DEARBORN
PARTNERS

Third Quarter 2021 Commentary **Carol M. Lippman, CFA**

Interest Rates

At the economic policy symposium on August 27, 2021, sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, Federal Reserve Chair Jerome H. Powell included the following in his address:

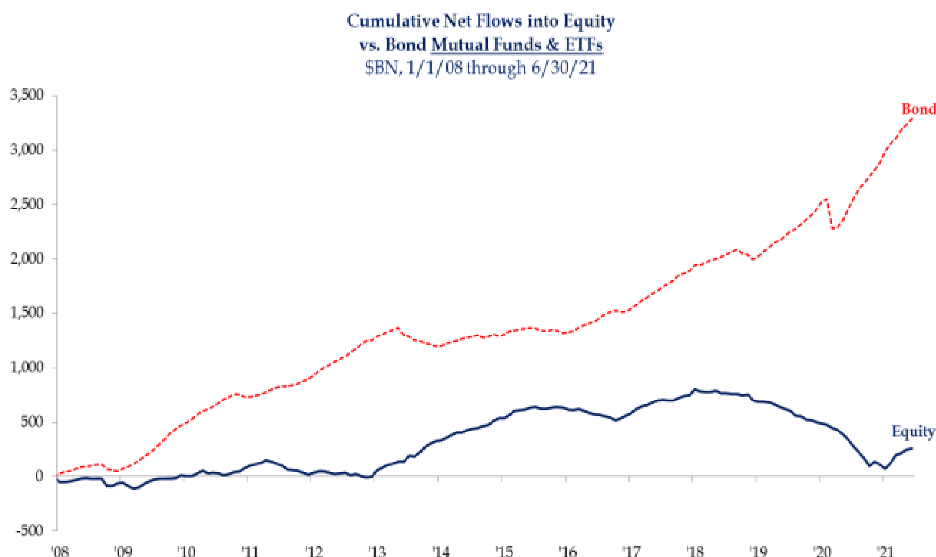
> "In my comments today, I will focus on the Fed's efforts to promote our maximum employment and price stability goals amid this upheaval and suggest how lessons from history and a careful focus on incoming data and the evolving risks offer useful guidance for today's unique monetary policy challenges. *** The economic downturn has not fallen equally on all Americans, and those least able to shoulder the burden have been hardest hit. *** We have said that we will continue to hold the target range for the federal funds rate at its current level" (0.00-0.25%)[1] "until the economy reaches conditions consistent with maximum employment, and inflation has reached 2 percent and is on track to moderately exceed 2 percent for some time. We have much ground to cover to reach maximum employment, and time will tell whether we have reached 2 percent inflation on a sustainable basis."[2]

The Fed Funds Rate is a peg for the returns offered by short-term U.S. treasury bonds, money market funds, CDs, and other generally riskless investments. The 10-year U.S. treasury bond, which has yielded less than 2% since the end of January 2020, ended the third quarter of 2021 at 1.53%. As long as interest rates are so low, if we want to make our money work harder—i.e., get potentially better returns than these interest rates—then we believe investors have to participate in the stock market. Year to date, the Standard & Poor's 500 index's total return has been 15.9%. Since the trough in the broad market on March 23, 2020, the S&P 500's total return has been 97.3%.

Yet, as Jason De Sena Trennert of Strategas Securities wrote on August 9, 2021:

> "Most investors, it seems, were too scarred by the two financial crises (the year 2000 crash after the 1990s dot.com bubble and the Great Financial Crisis of 2008-2009) in the first decade of the new millennium to seek refuge in anything other than bond and money market funds." . . . As seen in Figure #1 below, "inflows into bond funds this year seem poised to surpass the records established in 2019 and 2020."

Figure #1 Inflows to Equity and Bond Mutual Funds & ETFs[3]



[1] https://www.bankrate.com/rates/interest-rates/federal-funds-rate.aspx
[2] Monetary Policy in the Time of COVID. Jerome H. Powell. August 27, 2021.
[3] Investment Strategy Report, Strategas Securities LLC, Jason De Sena Trennert, Aug 9, 2021

Low interest rates make it affordable for companies and individuals to borrow money and make periodic interest payments for the use of that money. Historically low interest rates and the Federal Reserve's promise to keep rates low for many more months and possibly years, however, encourage some borrowers to take on excessive debt. Someday, the economy is likely to recover to the point that the Federal Reserve will raise interest rates (bond yields), adding pressure to debt holders. Remember that bond yields and bond values move inversely to one another. It is also important to keep in mind that debt *issuers* have the control, not debt *holders*.

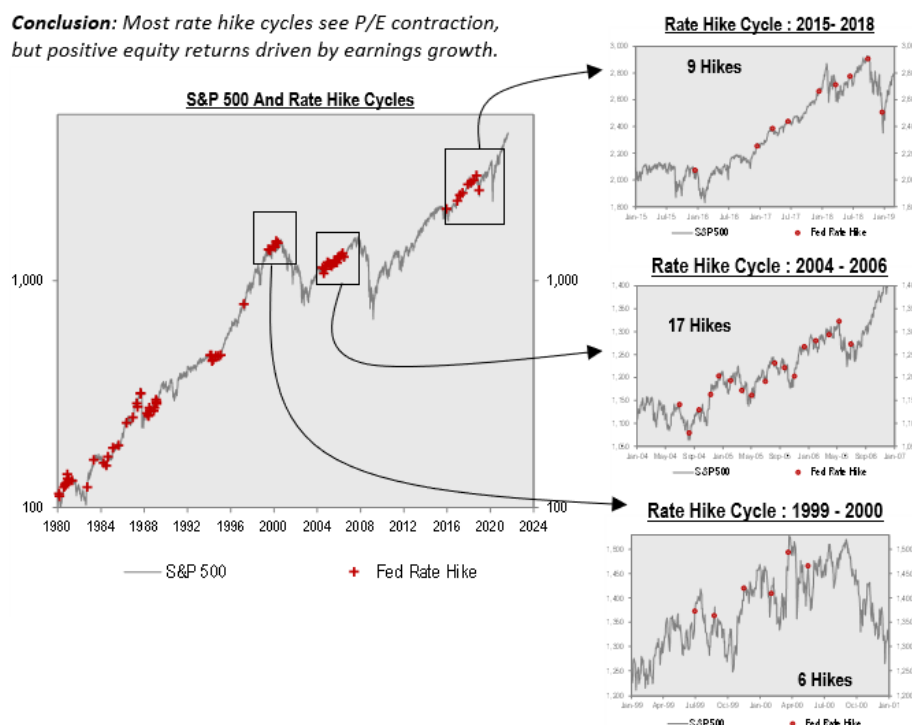
We prefer that investors in our strategy be in control. As a result, one of the first considerations for deciding if a company qualifies for inclusion in our strategy is the condition of its balance sheet. How much debt does the company have? How do the rating agencies rate the debt? For our portfolios we identify companies with manageable debt levels and ratios, and we will not consider companies with below investment grade debt ratings. Our work has shown that these are among the disciplines that contribute to the ability of companies to consistently increase their dividends, even in challenging environments. Furthermore, our work has shown that the stocks of companies that have consistently increased dividends over time have typically been less volatile in challenging markets.

What Happens to Stocks if Interest Rates Rise?

Inasmuch as stock markets have been so strong while interest rates have been kept so low, it's natural to wonder what could happen to equity markets if the Federal Reserve raises interest rates. Cornerstone Macro Research has examined all the periods since 1980 that the Federal Reserve raised (tightened) interest rates. Figure #2 shows that despite seven tightening cycles, the long-term trend of the market as illustrated by the S&P 500 has been up. Cornerstone's analysis further showed that stocks of high-quality companies outperformed in past rate hike cycles whereas poor quality (which they refer to as "volatility/(high)beta") underperformed. Cornerstone Macro's conclusion is that most rate hike cycles see price/earnings multiple contraction, but positive equity returns for stocks of companies that generate earnings growth. Of course, past performance cannot assure future results. Companies that consistently increase dividends typically also consistently increase earnings over time, paying out only a prudent percentage of earnings as dividends, thereby plowing the bulk of earnings back into the company for future growth—including growth of dividends.

Figure #2 What Happens to Markets During Fed Rate Hiking Cycles?

- Market Returns In Tightening Cycles Are Generally Positive But Subpar
- Nearly All Fed Tightening Cycles See Price/Earnings Multiple Contraction
- Quality Factors Outperformed In Past Rate Hike Cycles Whereas Volatility/Beta Underperformed
- May 2000 Was The last Time The Fed Raised Rates By 50 Basis points or More At One Time
- The Average Year-over-Year Change In The Fed Funds Rate During Modern-Day Tightening Cycles Is 1.25%

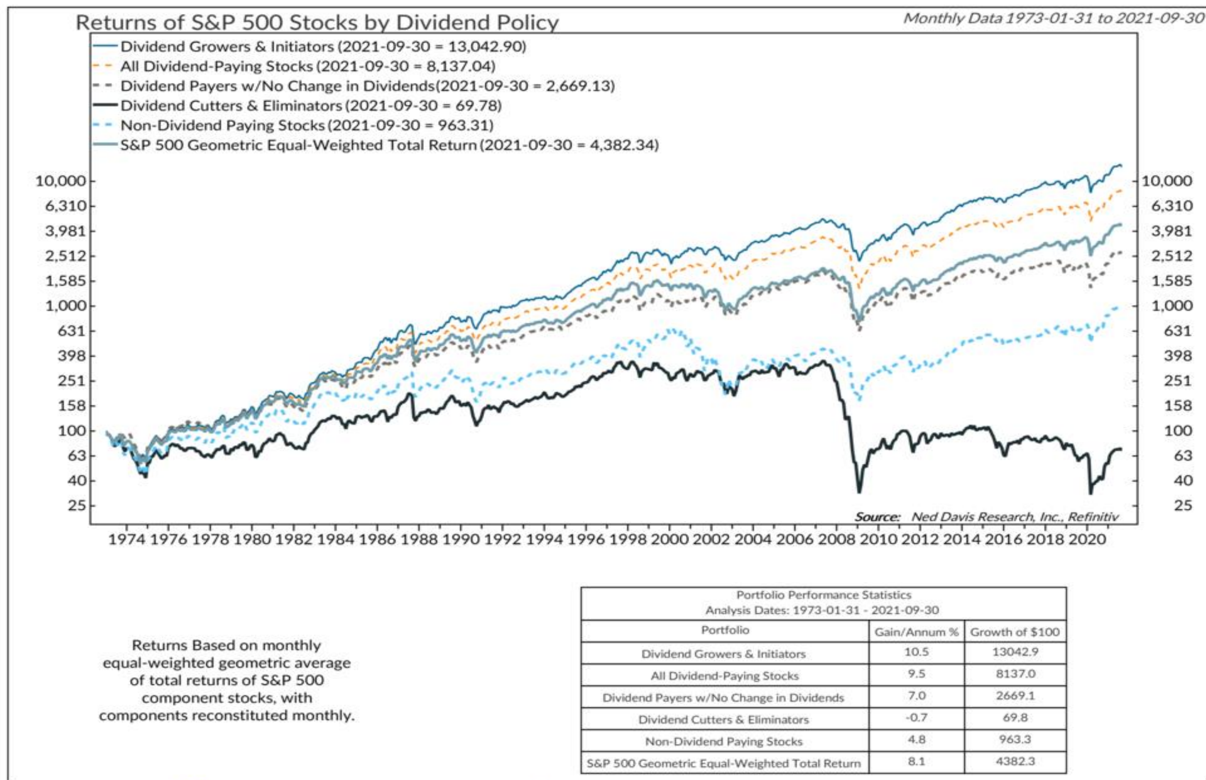


Source: Cornerstone Macro Portfolio Strategy

Then Versus Now

The Ned Davis charts below show how "out of whack" current trends in the stock market have been relative to history. Ned Davis divides the S&P 500 into categories by dividend policy. Since 1973, stocks of companies that cut or omitted their dividends—i.e., low quality companies (Dividend Cutters & Eliminators, the darkest line in Figure #3)—have produced the worst results by a wide margin: An assumed initial $100 investment on January 31, 1973 lost money—ending total return (i.e., price movement plus dividends) $69.80—nearly 50 years later as of September 30, 2021. On the other hand, an assumed $100 investment on January 31, 1973 in stocks of companies that have increased dividends outperformed all the other categories—ending total return $13,042.90—nearly 50 years later (Dividend Growers & Initiators, the top line in Figure #3). In this study, by the way, the total return of the broad market as measured by the geometric equal-weighted S&P 500 ended with a total return of $4,382.30, only about one-third as much as the ending value of the Dividend Growers. We believe this reinforces the wisdom of holding a Dearborn Partners Rising Dividend Strategy in at least a portion of well-diversified, long-term oriented portfolios.

Figure #3 Returns of S&P 500 Stocks by Dividend Policy 1/31/1973-09/30/2021



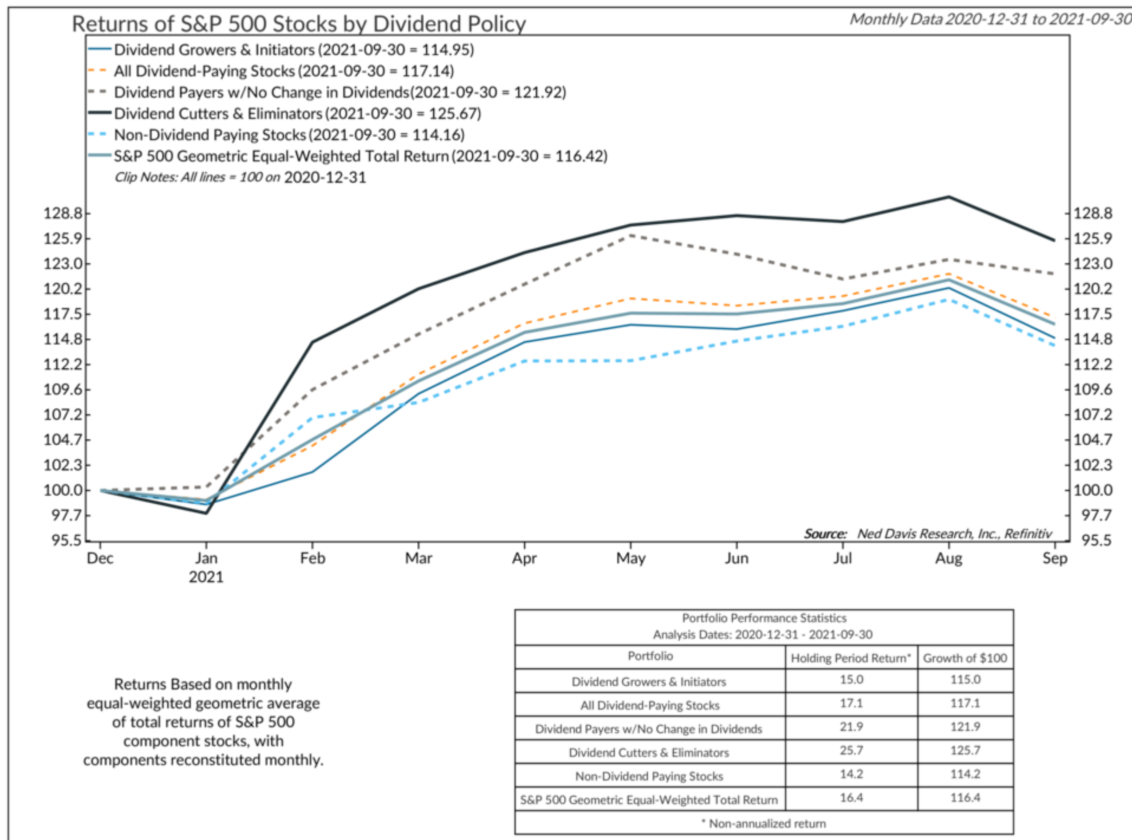
Portfolio Performance Statistics
Analysis Dates: 1973-01-31 - 2021-09-30

Portfolio	Gain/Annum %	Growth of $100
Dividend Growers & Initiators	10.5	13042.9
All Dividend-Paying Stocks	9.5	8137.0
Dividend Payers w/No Change in Dividends	7.0	2669.1
Dividend Cutters & Eliminators	-0.7	69.8
Non-Dividend Paying Stocks	4.8	963.3
S&P 500 Geometric Equal-Weighted Total Return	8.1	4382.3

© Copyright 2021 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. See NDR Disclaimer at www.ndr.com/copyright.html.
For data vendor disclaimers refer to www.ndr.com/vendorinfo/

This year, however, the sense that the perpetually low interest rate environment will render a perpetually "up" stock market, has led many investors to take extraordinary risks, including owning stocks of companies with poor fundamentals (Dividend Cutters & Eliminators, the top solid black line in Figure #4). In such an environment, stocks of historically high-quality companies, illustrated by those that consistently increase dividends (Dividend Growers & Initiators, the second from the bottom solid green line in Figure #4), have not kept up.

Figure #4 Returns of S&P 500 Stocks by Dividend Policy 12/31/2020-09/30/2021



Portfolio Performance Statistics
Analysis Dates: 2020-12-31 - 2021-09-30

Portfolio	Holding Period Return*	Growth of $100
Dividend Growers & Initiators	15.0	115.0
All Dividend-Paying Stocks	17.1	117.1
Dividend Payers w/No Change in Dividends	21.9	121.9
Dividend Cutters & Eliminators	25.7	125.7
Non-Dividend Paying Stocks	14.2	114.2
S&P 500 Geometric Equal-Weighted Total Return	16.4	116.4

* Non-annualized return

Customized client version of S09

© Copyright 2021 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. See NDR Disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers refer to www.ndr.com/vendorinfo/

Recently, a business partner with knowledge of this rising dividend strategy since the 1990s said that he makes sure his clients' portfolios are well diversified. Our strategy is for the "comfortable" part of their portfolios, he said. We wear that as a badge of honor and remain steadfast in our commitment to maintaining the disciplines toward identifying companies that we consider capable of consistently increasing dividends. Some portfolio managers drift from their stated investment objectives in an attempt to chase performance. The temptations are great to stray from disciplines when aberrant market behavior persists for longer than anyone could imagine. Maintaining discipline is always difficult. Investors in our Dearborn Rising Dividend Strategy, however, can count on us to maintain our disciplines of staying with investments of high quality and reasonable valuation.

Dividend Growth: Core Rising Dividend SMA portfolio

In the third quarter of year 2021, 11 of the 49 companies in this portfolio announced 11 dividend increases averaging about 8.5% more than those companies paid a year earlier. In the first nine months of year 2021, 36 of the 49 companies in our Core Rising Dividend portfolio announced 41 dividend increases averaging about 9.8% more than those companies paid a year earlier. No companies in our Core Rising Dividend portfolio have cut or suspended dividends so far this year.

Dividend Growth: High & Rising Dividend SMA portfolio

In the third quarter of year 2021, 5 of the 25 companies in the portfolio announced 5 dividend increases averaging about 5% more than those companies paid a year earlier. In the first three quarters of this year, 17 of 25 companies in our High & Rising Dividend portfolio announced 19 dividend increases averaging about 5.7% more than those companies paid as dividends a year earlier. No companies in our High & Rising Dividend portfolio have cut or suspended their dividends so far this year.

Cumulative Income Summary

Here is the cumulative gross (before fees) dividend income generated by the companies in both of our Dearborn Partners Rising Dividend Separately Managed Account (SMA) Portfolios from an initial $200,000 investment on September 30, 2011 (the inception date of our SMA portfolios) through September 30, 2021:

	Average Current Yield	Cumulative Income*
Core Rising Dividend SMA	1.8%	$93,373
High & Rising Dividend SMA	3.0%	$123,508
S&P 500	1.4%	$82,348

**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 September 30, 2011, through September 30, 2021.*

The table above shows that the average yield of both of our Rising Dividend SMA portfolios at the end of the third quarter of year 2021 exceeded the average yield of the S&P 500. As a result of their above average yields, lower volatility, and generally conservative features, our portfolios may appeal to some generally risk-averse investors who are in search of yields greater than those offered by both long-term bonds and the broad market.

Dearborn Partners' Rising Dividend Philosophy

The Dearborn Partners Rising Dividend investment team works very hard to try to find companies that we consider capable of increasing dividends at rates that help investors keep ahead of the rising costs of living throughout any kind of environment—economic, interest rate, political, social, taxation, unprecedented pandemics, severe weather, etc. Some of the eleven sectors into which Standard & Poor's divides the marketplace are more economically sensitive than others. From every sector, however, we look for what we consider to be the most defensive—i.e., consumers patronize their products or services in tough economic times as well as good times—and now the most essential businesses with strong balance sheets, high barriers to entry, and solid management. As we know, companies don't grow overnight; growth takes years and investors must be patient. We insist that every company pays dividends. In fact, we insist that the dividends represent a prudent percentage of earnings and cash flow so that the companies can reinvest most of the cash generated for future growth of revenues, cash flow, earnings, and dividends. Historically, stock prices move as the earnings of the underlying company move. If the earnings and dividends can march upward over time, so should the stock prices and provide attractive total returns over the long term. We think our strategy of paying investors while waiting, and consistently getting pay raises through dividend increases should, we hope, give investors the fortitude to stay invested throughout any environment.

The lens through which we examine every company in our portfolios and those that may be candidates for our portfolios is: do they possess the ability to not only pay a dividend but increase the dividend consistently over time. **Our view is: A dividend is tangible evidence of a company's health; a rising dividend telegraphs a company's strength.**

We are truly grateful that you are taking this journey with us and hope that you will patiently stay with us for many years to come. That we concentrate so intently on including in our portfolios companies that offer the potential to continuously pay and increase dividends we hope will enable you to get invested and stay invested in our equity portfolios throughout the volatility and in any environment. We promise to continue to work hard to try to bring you lots of rising dividends.

The Dearborn Partners Investment Team,
Carol, Mike, Pete, Matt, and Jack

Research assistance provided by Jackson Finks, CFA

Dearborn Partners Rising Dividend Separately Managed Account Average Calendar Dividend Increases

	Core Rising	High & Rising	CPI*
2021 YTD	9.8%	5.7%	4.0%
2020	7.6%	5.9%	1.6%
2019	9.6%	8.2%	2.3%
2018	13.3%	9.5%	2.2%
2017	7.8%	5.8%	1.7%
2016	8.0%	6.5%	2.1%
2015	9.7%	7.5%	2.1%
2014	12.2%	7.4%	1.6%
2013	12.2%	8.7%	1.7%
2012	13.0%	9.6%	1.9%

** Core Consumer Price Index for All Urban Consumers Unadjusted 12-month Percent Change. Year to Date (YTD) 2021 CPI through August. Updated September 14, 2021.*

Source: U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items Less Food and Energy [CPILFENS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CPILFENS September 14, 2021.

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. Dividend yield is one component of performance and should not be the only consideration for investment.

This commentary presents general views on the securities markets and should not be construed as financial or investment advice on any subject matter. This commentary may not be redistributed without Dearborn's written consent. Some of the information herein has been obtained from third party sources. We believe such information is reliable, but we have not in each case verified its accuracy or completeness. All securities investing involves risks, and this commentary is not intended to address such risks. Dearborn may make securities recommendations to clients that are inconsistent with the views herein. Any opinions herein are as of the date of this report and are subject to change without notice. Dearborn Partners L.L.C. is an investment adviser registered under the Investment Advisers Act of 1940, as amended. Registration does not imply a certain level of skill or training.