<u>Third Quarter 2023 Commentary</u> **Carol M. Lippman, CFA**

Question: What Is Your Outlook? Answer: Stay Invested.

Occasionally—fortunately it isn't more frequent—we are asked our view on markets and the economy one to two years out. Here is our response.

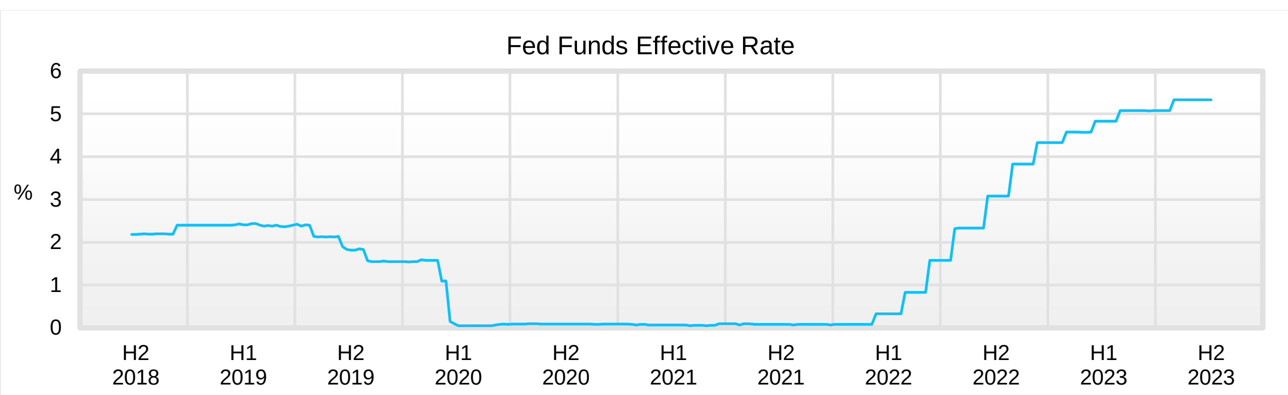
The Dearborn Partners investment team does not make predictions about the market or the economy or interest rates or any other macroeconomic factors. We concentrate solely on finding high quality, financially solid companies that we think are capable of consistently increasing dividends at rates that can help investors keep ahead of the rising costs of living, i.e., inflation—which has averaged 3% per year for the past nine-plus decades—regardless of the environment. Then we assemble what we consider to be these great companies into well-diversified portfolios. As can be seen on the table on the last page of this Commentary, inflation over the past 11 years has averaged about 2.6%. Dividends paid by the companies in our portfolios have increased roughly three to four times the average annual rate of inflation. Our stated objective for average annual dividend growth is mid- to high single digits.

We are stock pickers. We certainly subscribe to and read a great deal of macroeconomic and market research. We take economic and market strategy views into account as we decide what companies to include in our portfolios. We make no predictions ourselves, however. We believe that always owning well diversified portfolios of good quality companies that pay us dividends while patiently waiting is a viable strategy for building wealth over the long term. Trying to time when to get in and out of the market, and back in again, can result in missing wealth-building opportunities.

Why Do We Believe in Staying Fully Invested at All Times?

When the novel coronavirus emerged early in 2020, in an effort to stimulate the economy, the Federal Reserve cut the Fed Funds Rate to 0-0.25% and kept rates there until early in 2022.

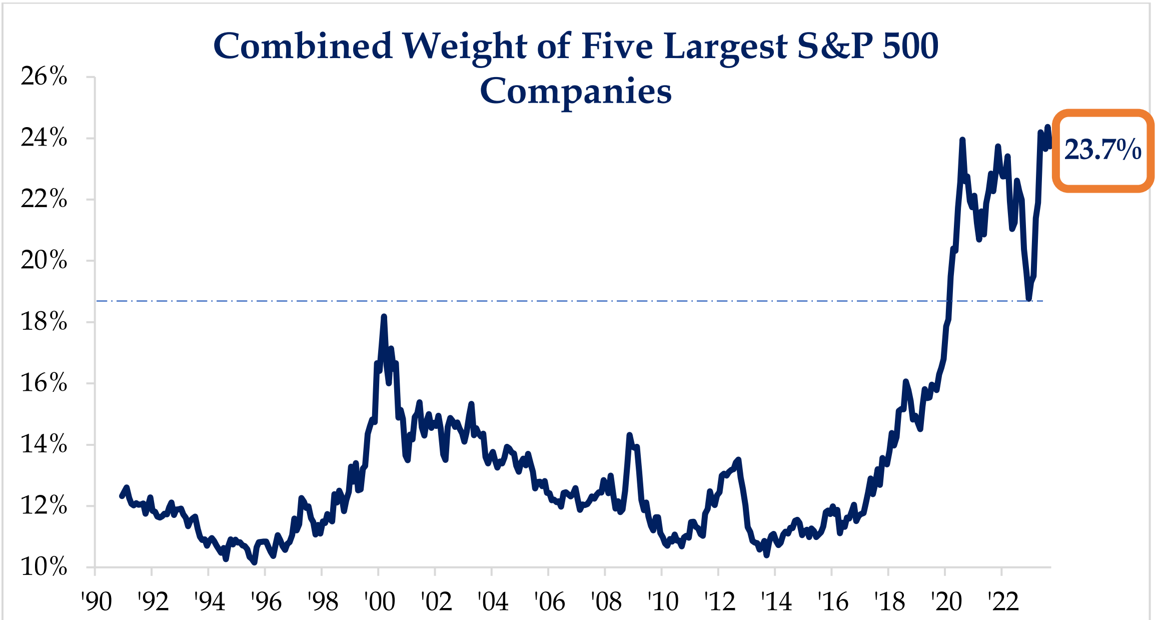
Figure #1: 5-Year Federal Funds Rate



Source: FactSet Data Services

While interest rates were zero, investors seeking greater returns turned to the stock market. In 2020 and 2021, the benchmark market cap-weighted S&P 500's total returns were +18.4% and +28.7%, respectively, +47% cumulatively. Stocks of a few companies accounted for a substantial part of the returns those two years. Figure #2 by Strategas shows that five stocks combined to account for roughly one-quarter of the broad market's returns for much of 2020 and 2021 (orange box). Of the five largest stocks, three pay no dividends.

Figure #2: The Stock Market Remains Heavily Concentrated



Source: Strategas Investment Strategy

Ned Davis Research (NDR) has divided the marketplace into categories by dividend policy: Dividend Growers & Initiators, All Dividend-Paying Stocks, Dividend Payers with No Change in Dividends, Dividend Cutters & Eliminators, and Non-Dividend Paying Stocks. NDR compares these dividend categories with the equal-weighted S&P 500 Index. Figure #3 shows the two-year performance (full years 2020 and 2021) of each category. Non-dividend paying stocks performed the best: +17.6% (orange arrow).

Figure #3: Performance by Dividend Category December 31, 2019 through December 31, 2021

Portfolio Performance Statistics Analysis Dates: 2019-12-31 - 2021-12-31		
Portfolio	Gain/Annum %	Growth of $100
Dividend Growers & Initiators	13.8	129.5
All Dividend-Paying Stocks	14.6	131.5
Dividend Payers w/No Change in Dividends	12.6	126.8
Dividend Cutters & Eliminators	11.1	123.5
Non-Dividend Paying Stocks	17.6	138.4
S&P 500 Geometric Equal-Weighted Total Return	15.1	132.6

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In March of 2022, the Federal Reserve started to aggressively raise the Fed Funds Rate. By the end of 2022, Fed Funds were 4.1%. In 2022, the market cap-weighted S&P 500's price declined 20%, the textbook definition of a bear market. The correction in the performance of the five largest stocks contributed to the negative returns of the broad market. Figure #2 shows that in 2022, the concentration of the stocks of the five largest companies dropped from about 24% to about 19% (broken blue line). A conclusion to draw about markets from 2020 to 2022 is that when interest rates were zero, stocks performed well. When interest rates rose, stocks struggled. Figure #4 shows performance by dividend category for the full year 2022. Non-dividend paying stocks performed the worst: -29.9% (orange arrow). Stocks of companies that increase dividends, the first row, declined less than -10%.

Figure #4: Performance by Dividend Category December 31, 2021 through December 31, 2022

Portfolio Performance Statistics Analysis Dates: 2021-12-31 - 2022-12-31		
Portfolio	Gain/Annum %	Growth of $100
Dividend Growers & Initiators	-9.3	90.7
All Dividend-Paying Stocks	-9.9	90.1
Dividend Payers w/No Change in Dividends	-14.5	85.5
Dividend Cutters & Eliminators	-7.1	92.9
Non-Dividend Paying Stocks	-29.9	70.1
S&P 500 Geometric Equal-Weighted Total Return	-14.8	85.2

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Investors who don't lose as much in difficult markets don't have to work as hard to recoup the loss. Figure #5, showing the performance of the dividend categories for the entire period from the beginning of 2020 through the end of the third quarter of 2023, illustrates this investing truism. In 2023, the broad market has recovered, as has the dominance of the largest stocks: 23.7% as of September 30, 2023 (See Figure #2.). Although the first two dividend categories underperformed the non-dividend paying stocks and the equal-weighted broad market in years 2020 and 2021 (Figure #3), because the first two dividend categories declined considerably less than the non-dividend payers and the broad market in 2022 (Figure #4), the results for the entire period favored the top two dividend categories (green box in Figure #5).

Figure #5: Performance by Dividend Category December 31, 2019 through September 30, 2023

Portfolio Performance Statistics Analysis Dates: 2019-12-31 - 2023-09-30		
Portfolio	Gain/Annum %	Growth of $100
Dividend Growers & Initiators	3.8	114.9
All Dividend-Paying Stocks	4.0	116.0
Dividend Payers w/No Change in Dividends	2.2	108.3
Dividend Cutters & Eliminators	1.0	103.8
Non-Dividend Paying Stocks	1.2	104.5
S&P 500 Geometric Equal-Weighted Total Return	3.2	112.4

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Ned Davis Research (Issue #SSF23_29) summarized this well in its August 2, 2023 Daily Bullet Points:

> "The most aggressive tightening cycle in at least 40 years was the primary reason for last year's equity bear market. The anticipation of a slower pace of rate hikes and eventual end to the tightening cycle has been one of the main drivers of this year's bull market."

But this statement was written in hindsight. As investors were living through 2022, who knew that the year would suffer the textbook definition of a bear market: down -20%? Then, as investors were living through the first half of 2023, who knew that the S&P 500 would climb 16.9%, with 70% of that return coming from seven large cap stocks? Few market strategists correctly called those returns in advance. Rather than making market forecasts or trying to time when to get in and out of the market, we prefer to stay invested at all times in a generally conservative strategy of investing in well-diversified portfolios of stocks of high-quality companies that pay dividends with the potential to increase year after year over time. If we can participate on the up days and go down less on many of the down days, we should be able to help investors.

Patience Is Critical

As seen in Figure #6, since 1926, there have been 96 years. The broad market as measured by the S&P 500 has seen double-digit negative returns 12 times, including last year, 2022. In 14 of the 96 years, the market has declined -10% or less. That means that in 70 of the past 96 years, markets have provided positive returns for investors who have been patient and stayed invested. That's almost three-quarters of the time. The message, as we see it, is: You must be in there participating at all times. We think we have a strategy of investing in stocks of high-quality companies that makes it palatable for investors to get in the market and stay in the market, getting paid (dividends) and pay raises (potential dividend increases) while waiting.

Figure #6: Distribution of S&P 500 Total Returns Since 1926

SINCE 1926 THE S&P HAS SEEN DOUBLE-DIGIT NEGATIVE RETURNS 12 TIMES INCLUDING 2022

< -20%	-20% to -10%	-10% to 0%	0 to 10%	10% to 20%	>20%	
6	6	14	14	21	36	
1930	1941	1929	1947	1926	1927	1976
1931	1957	1932	1948	1944	1928	1980
1937	1966	1934	1956	1949	1933	1982
1974	1973	1939	1960	1952	1935	1983
2002	2001	1940	1970	1959	1936	1985
2008	2022	1946	1978	1964	1938	1989
		1953	1984	1965	1942	1991
		1962	1987	1968	1943	1995
		1969	1992	1971	1945	1996
		1977	1994	1972	1950	1997
		1981	2005	1979	1951	1998
		1990	2007	1986	1954	1999
		2000	2011	1988	1955	2003
		2018	2015	1993	1958	2009
				2004	1961	2013
				2006	1963	2017
				2010	1967	2019
				2012	1975	2021
				2014		
				2016		
				2020		

Source: FactSet Data Services

This Quarter's Generative Artificial Intelligence (AI) Test Run

This quarter we asked ChatGPT, a generative AI program developed by Microsoft, "How can investors tell if a company's dividend is secure?". Here are excerpts from the response, once again complete with a disclaimer.

> "Investors assess the security of a company's dividend by conducting a thorough analysis of its financial health, operational performance, and other relevant factors. While no approach can provide absolute certainty, a combination of the following methods can help investors gauge the security of a company's dividend:
>
> 1. Dividend History: A consistent history of dividend payments and, ideally, a track record of dividend increases can signal a company's commitment to maintaining its dividend policy.
> 2. Dividend Payout Ratio: The dividend payout ratio compares the dividends paid to shareholders with the company's earnings. A lower payout ratio indicates that the company is retaining a larger portion of its earnings for reinvestment, which can contribute to dividend security.
> 3. Earnings and Cash Flow: Analyze the company's earnings and cash flow trends. A company with stable or growing earnings and healthy cash flow generation is better positioned to maintain its dividend payments.
> 4. Debt Levels: Excessive debt can strain a company's financial resources and jeopardize its ability to pay dividends. Evaluate the company's debt levels and its capacity to service its debt obligations.
> 5. Free Cash Flow: Positive free cash flow (the cash remaining after operating expenses and capital expenditures) is a crucial factor in dividend security. It indicates the company has surplus funds that can be allocated to dividend payments.
> 6. Industry Stability: Consider the industry the company operates in and its susceptibility to economic downturns. Companies in stable industries are more likely to maintain secure dividends.
> 7. Competitive Position: A company with a strong competitive position and market share is better equipped to endure challenges and maintain its dividend payments.
> 8. Management's Commitment: Assess management's stance on dividends. Companies with a clear commitment to maintaining dividends, even in tough times, demonstrate a higher likelihood of dividend security.
>
> It's important to emphasize that no method guarantees absolute dividend security. Investors should conduct thorough research, consult financial professionals, and consider their risk tolerance before making investment decisions based on dividend income."[1]

We on the Dearborn Partners investment team try to analyze the companies for our portfolios so well before adding them that we hope to be able to own them "forever." In fact, our average turnover is very low: about 12% annualized since inception. Sometimes, however, companies lose their disciplines or unforeseen developments change the dividend's position relative to other important fundamentals. Our discipline emphasizes assessing our view of a company's ability to not just maintain a dividend but to be able to increase it with regularity and consistency. We believe that enforcing such a strict criterion provides for removing a company before the security of the dividend becomes a concern.

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[1] ChatGPT, response to "How can investors tell if a company's dividend is secure?" 9/19/2023, OpenAI.

Here are some details about the dividend increases announced by the companies in our separately managed accounts (SMAs) in the third quarter of 2023.

Dividend Growth: Core Rising Dividend SMA portfolio

In the third quarter of 2023, 11 of the 49 companies in our Core Rising Dividend portfolio announced 11 dividend increases averaging about 9.5% more than those companies paid a year earlier. In the first nine months of 2023, 32 of 49 companies announced 33 dividend increases averaging about 8.4% more than those companies paid a year earlier. One company declared a special dividend this year. No companies in this portfolio have reduced or suspended dividends so far this year.

Dividend Growth: High & Rising Dividend SMA portfolio

In the third quarter of 2023, 3 of 25 companies in our High & Rising Dividend portfolio announced 3 dividend increases averaging about 4.4% more than those companies paid as dividends a year earlier. In the first nine months of 2023, 16 of 25 companies announced 19 dividend increases averaging about 6.1% more than those companies paid a year earlier. One company announced a dividend increase after only two months and another increase after only one month. One company announced a dividend increase after only one quarter. No companies in this portfolio have reduced or suspended dividends so far this year.

Cumulative Income Summary

Here is the cumulative dividend income generated by the shares held in companies in both of our Dearborn Partners Rising Dividend SMA Portfolios from two actual accounts, each with an initial $200,000 investment on September 30, 2011 (the inception date of our SMA portfolios) through September 30, 2023:

	Average Current Yield	Cumulative Income*
Core Rising Dividend SMA	2.1%	$121,726
High & Rising Dividend SMA	3.5%	$165,367
S&P 500	1.6%	$106,149

**The S&P 500 dividend income in the table above is calculated by creating investable "share units" by dividing an actual $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 September 30, 2023.*

The table above shows that the average yield of both of our Rising Dividend SMA portfolios at the end of the third quarter of 2023 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 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, war, peace, 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—with strong balance sheets, high barriers to entry, and solid management.

This year, many market strategists or prognosticators predicted a poor stock market and encouraged waiting in U.S. Treasury bills until more favorable market conditions develop. Consider what their followers missed: the S&P 500's total return for the year ended September 30, 2023 was +21.6%. It's true that short-term U.S. Treasury bill yields are finally offering rates that provide decent alternatives to stocks of companies that offer attractive dividend yields. As of September 30, 2023, the 6-month U.S. Treasury bill yields 5.55%. For the first time since before the Global Financial Crisis in 2008, savers are no longer being punished and securities with the full faith and credit backing of the United States government can provide decent returns risk free and thus viable diversification to portfolios. Remember, however, that U.S. Treasury instruments offer no growth. The Federal Reserve is signaling that they may continue to raise the Fed Funds Rate at more upcoming meetings. If so, when current 6-month bills mature, rolling into the next ones could make sense for a while. But once the Fed believes that inflation is under control, or the economy enters a recession, interest rates may decline. In other words, we make no market forecasts; instead, we continue to believe that owning well-diversified portfolios of high-quality companies that offer the potential to consistently increase dividends over time makes sense as a core component of investors' portfolios.

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 Jon

Dearborn Partners Rising Dividend Separately Managed Account Average Calendar Year Dividend Increases[1]

	Core Rising	High & Rising	CPI*
11-Year Average	10.4%	7.6%	2.6%
YTD 2023	8.4%	6.1%	4.4%
2022	11.8%	8.7%	6.0%
2021	9.9%	6.3%	5.5%
2020	7.6%	5.9%	1.6%
2019	9.6%	8.2%	2.3%
2018	12.9%	8.8%	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 for 12 months ending August 2023 Updated Sept. 13, 2023. 11-Year Average represents December 2012-December 2022. YTD = Year to Date*

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 13, 2023.

[1] 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.

Disclaimer:

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