Donaldson CAPITAL MANAGEMENT

SUMMER 2021

RISINGDIVIDEND REPORT

Highlights from the Investment Policy Committee

1. Inflation is the general increase in prices over time.
2. May 2021's inflation rate was 5%, which has sparked concerns that inflation could hurt stocks and other assets.
3. Distortions from the pandemic are causing pricing pressures; many of those should subside over the next 12-18 months.
4. We expect inflation to remain below 3% in the longer term.
5. Stocks have historically been the best asset for protecting against inflation over long periods of time.
6. We have tilted client portfolios towards stocks that tend to benefit from rising inflation.

Read the IPC Letter on page 3

Behind the Scenes of the Investment Policy Committee

WE BECOME ACCUSTOMED TO HEARING CERTAIN COMFORTING SOUNDS IN OUR MORNING ROUTINES: the local news anchor's voice, the coffee pot gurgling, the door lock latching. During the pandemic and our remote work, I missed the Monday morning buzz of our Investment Policy Committee (IPC) room.

As Co-Chief Investment Officer, one of the most important jobs I have is chairing the IPC. This committee is responsible for setting, executing, and maintaining our investment philosophy, and ultimately the success or failure of our investment strategies. The IPC meets every Monday morning to review the investment environment and discuss opportunities and threats. Investment strategy changes are presented, debated, and voted upon during our meeting, which is why they are so very important. All changes are communicated with our advisory and investment operations team and then executed in affected client accounts. These meetings continued via Zoom throughout our time working remotely. They occurred more frequently than usual in the early innings of the pandemic as we sought to understand the impact the pandemic would have on the economy and companies in client accounts.

The investment team is composed of Portfolio Managers and Analysts who work every day to uncover threats and opportunities based on the direction of the economy, earnings, valuations, and strategies for the companies we own and companies we don't yet own. We regularly run our proprietary valuation models and screen them to uncover opportunities. The team then does a deep dive on potential opportunities to better understand their strategy for long-term growth.

We are very fortunate to have the team we do and are excited to be back together in the office. The past 15 months have presented challenges never anticipated, and we are grateful for the normalcy that is returning to our personal and professional lives each day. The buzz from the IPC room is loud again, and we are loving it.

All the best,

Kyle Markle

Kyle Markle
Chief Investment Officer &
Senior Investment Advisor

Your Retirement Journey:

James Silk — Retired 1 Year

James Silk was born in New York, the son of an NYPD officer. His family moved to Florida when he was young, and he ended up working in Florida Power & Light's generating station. His wife and family moved to the family farm, where he worked for Duke Energy from 2000 to 2020. His artwork is truly remarkable, and we are privileged to share how James is using his passion and talent. - Brandon Roop, DCM Investment Advisor

1. What change do you like most since retiring?

The best change in my life has been being able to be on my own clock. As a shift worker for 37 years, I missed out on so many family functions and holidays and not getting to sleep properly. I am looking forward to us doing a little traveling and being with family as much as possible.

2. What do your best days look like?

All my days I consider to be my best, whether it's just getting chores done around the home or just working on my art and hanging out with my wife of 41 years and seeing our children and grandchildren.

3. What advice would you give someone getting close to retirement?

My advice would be to get prepared at least a year before retiring. It comes up very fast and there's a lot to sort out and think about. After that, just enjoy!

ABOUT THE ARTIST

- James' artistry is self-taught.
- James' work has been featured in Blueprint Magazine, Born to Run Magazine, the Ty Cobb Museum, and the Sallie and Berton Korman Gallery.
- He won first place for Best Editorial Cartoon in the Hoosier State Press Awards.
- At the age of 19, James toured as a musician across the eastern U.S. and parts of Canada.
- During his childhood in the 1970s, James met Janis Joplin.
- James met and gave Johnny Winter a character drawing he drew of the famous musician when he was invited to a meet-and-greet on the tour bus.
- He once enjoyed a session in Nashville with the members of Bruce Springsteen's band, Van Morrison, and drummer extraordinaire Craig Krampf, co-writer with Steve Perry of the hit song "Oh Sherry."
- James is currently in the process of illustrating a book cover for Jenny La Sala, about widows and Vietnam.

Inflation: Friend or Foe?

A Letter from the DCM Investment Policy Committee

Nathan Winklepleck, *Author*   Preston May, Sarah Moore, Kyle Markle, Joe Zabratanski, *Contributing Editors*

A foot of lumber cost $0.40 in January 2021; the price tripled by May. Used car prices shot up 10% this April.[1] Food prices recently hit their highest levels in 6 years.[2] Homes increased by nearly 14%.[3] This is inflation; the general increase in prices over time. In May, US inflation reached 5% for the first time since 2008. Core inflation saw its sharpest increase in 30 years.[4]

Inflation is back; is it temporary or here to stay? And how will it affect your portfolio?

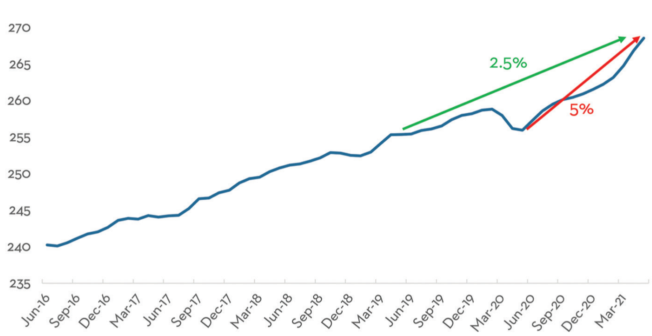
INFLATION: TRANSITORY OR PERMANENT?

Inflation is a part of a healthy economy. Inflation is better than deflation; however, too much can be disruptive. The latest inflation reading at an annualized 5%[5] has raised concerns, but fears of runaway, long-lasting inflation seem overblown for several reasons.

Distorted Numbers

The first reason is we're comparing prices today to prices in the worst of the pandemic. The chart below shows the annualized change in the Consumer Price Index since 2016. Prices increased by 5% from May 2020 to May 2021 (red line); however, the 2-year trend from May 2019 to May 2021 is an annualized 2.5% (green line).

Consumer Price Index for All Urban Consumers



Before the pandemic, inflation was running just below 2%. We are seeing higher inflation; however, it's not as high as the 5% headline would suggest.

Supply/Demand Shock

Demand for both goods and services has surged in 2021 as the economy has reopened. Meanwhile, supply has been constrained by fewer workers. A lack of childcare and hesitancy to get the vaccine have made it difficult for many to work; government stimulus checks and increased unemployment benefits have also contributed to labor shortages.

Demand is as high (or higher) today than before the pandemic; meanwhile, supply has been slower to recover. **When there is an imbalance in supply/demand, prices tend to increase.** As people rejoin the workforce, supply disruptions will likely fade and we should find the US economy closer to equilibrium. Prices may jump temporarily, but we wouldn't expect that to be sustained beyond 12-18 months.

The biggest risk to rising inflation would be a permanent decline in the workforce without an offsetting decline in demand. If that continues, businesses will have to raise wages to attract workers. Higher wages could force some businesses to raise prices and those prices are likely to stick. However, we would not expect price increases to start a new trajectory. Wages and prices will more likely see a large one-time jump followed by lower increases going forward.

Technology

If a pandemic had shut down DCM's operations back in 1990, we -- and many other businesses -- would have experienced crippling disruptions. Today, we can do virtually everything we need from anywhere.

Over the next 25 years, new technologies will help businesses serve customers faster with fewer resources. Tasks that take 10 hours to do today might take 1 hour in the future; they may even be completely automated. **Technology has been a huge deflationary force over the last few decades and will continue to be.**

Monetary Policy

Finally, inflation is likely to be kept under control by monetary policy. The Fed has stated they will focus on achieving inflation that will average 2% over time. While they can't control inflation, they can take steps to slow it. Raising the short-term interest rate would slow economic activity and reduce pricing pressures.

While we don't expect runaway inflation, we do expect to see more inflation in the next decade than we saw in the last.

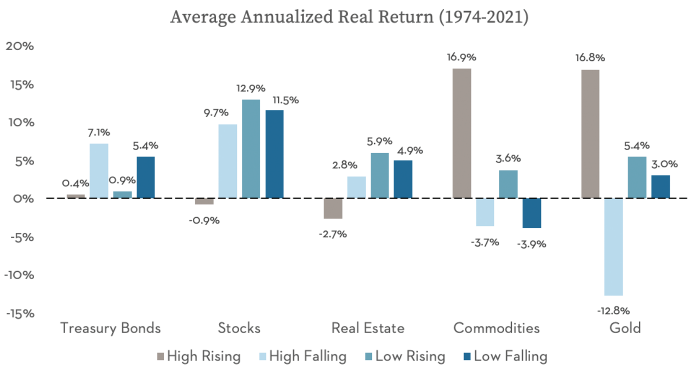
WHICH ASSETS PERFORM BEST IN INFLATIONARY ENVIRONMENTS?

How do stocks, bonds, real estate, gold, and commodities do when inflation goes up? We studied four types of inflationary environments from 1974 to 2021:

#1: Low inflation (under 3%) & falling
#2: Low inflation (under 3%) & rising
#3: High inflation (over 3%) & falling
#4: High inflation (over 3%) & rising

As the chart on the following page shows, stocks have historically produced the highest returns in 3 out of the 4 environments. **They also outperformed inflation with more regularity.** [6]

[1] "Used Car Prices Saw Their Biggest Monthly Increase." Business Insider (2021). [2] "Food Prices Are Soaring Faster Than Inflation and Incomes." Bloomberg (2021). [3] Source: US House Price Index YoY, YCharts [4] US Inflation Rate & US Core Inflation Rate, YCharts. [5] Source: US Bureau of Labor Statistics, May 2021. [6] Source: DCM Research. Stocks beat inflation between 78% and 89% of the time in environments #1 through #3. Gold & commodities managed to beat inflation between 22% and 56% of the time.



When inflation was over 3% and rising, however, both stocks and real estate produced negative real returns. Gold commodities each returned 17% per year in these inflationary periods.[7] While it is possible we could enter this environment, we don't expect it. Over the next 5+ years, we expect the trend of inflation will remain under 3%.

SHOULD YOU HEDGE FOR INFLATION?

If gold & commodities tend to perform best in rising interest rate environments, should you consider them for your investment portfolio? We have never recommended owning gold or commodities directly. (We have owned companies that sell them.) Here are three reasons why we don't like inflation hedges as long-term investments:

#1: No Cash Flows

Legendary investor Philip Caret's book, The Art of Speculation (1930), teaches us that not everyone who buys a stock is an investor. Most, in fact, are what we might call 'speculators' or 'gamblers'.

What's the difference? Caret says, "The man who bought United States Steel at 60 in 1915 in anticipation of selling at a profit is a speculator. On the other hand, the gentleman who bought American Telephone at 95 in 1921 to enjoy a dividend return of better than 8% is an investor."

A speculator buys with the intent to sell; she cares nothing for the value of the underlying asset itself. Her only way to profit is if someone else is willing to pay her more in the future than she pays today. The real investor, on the other hand, does not depend on the actions of other investors. She buys based on **the ability of the underlying asset to generate cash flow.**

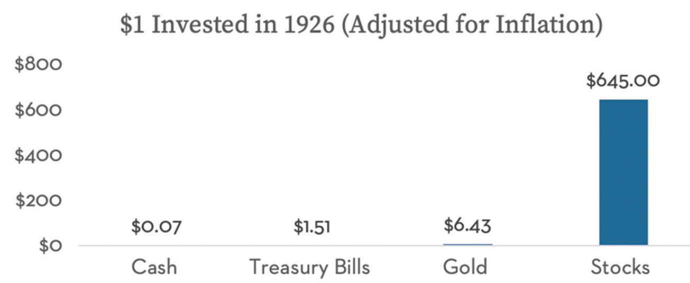
Your decision to buy gold & commodities cannot be based on anything other than price because there is nothing else to it. You cannot grow crops on a bar of gold. It doesn't create innovative products. Gold does not currently generate cash flows, nor does it have the potential to. The only way to profit from gold is if someone else pays you more for it in the future.

Companies, on the other hand, generate cash flows for their owners. These profits can be paid out to owners as a dividend or reinvested to increase future cash flows. **All businesses, even non-dividend payers, can generate value apart from the market price.[8]** So can bonds, real estate, and any other cash-generating asset.

#2: Long-Term Results

Gold & commodities are a great short-term hedge against inflation, but the long-term performance is unimpressive. From 1973–2019, gold & commodities returned 5.6% and 7.0%, respectively. Only short-term US Treasury bills performed worse.[9]

Things get even more lopsided if we go back even further. The chart below shows how a $1 investment in five different asset classes would have grown from 1926 through 2019:



Over the last 94 years, stocks outperformed gold 100 to 1.[10] There were short-term periods when gold did better than stocks; however, the historical evidence suggests these are likely to be short-term. In our view: **If you're concerned about inflation over the next 12 months, own gold & commodities; If you're concerned about inflation over the next 12+ years, own stocks.**

#3: Predicting Inflation Is Difficult

If anyone could predict inflation, it would be the US Federal Reserve. "The Fed" has infinite resources and massive economic data. They even have the power to influence inflation with their own policies. The Fed's 1968-2012 inflation forecasts had a typical error of 3.4% compared with inflation at 4.4% over that time period.[11]

It's not that the Fed or other inflation forecasters aren't smart; they are. It's just that **predicting the collective actions of 300 million people is difficult to do**. Unlike chemists, economists don't have controlled labs to run experiments in; they can't hold A and B constant while they change C to see how that impacts inflation.

Economic theory says that more stimulus should cause inflation, but actual experience is less clear. Many had expected inflation in the US after trillions in stimulus during the Great Financial Crisis in 2008 and multiple rounds since. So far, we've not seen it.

Japan's stimulus has been even more substantial than ours. Their debt-to-GDP currently exceeds 230%.[12] Economics books will tell you that's a recipe for disastrous inflation, yet Japan's inflation rate is -0.02% and hasn't exceeded 1% since 2013.[13]

Even if you could forecast inflation accurately, you could only profit from inflation hedges if you forecast better than others. If everyone knew inflation will be 10% in 2022, the price of inflation hedged assets would increase to reflect this new information. **You can only profit if your inflation forecast is both accurate and different from the consensus.**

Traditional inflation-hedging assets have had weak long-term returns. **We prefer to focus on the best asset for long-term inflation protection: stocks.**

[7] DCM Research [8] To be clear, not all of them create value or will; they have the potential to. [9] "The Complex Relationship Between Inflation and Asset Prices" Cambridge Associates. [10] "Time in the Market -- Long Term Returns from Stocks, Bonds, T-bills, and Gold." Investors Friend. [11] https://www.stlouisfed.org/on-the-economy/2019/october/comparing-fed-forecasts-private-sector [12] Source: Statista [13] Source: Statista

WHAT TYPES OF STOCKS?

Over the last few months, we have tilted client portfolios towards companies that historically tend to do better than others when inflation rises. Those tend to be:

Companies with Income Tied to Interest Rates

If inflation picks up, interest rates will likely move higher. That benefits companies that earn interest income. Banks are the most obvious example. They have the most interest income of any sector, so they tend to have the highest positive correlation to interest rates and, by extension, inflation.

Other financial companies also earn interest. For example, Paychex (PAYX) holds cash for its clients between paychecks. They earn interest on this money; if interest rates rise, so will their profits.

Commodity Companies

While we don't invest in commodities directly, we do often invest in companies that sell commodities. And since those commodity prices tend to increase with inflation, companies who sell them will benefit as well.

This is particularly true for companies who have made large investments in the past that require little ongoing expenses. If Exxon Mobil spent $10 million digging a new oil well back in 2003, they no longer spend much money on that well today. If inflation pushes oil from $70 to $100, Exxon's revenues will increase while their expenses are close to fixed. We anticipate the majority of that additional revenue will flow straight to the bottom line.

This is why Energy tends to be one of the best performing sectors in high inflationary environments. Energy stocks have outperformed the S&P 500 by a median of 14% per year during inflationary environments since 1972[14]

'Value' Stocks

"A bird in the hand is worth two in the bush." -Aesop

Finance 101 tells us that money gets less valuable over time. You would rather have $1 today than $1 in 10 years. And you would rather own a business that profits $1 million next year than one that profits $1 million in 20 years.

We can calculate the trade-off between money today and money tomorrow with interest rates. If you could invest at 2% per year, then you would be fine to have either $1 today or $1.22 in a decade. If interest rates go up to 12% per year, you need $3.11 to give up the $1 today.

Some companies in the S&P 500 have little or no earnings; the only value they have is based on the earnings they are expected to have in the future.

For example, Tesla made $721 million in 2020. If that's all they made every year going forward, their company would be worth $34 billion.[15] Right now, the market values Tesla at just over $600 billion. **94% of the value of Tesla depends on earnings the market thinks are coming over 5, 10, 20+ years from now.**

If interest rates were to increase by just 2%, Tesla's future earnings would be worth 38% less.[16] **The further off earnings are for a company, the more they will be hurt by rising interest rates.** All else being equal, companies with earnings today will do better than those with earnings in the future if inflation and interest rates rise.

Dominant Companies

Companies that dominate their niche or have 'special' products can charge higher prices than their competitors and, in general, earn more money with the same resources. These businesses do relatively well in most environments, but especially when inflation increases.

To illustrate, imagine you are the sole owner of two companies:

> Company A generates $25 in profits for every $100 invested in the business.
>
> Company B generates $6 for every $100 invested.

Let's say both companies have the opportunity to build a new factory for $1 million each. Would you build the factories? That depends; what other investment options do you have? Let's say your only other option is to invest in a risk-free account generating 2% per year.

In that case, you would build both factories. Company A's new factory would generate $250,000 compared with $60,000 for Company B. Both would be superior to earning $20,000 in your risk-free savings account.

What happens if your risk-free option goes to 7% instead of 2%? Now you would build the factory for Company A since it would still produce more income than the risk-free rate. However, you would not build a factory for Company B. You would prefer to invest that $1 million in a risk-free account at 7% than build the factory earning 6%.

In our example above, Company A is Apple (AAPL)[17] and Company B is Ford (F).[18] If inflation rises and interest rates go from 2% to 7%, Ford would be in quite the predicament. Their business would no longer be generating more than investors could get on a risk-free Treasury bond. **Shareholders would be better off if Ford sold their assets and invested the proceeds in US Treasury bonds.** That is the destructive power of higher interest rates on weak businesses.

If inflation and interest rates rise dramatically, Ford would not be the only company in this predicament. At present, there are 187 companies in the S&P 500 that have returns on capital lower than 7%.[19] If rates were to rise above that level, these companies would no longer have a reason to exist. Why put money to work earning less than you could make in a risk-free asset?

When interest rates are 2%, both companies can survive. **In high interest rate environments, dominant companies still create value for their shareholders; average companies do not.** If inflation remains under 3%, as we expect, friendly conditions are likely to remain for stocks.

[14] Source: Ned Davis Research [15] If we assume $721 million discounted at a perpetual rate of 2.1%, which is the current 30-year US Treasury yield. [16] Tesla's $600 billion market cap implies $721 million growing at around 21% annually for 30 years. If we discount that back at 4.11% instead of 2.11% (30-year US Treasury yield), the present value of those cash flows would be $373 billion. [17] Apple's 5-year average earnings divided by its invested capital is 25%. Source: Morningstar. [18] Ford's 5-year average earnings divided by its invested capital is 5.9%. Source: Morningstar. [19] Using trailing 12-month earnings divided by invested capital. Source: DCM Research. Data from S&P Global's ClariFi.

DCM Welcomes New Team Members

Because our clients continue to refer people they care about, DCM continues to grow. We take the responsibility of referrals seriously. That means we must always have the right people to maintain the quality of service that makes DCM who we are. We work hard to keep top-of-mind that skills and procedures can be learned during our hiring process. Values and attitude cannot. We aspire always to hire bright and capable people like the new DCM team members below, ensuring that we meet DCM Founder Greg Donaldson's test of having "good heads and great hearts."

HOPE MILLS, CLIENT SERVICES ASSOCIATE

Before joining DCM, Hope graduated from the University of Evansville with a degree in Business and Marketing. She has a background in event planning and fundraising for non-profits in the Evansville community. Keeping in the spirit of community involvement, Hope is a member of the Junior League of Evansville. In her free time, she enjoys baking and traveling to new cities with friends.

DEREK RIDDLE, CRPC®, ASSOCIATE INVESTMENT ADVISOR

An Evansville native, Derek spent his time after college in Phoenix, Arizona, on Charles Schwab's High-Net-Worth Active Trader team, where he provided client education such as how to read charts, actively trade using technical analysis, and evaluate different options strategies. Derek was most recently an experienced Financial Consultant and a successful Branch Manager with TD Ameritrade, where he earned his Chartered Retirement Planning Counselor® (CRPC®) designation in 2018. Derek and his wife Christine enjoy college basketball and have two Siberian Huskies that keep them active.

COLBY DECKER, TRADING SPECIALIST

Colby brings eight years of experience from the insurance industry, where he worked as an Underwriter and an IT Business Analyst. He was an integral team member of a multi-million-dollar overhaul of his previous employer's website and platform. Colby decided to return to school and obtained his Bachelor of Science in Business - Information Technology Management. Colby lives on the East side of Evansville with his wife Jennifer and their menagerie of pets.

MATTHEW WRIGHT, CPA, SENIOR FINANCIAL ANALYST

Matt holds his Bachelor's degree in Accounting and his MBA from Ball State University. After college, he earned his Certified Public Accountant (CPA) designation while working for Somerset CPAs in Indianapolis, Indiana. Matt's work experience includes serving as Financial Analyst for the global pharmaceutical company AstraZeneca and Assistant Director of Business Affairs for Evansville Vanderburgh School Corporation. Matt enjoys playing games, hiking, and camping with his wife Kelsey and two sons, Coen and Fletcher.

Welcome to the "Gap"

If you have retired and are not yet 65, you may be in the gap between employer health insurance and Medicare. Here comes The American Rescue Plan Act (ARP). If you are currently enrolled in coverage through the Affordable Care Act Marketplace, you should see a reduction in your premiums. Before the ARP, your income may have excluded you from the Marketplace or made it too expensive. Look again. If you would like help walking through the eligibility explanations, contact your DCM Advisor. To get covered in 2021, visit HealthCare.gov or call 1-800-318-2596.

Sources: https://www.HealthCare.gov

DCM's Rising Dividend Cornerstone Receives a 5-Star Overall Morningstar Rating

Donaldson Rising Dividend Cornerstone

DCM's Cornerstone investment strategy recently received a 5-Star Overall Morningstar Rating, signifying that Cornerstone performed in the top 10% overall of its peer group in past performance return. In addition, Cornerstone also received a Silver Morningstar Quantitative Rating, a forward-looking rating.

About the Strategy

DCM's Cornerstone investment strategy is made up of 100% dividend-paying stocks, positioned for clients seeking growth of both income and capital while seeking to limit risk and volatility to less than that of the stock market.

Overall Morningstar Rating™ out of 582 funds in the Large Value Morningstar category as of 3/31/2021

The Morningstar Rating™ for funds, or "star rating," is calculated for separate accounts with at least a three-year history. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The Morningstar Rating does not include any adjustment for sales loads. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods.

Fees for separate accounts can vary widely and are negotiated between the asset manager, the separate account program sponsor or advisor, and the investor. Morningstar has chosen to present gross-of-fees performance (before fees have been taken out) to compare separate accounts. Net-of-fees calculations often deduct the highest theoretical fees that an investor may pay. Morningstar will not calculate ratings for categories or time periods that contain fewer than five separate accounts. Each investor in the same separate account can experience slightly different total returns, because investors have different account preferences and restrictions. Therefore, to ensure that ratings are fairly assigned, Morningstar will calculate ratings for only those firms that report performance for "composites" of similarly managed portfolios according to the guidelines of the CFA Institute's Global Investment Performance Standards (GIPS®).

Separate accounts that do not have ratings can be divided into two groups: those that do not qualify to be rated and those that did not participate. A separate account will not get a Morningstar Rating if: It is less than three years old, the firm is not GIPS-compliant, or the category contains fewer than five separate accounts that are eligible for a rating.

Donaldson
CAPITAL MANAGEMENT

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