DEARBORN PARTNERS

Year End 2017 Commentary **Carol M. Lippman, CFA**

Taxes are important to consider, but taxes should not drive prudent investment decisions.

The Tax Cuts and Jobs Act of 2017 has been signed into law. The goal of the legislation is to further stimulate the economy by requiring companies and individuals to pay fewer taxes, thereby providing more money to spend, invest, and create jobs. Key features of the complicated, 400-plus page document—far from the simplified tax code originally put forth—include:

- a permanent 21% federal tax rate down from a top rate of 35% for corporations;
- a temporary top individual tax bracket of 37% down from 39.6% until year 2025;
- expensing 100% of the costs of qualified property acquired and placed in service through year 2022, followed by decreases in 20% annual increments over the following five years;
- eliminating corporate deductions for interest expense above 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA);
- $1.5 trillion of tax cuts.

As the title of the legislation states, these are tax cuts, not tax reform. Because the legislation does not eliminate enough tax breaks, rework the tax code, or otherwise generate enough in savings at this point to offset the tax cuts, if these provisions do not create enough economic growth, the federal deficit is likely to increase. To attempt to address deficit reduction, some provisions regress after four or more years and expire on December 31, 2025, reverting to current law if Congress does not then approve extensions.

Opinions differ as to the legislation's effects on various sectors. For example, some think the law will penalize Utility companies; others disagree with that premise.

A December 16, 2017 Barron's article by Ben Levisohn, *Tax Reform Bypasses Utilities* states: "The market might be going gaga for tax reform, but there's one sector that's sitting out this latest rally: utilities."[1] The article indicates that utilities with high levels of debt may be at greatest risk because the new lower corporate tax rate means that companies benefit less from interest expense deductions. This article does, however, cite diversified utilities as potential beneficiaries as those with non-regulated business segments would benefit from lower tax rates. (The Utilities in our Dearborn Partners portfolios are diversified utilities.)

On the other hand, the Ned Davis Research 2018 Outlook examined the percent of companies in each S&P 500 sector that have an effective tax rate above 30%, and concluded that Utilities —65% of which have tax rates greater than 30%—rank high "in the tax reform winner camp."[2]

Acting on near-term forecasts can be hazardous to a portfolio's health. The November 23, 2017 Wall Street Journal (WSJ), for example, ran an article titled: "*Wall Street's 2017 Market Predictions: Pathetically Wrong; Forecasting is difficult, but this year showed exactly how pointless it can be: Market performed opposite of virtually all predictions.*"[3] This WSJ article reinforces why—when we are asked for our views on where markets are going—we emphasize our focus on trying to find companies capable of increasing dividends regardless of the environment. Few, if any, can accurately and consistently predict what stock prices will do. We believe that if we can find companies that consistently increase dividends, at least something in the portfolio would be rising. Furthermore, history has shown that over time, stock prices tend to follow the direction of consistent dividend increases.

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[1] Levisohn, Ben. "Tax Reform Bypasses Utilities." Barrons (December 16, 2017)

[2] Ned Davis Research Group. "2018 U.S. Outlook." Ned Davis Research Group (December 7, 2017)

[3] Mackintosh, James. "Wall Street's 2017 Market Predictions: Pathetically Wrong." Wall Street Journal (November 23, 2017)

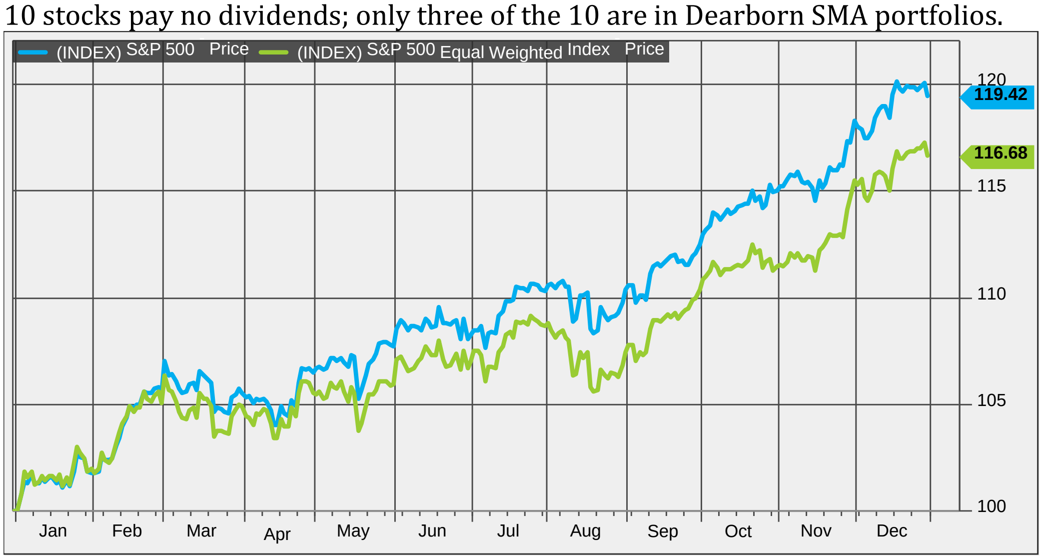
We are not fans of debt. We look for companies with solid balance sheets, i.e., not a lot of debt. Therefore, the cap on the deductibility of debt expense should not be a problem for most of the companies already in our separately managed account (SMA) portfolios.

We are not going to move in and out of stocks just because new tax laws may appear to improve the potential fortunes of some companies over others. We strive for low turnover. Low turnover, by the way, generally results in tax efficient investing.

Rather than reacting to near-term forecasts, new legislation or other changes, we strive to be patient, long-term investors in what we consider to be great, defensive businesses. We look for companies that are capable of increasing dividends annually regardless of the environment—be it fiscal, economic, judicial, or legislative.

<u>Only a few stocks led the benchmark's return</u>

In year 2017, the market cap-weighted S&P 500 index (the blue line in the chart below) outperformed the equal-weighted S&P 500 index (the green line). Ten stocks accounted for more than 20% of the S&P 500's market capitalization and, thus, the difference in the performance. Four of those 10 stocks pay no dividends; only three of the 10 are in Dearborn SMA portfolios.



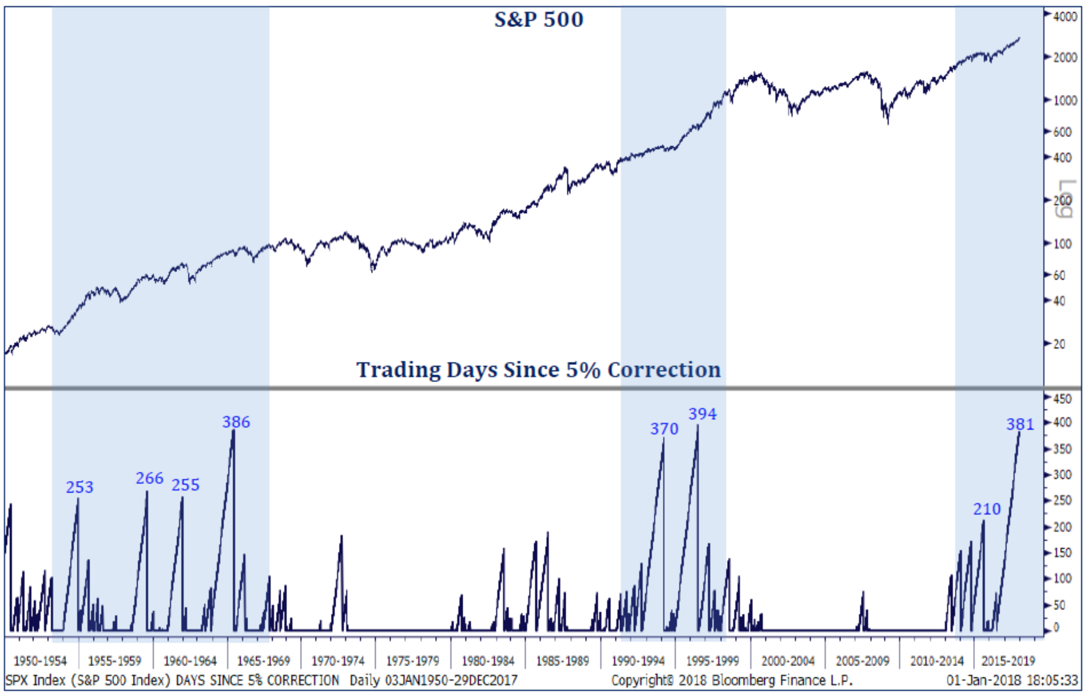
Source: FactSet

COMPANY	MARKET VALUE $ MILLIONS	% OF INDEX	CURRENT ANNUAL DIVIDEND	
Apple Inc	$868,880	3.63%	$2.52	Dearborn Core Rising Dividend SMA
Alphabet Inc 'C'	$677,027	2.83%	$0.00	
Microsoft Corp	$659,906	2.76%	$1.68	
Amazon.com Inc	$563,535	2.35%	$0.00	
Berkshire Hathaway B	$489,045	2.04%	$0.00	
Facebook Inc 'A'	$420,821	1.76%	$0.00	
Johnson & Johnson	$375,361	1.57%	$3.36	Dearborn Core and High & Rising Dividend SMAs
JP Morgan Chase & Co	$371,052	1.55%	$2.24	
Exxon Mobil	$354,405	1.48%	$3.08	Dearborn Core Rising Dividend SMA
Bank of America	$307,912	1.29%	$0.48	
Total:		**21.25%**		

Source: S&P Dow Jones Indices

In other words, our portfolios underperformed the well-known, widely used benchmark. Nonetheless, inasmuch as over the past nine decades, the average compound annual total return of common stocks as measured by the S&P 500 has been about 10%, a one-year return in the teens is not shameful, in our opinion. Our betas below one indicate that we achieved our results with less risk than the benchmark.

A recent piece from Strategas Research Partners highlights the longest streaks since the 1950s that the S&P 500 has gone without a 5% correction.[4] As of the final day of 2017, the current streak stood at 13 days short of a record. If one were waiting for a "pullback" to get invested, that would mean having been on the sidelines for quite some time and still on the sidelines for possibly quite some time longer.



Source: Strategas Research Partners

We believe this reinforces our opinion that it is important to be invested in the stock market to participate. We believe that investing in a strategy that continually pays dividends from companies that offer the potential to increase those dividends is a palatable way to participate in the markets.

[4] Verrone, Chris. "Framing Our 2018 Outlook." Strategas Research Partners (January 2, 2018)

How Did We Do?

Here are the performance results of our two Dearborn Partners 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 year ended December 31, 2017.

Fourth Quarter 2017 Total Returns (%) as of December 31, 2017[5]

	Gross	Net
Core Rising Dividend SMA	6.4	6.0
High and Rising Dividend SMA	4.9	4.4
S&P 500[6]	6.6	

Total Returns Annualized (%) as of December 31, 2017

	1- year		3- year		5- year		Since Inception (9/30/11)	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Core Rising Dividend SMA	15.7	13.9	9.5	7.8	13.5	11.7	14.3	12.4
High & Rising Dividend SMA	14.0	12.2	9.4	7.8	13.5	11.9	14.4	12.7
S&P 500	21.8		11.4		15.8		17.2	

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 December 31, 2017 in each of:

	Current Yield	Cumulative Income*
Core Rising Dividend SMA	2.4%	$49,088
High & Rising Dividend SMA	3.1%	$63,642
S&P 500	1.8%	$44,364

**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 December 31, 2017.*

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[5] 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.

[6] 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.

Dividend Increases

Core Rising Dividend SMA portfolio:
In the fourth quarter of 2017, 15 of the 49 companies in our Core Rising Dividend SMA portfolio announced 15 dividend increases averaging about 9.1% more than those particular companies paid a year before their latest dividend increase announcement date. One company in this portfolio made five dividend increase announcements in 2017.

High & Rising Dividend SMA portfolio:
In our High & Rising Dividend SMA portfolio, 6 of the 25 companies in the portfolio announced 6 dividend increases averaging about 7.4% more than those particular companies paid a year before their latest dividend increase announcement date. One company in this portfolio made five dividend increase announcements in 2017.

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. We further believe that rising dividends offer the potential to reduce vulnerability in challenging markets.

The broad market has not presented many challenges for more than a year. It is our experience, however, that markets have not remained complacent and on an uptrend forever. When that trend ends, we believe that the solid companies in our portfolios are likely to not only survive 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.

D E A R B O R N

P A R T N E R S

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%

** Core Consumer Price Index for All Urban Consumers Unadjusted 12-month Percent Change. 2017 CPI through November.*

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

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.

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