	
Total "Big Down Days" (down more than 1%)	146	
Total days that the Core Rising Dividend SMA ("CRD") outperformed the S&P 500 on "Big Down Days"	134	91.8%
Total days that the High & Rising Dividend SMA ("HRD") outperformed the S&P 500 on "Big Down Days"	130	89.0%

How Did We Do?

Here are the performance results of our two Dearborn Partners Rising Dividend SMAs and the S&P 500 Composite Index ("S&P 500," the benchmark against which we compare our portfolios) for the quarter as well as longer term results through June 30, 2018.

Second Quarter 2018 Total Returns (%) as of June 30, 2018[4]

	Gross	Net
Core Rising Dividend SMA	3.5	3.1
High and Rising Dividend SMA	4.3	3.9
S&P 500[5]	3.4	

Total Returns Annualized (%) as of June 30, 2018[4]

	Year-to-Date		1- year		3- year		5- year		Since Inception (9/30/11)	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Core Rising Dividend SMA	1.8	1.0	11.0	9.3	10.8	9.1	11.2	9.4	13.5	11.6
High & Rising Dividend SMA	0.5	-0.3	9.5	7.8	10.9	9.3	10.8	9.2	13.3	11.7
S&P 500[5]	2.7		14.4		11.9		13.4		16.3	

[4] Returns are presented on a pure gross and net basis and include the reinvestment of all income. Pure gross returns do not reflect the deduction of any expenses, including trading costs, and are supplemental to net returns. Net of fee performance was calculated using actual fees, which include wrap fees, management fees and trading commissions. The Dearborn management fee schedule is 1.00% on the first $1 million and 0.75% on amounts over $1 million, but actual fees may vary.

[5] The S&P 500 is an unmanaged index of 500 widely held stocks that is generally considered to be representative of the U.S. stock market. Inclusion of this index is for illustrative purposes only. Historical performance results for investment indexes generally do not reflect the deduction of transaction and/or custodial charges or the deduction of an investment management fee, the incurrence of which would have the effect of decreasing historical performance results. Economic factors, market conditions, and investment strategies will affect the performance of any portfolio and there are no assurances that it will match or outperform any particular benchmark.

Cumulative Income Summary

Here is the cumulative gross (before fees) dividend income from an initial $200,000 investment on September 30, 2011 (the inception date of our SMA portfolios) through June 30, 2018 in each of:

	Current Yield	Cumulative Income*
Core Rising Dividend SMA	2.4%	$54,460
High & Rising Dividend SMA	3.2%	$70,950
S&P 500	1.8%	$48,942

**The S&P 500 dividend income in the table above is calculated by creating hypothetical investable "share units" by dividing the assumed initial $200,000 investment by the price of the index (1131.42) on September 30, 2011 (the inception date of our Rising Dividend SMA portfolios), resulting in 176.77 share units. The dividends per share unit of the index, provided by S&P Dow Jones Indices, are applied to the calculated units on a quarterly basis. The total represented in the table is the sum of those quarterly dividends per share unit, from December 31, 2011, through June 30, 2018.*

Dividend Increases

Core Rising Dividend SMA portfolio:
In the second quarter of 2018, 13 of the 49 companies in our Core Rising Dividend SMA portfolio announced 13 dividend increases averaging about 14% more than those particular companies paid a year before their latest dividend increase announcement date. In the first half of 2018, 28 of the 49 companies in our Core portfolio announced 32 dividend increases averaging about 13.4% more than those particular companies paid a year earlier.

High & Rising Dividend SMA portfolio:
In our High & Rising Dividend SMA portfolio, 5 of the 25 companies in the portfolio announced 5 dividend increases averaging about 13.2% more than those particular companies paid a year before their latest dividend increase announcement date. In the first half of 2018, 15 of the 25 companies in our High & Rising portfolio announced 18 dividend increases average about 9.1% more than those particular companies paid a year earlier.

A Premise for our Strategy

An objective of our strategy is to reduce vulnerability. Among the ways that we attempt to achieve that objective are to include in our portfolios companies that are in strong financial condition with little or no debt, that we believe are capable of increasing dividends at rates above the historic average annual 3% rate of inflation regardless of the economic environment, and to diversify properly across and within the sectors. As shown in the last month of the second quarter, we further believe that rising dividends offer the potential to reduce vulnerability when more challenging markets come along.

We believe that the solid companies in our portfolios are likely to not only survive long term, but continue to pay dividends with the potential to increase with regularity. Successful investing typically requires patience. Every company in our portfolios pays us while we patiently hold.

Thank you for your interest in our Dearborn Partners Rising Dividend Strategy.

Dearborn Partners Rising Dividend Separately Managed Account Portfolios
Average Calendar Year Dividend Increases

	Core Rising	High & Rising	CPI*
2012	13.0%	9.6%	1.9%
2013	12.2%	8.7%	1.7%
2014	12.2%	7.4%	1.6%
2015	9.7%	7.5%	2.1%
2016	8.0%	6.5%	2.1%
2017	7.8%	5.8%	1.7%
H12018	13.4%	9.1%	2.2%

** Core Consumer Price Index for All Urban Consumers Unadjusted 12-month Percent Change. First half (H1) 2018 CPI through May.*

Source: https://www.bls.gov/news.release/cpi.nr0.htm

Research assistance provided by Jackson Finks, CFA and Matthew Guttosch, CFA

Disclaimer:

On the date that a company in our SMA portfolios announces a dividend increase, we calculate the percentage difference from the dividend the company paid a year earlier. We are excluding any special or accelerated dividends paid. We then calculate the average of all those year-over-year increases. However, if a company announces a dividend increase more than once a year, we use the average of that company's multiple increases to be considered in the year-over-year comparison.

Past performance is no guarantee of future results. Dividends are not guaranteed and must be authorized by the company's board of directors.

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