Donaldson CAPITAL MANAGEMENT

SUMMER 2022

RISINGDIVIDEND
REPORT

Highlights from the **Investment Policy Committee**

1 If you're hiking in bear territory, you need to protect yourself against bear attacks. If you're investing in stocks, you need to do the same.

2 Investors face three types of bears: the valuation bear, the black swan bear, and the recession bear. Which are we in?

3 A recession between now and summer 2023 is more likely than not; that's a good thing if it breaks inflation.

4 Running away from real bears is a bad idea. Selling stocks in a bear market may be as bad; missing out on the market's 30 best days eliminated all of investors' gains over the last 20 years.

5 The most important things you can do to survive a bear market are (1) own great businesses that will survive, even thrive, during a recession, (2) revisit your financial plan (or create one if you haven't) and (3) lean on your guide to help get you through.

Read the IPC Letter on page 3

It's Summer, But We Have the Chills

WHAT GIVES YOU THE CHILLS? I'm talking about that all-consuming feeling that raises the hair on your arms when you know something special just happened. For me, it's the moment it clicks for my client: she can confidently retire without worrying about money.

But Blake, you say, how could I possibly have peace of mind about retirement right now? The stock market just fell 20%, there is global conflict, high energy costs, record-high inflation, rising interest rates, and a midterm election, to name a few. I can't imagine letting go of my paycheck in this uncertainty. Plus, what would I do with my time? My colleagues are my friends and I'm fulfilled by my accomplishments at work. But I do wish I had more time with my grandkids, and my spouse often has to travel without me.

To be perfectly honest, there are countless reasons that make it difficult to decide to retire in times of prosperity and peace; there are even more in times of economic stress and uncertainty. In either case, most fears are financial. A meaningful part of my job is helping clients name each of those fears, and then build a financial plan that shows they can successfully handle the scenarios that are keeping them up at night.

Donaldson has been an investment manager for over 25 years. With our comprehensive financial planning experience, we seek to help you understand how much income you may need to support your lifestyle. DCM's Certified Financial Planners® build scenarios to answer many "what-if" questions that may be holding you back from making that final decision.

If you have fears that are stopping you from considering retirement seriously, give us a call. We'd love to help you make a plan that addresses them head-on and sets you up for your next chapter with peace of mind.

We never get tired of getting the chills around here.

Blake Alsman CFP®
Senior Investment Advisor

All the best,

Blake Alsman

Look for the Dividends

The day-to-day swings in the market can make an investor's head spin and often amount to little more than noise. That is why we take a long-term approach. Our priorities in our Cornerstone investment strategy are Security, Income, and Growth. We hold companies that sell goods and services the world cannot live without, share their profits with investors via dividends, and increase the dividends they pay each year. This focus allows us to tune out the noise and zero in on great businesses.

The dividend growth rate is one of our key measuring sticks when assessing the health of a business. We want to own companies that consistently and sustainably increase the cash they distribute to shareholders. As the dividend increases, so too should the value of the business. Though not always in lockstep, dividends and price tend to move together over time. For example, the stocks that currently make up the Cornerstone portfolio have increased their dividends by an average of 11.6% a year over the last 5 years. Over the same time frame, the prices of these stocks have increased by an average of 13.6% a year. Considering the ups and downs of the last 5 years, this is quite remarkable.

Because of this relationship, we look to the dividend in times of stress. If a company is increasing its dividend, it signals management's confidence in the prospects of the business. Regardless of what is going on in the world or what price a stock might be trading at on a particular day, a dividend increase represents real growth in the value of a business.

So far in 2022, 19 of our Cornerstone companies have announced dividend hikes with an average increase of 9.6%. These companies are growing their fundamental values and we believe the stock prices will catch up in time.

How Much Cash Is Right for You?

Virtually all assets, from stocks to bonds to real estate, are down in 2022. The mantra "cash is king" certainly holds this year. (So far, at least.) Cash can be great for providing liquidity while you wait for stocks and, in some cases, bonds to recover. However, cash is best reserved for short-term needs and emergency funds. It's not a great holding for the long-term, particularly after adjusting for inflation.

How much cash is right for you depends on your situation, and the answer can range from 3 to 12 months' worth of spending cash. Less than that and you risk having to sell stocks or bonds in an emergency; more than that and you erode purchasing power over the long-term and waste the opportunity to earn more in other assets.

Talk to your Investment Advisor if you would be interested in exploring your cash balance further. Our financial planning team can help you optimize the amount of cash you should hold for your particular needs. And our investment team can help you explore some ways to earn more money while preserving your capital to the greatest extent possible.

Surviving a Bear Attack

If you ever hike in bear territory, you must know how to protect yourself. Experts offer these tips:

1. **Identify the bear.** How you approach a bear attack depends on what kind of bear it is.
2. **Don't run.** Bears are much faster than you. If you run, they will think you are prey. Stay put.
3. **Fight back.** If a black bear attacks you, use anything you can find as a weapon: rocks, sticks, fists. If you put up a fight, the bear may give up.

The above advice may help save your life in a real bear attack; it's also appropriate for investors.

In June, the S&P 500 fell into a bear market,[1] the 28th since 1928 and the first since 2020. So, how do we survive this bear market?

Step #1: Identify the Bear

You make most of your money in a bear market, you just don't realize it at the time. -Shelby Cullom Davis, retired money manager and philanthropist

DCM has fought through all of the different types of bear markets since its founding in 1994. Let's take a look at each type and the unique challenges each present.

The Black Swan Bear Market

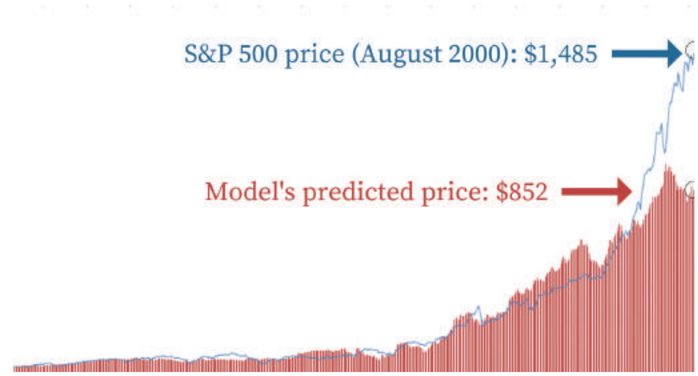
In 1987, there was no recession in sight; then–in a matter of two days–the Dow Jones dropped by over 25%.

2020 was another black swan event. The S&P 500 dropped by over 33% in 24 trading days—the sharpest decline in US stock market history. It was over as fast as it began; the Index went on to post an 18.4% gain for the year.[2]

Black Swan Bear Markets are virtually impossible to prepare for and incredibly difficult to defend against. In 2020, for example, speculative growth stocks did better than many blue-chip dividend-paying stocks.

The Valuation Bear Market

In the graph below, DCM's Dividend Valuation Model (DVM) shows how tech stock enthusiasm in the dot-com bubble of the late 1990s drove the market well above its intrinsic value.

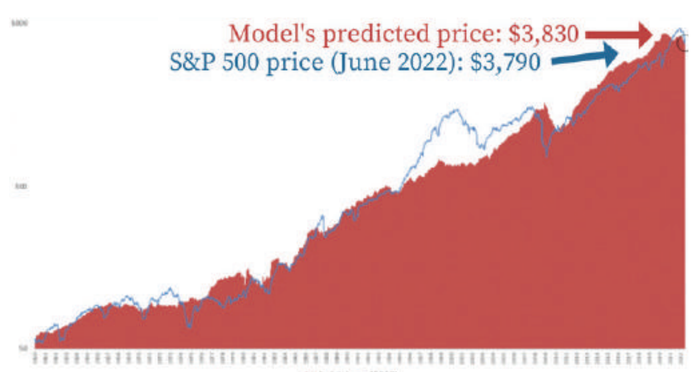


In August 2000, our DVM model predicted the S&P 500 was 42% overvalued. Eighteen months later, when the Valuation Bear finished its attack, the Index had declined 43%.

Could we be in a Valuation Bear right now?

Partly, yes, but not like 2000. Interest rates have been incredibly low for the last decade, which means above-average valuations have been justified. However, as interest rates have risen significantly in 2022, the price-to-earnings (P/E) multiple investors are willing to pay has fallen—as it should.

Based on our DVM model, the S&P 500 is worth 16% less after the 10-year US Treasury rose from 0.6% in mid-2020 to 3.2% today. If interest rates remain where they are, stocks appear to be about fairly valued. Below is our DVM model updated for June 2022:



While the sharp rise in interest rates has negatively impacted valuations over the last year, the real long-term Investment Advisor value driver in our DVM model is changes in dividends. Using 2022 and 2023 dividend estimates, the DVM model projects the S&P 500 will reach 4,030 by year-end and 4,440 by year-end 2023. If those targets are hit, returns would be approximately 8% and 20%, respectively.

Whether those projections ultimately come to fruition depends on the path of economic growth, which brings us to our next bear.

[1] A "bear market" is technically any top-to-bottom decline of 20% or more.
[2] Source: S&P Global, S&P 500 Total Return, 2020.

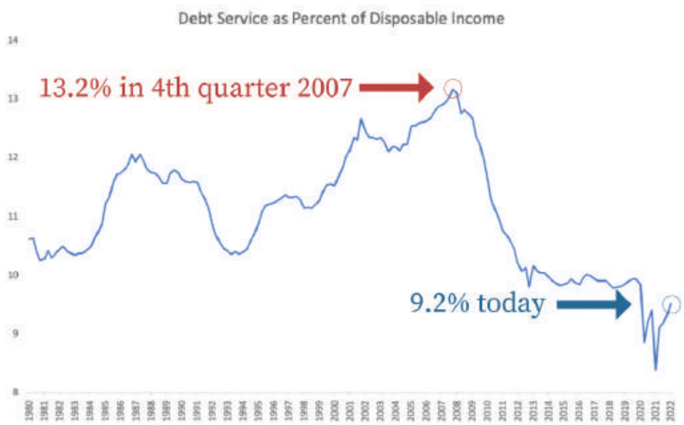
The Recession Bear Market

Most bear markets happen because of recessions.[3]

Our Macroeconomic Model estimates the odds of a US recession in the coming year at slightly above 50%. The model suggests that should a recession occur, it is likely to be mild.

Heading into the Financial Crisis of 2008-09, Americans were heavily indebted. The average US household paid 13.2% of their disposable income in debt service.[4] Millions owed more on their homes than they were worth, leading to an increase in mortgage defaults. Massive defaults hit banks hard, forcing them to seek government assistance to avoid bankruptcy.

Regulations and the strong economy since 2008 have led to banks being in far better financial shape.[5] And American households are in much stronger financial condition as well. Consumers have $2 trillion in excess savings and are fortified by a robust employment market: there are nearly two job openings for every unemployed person.[6] The average US household debt service is now 9.2%–less than any year between 1980 and 2019.



The magnitude of any potential recession will grow until inflation moderates. That is why the Fed is so determined to bring inflation down, even if it causes a mild recession in the near term. The Fed's inflation-fighting attitude is the right stance to take.

Breaking Inflation

Supply and demand determine the price of everything. Inflation is too many dollars chasing too few goods. Inflation will decline only when either the supply of goods increases or the demand for them decreases or some combination of both.

Consider gas prices, which are driven by the price of oil. An increase in oil supply would lower prices, but that would require either (1) a resolution to the Russia-Ukraine conflict or (2) an increase in output from US producers. Since neither of those actions is likely, the only way to reduce gas prices will be to decrease demand.

This is why the Fed is raising rates; they want to slow the economy and lower overall demand to break the back of inflation. Once inflation pressures decrease, the Fed can lift its foot off the brakes.

Step #2: Don't Run

As an investor staring down a bear market, your first instinct is to run. It's natural to be afraid, but don't let your emotions drive decisions.

Though tempting, trying to time the market is a loser's game. $100,000 invested at the beginning of 2007 grew to over $450,000 by year-end 2021. **If you missed just 30 of the best days, you would have had a negative return over that period**.[7]

Step #3: Fight Back

As frightening as bear markets can be in the near term, history tells us they eventually go away. Some stay longer than others, but they do leave. Until then, we have to fight back. Here's how:

Many of the market's best days occur when things look their worst. Half of the S&P 500's biggest single-day gains have happened *during a bear market*.[8]

The turn at market bottoms is often so powerful that it wipes out huge losses in a matter of days or weeks. If you want to participate in the markets' recovery, history is clear: stay invested.

Buy Dominant Companies

If you own the most dominant company in an industry, stressful economic times can be a *good thing*. The weaknesses of your competitors are exposed when the economy slows and many will not survive. Larger and stronger companies, on the other hand, can keep innovating and building market share even in tough times. In addition, the financially strong companies can acquire those weakened by the recession—at bargain prices.

Great companies are constantly adapting to their environment. If the world changes, they don't sit around waiting for it to change back in their favor. They have the resources to thrive in whatever new world they see coming.

Stocks are not just ticker symbols; they are real businesses making real products. Every day, thousands of their employees wake up trying to compete and innovate, regardless of economic conditions.

Watch Dividends

If you want to sleep peacefully during a bear market—here's how you do it: **Instead of checking the market value of your portfolio every 90 minutes, start checking your dividends every 90 days**.

Stocks may be down over 20% this year, but dividends are up. Since the start of the year, 19 Cornerstone companies increased dividends by an average of 9.6%.[9]

In the near term, stocks and prices can move in different directions; however, they have moved together in the long run. Follow dividends. We expect that you will achieve better results than if you constantly chase prices—you'll also sleep better at night.

Own Financially Strong Businesses

High-quality businesses with strong balance sheets tend to hold up better than others in recessions.

One way to find strong businesses is to look at their dividend history. There are close to 6,000 businesses on the US stock market. A mere 65 of them have grown their dividends for 25 consecutive years or more.

Think of everything that has happened since 1997. We had the dot com bubble burst in 2000, September 11th, numerous wars, Republican-controlled governments, Democrat-controlled governments, housing bubbles, financial crises, global pandemics, inflation, deflation, and countless other events. **Yet, these businesses continued to pay *and* increase their dividends every single year**.

These businesses are essential to our way of life and it shows in their dividend history.

Another way to find a strong business is to analyze its balance sheet. Companies with high debt relative to their earnings tend to suffer in bear markets; debt payments don't decline as quickly as profits in a recession.

One metric we like to use here at DCM is ValueLine's Safety ratings. ValueLine has been providing quantitative research for decades. They classify each stock in their universe between 1 (safest) and 5 (most risky). Below is the performance of the stocks in each Safety rating in down markets since 1966.

In down markets since 1966, stocks with ValueLine's Safety rank of 1 declined by less than half as much as lower-quality stocks scored as 4's and 5's.[10]

Position Defensively

Over the last 18 months, we've been positioning portfolios more defensively. As we mentioned in last quarter's letter:

*"Since early 2021, we've been positioning DCM portfolios towards what we call "D-E-E-P" businesses: **domestic**, **essential**, **energy-immune** with **pricing power**. Not every company can fulfill all four, but companies with at least some of these characteristics should hold up well in this slow growth, inflationary environment." -DCM's Spring 2022 investment commentary*

We continue to believe this is the right strategy as we move into year-end 2022. However, we are beginning to see some bargains start to show in sectors that have been hit hardest this year. Our investment team is actively looking for great businesses with bright futures, but whose stock prices reflect some temporary hard times.

Revisit Your Financial Plan

The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioral discipline that are likely to get you where you want to go. -Benjamin Graham, Warren Buffett's graduate finance professor

If you're worried about how a prolonged bear market could impact your financial picture, set up a meeting with your advisor to develop or update your financial plan.

Comprehensive financial planning is available for you and all DCM clients; take advantage of it. It can help you feel confident that, even if this bear goes on longer or deeper than we think, you're still on track to reach your financial goals.

Blessings,
Joe Zabratanski, Kyle Markle, & Nathan Winklepleck

[3] Defined as two consecutive quarters of GDP declines. [4] Source: JPMorganChase. [5] Tier 1 capital as a percentage of risk-weighted assets is now 15.1% compared with 11.4% in 2009. Source: FRED. [6] Source: Fidelity, https://www.fidelity.com/viewpoints/market-and-economic-insights/quarterly-market-update. [7] "Missing the best days crushes investor returns." Winthrop Wealth, July 2021. [8] "10 Things You Should Know About Bear Markets." Hartford Funds, 2021. [9] DCM's calculations. Using the Cornerstone model portfolio as of June 27, 2022. [10] Source: ValueLine.

Did You Know?

As a DCM client, you get comprehensive financial planning such as Social Security strategies and tax planning. Ask your DCM Advisor if you can benefit from a financial plan.

The Risk of Playing It Safe

It seems like the simplest, most straightforward, common-sense thing to do:

1. Sell your stocks when you expect the market to drop.
2. Wait in cash until it's safe to get back in.
3. Reinvest at lower prices than before the fall.

Don't give in to the siren call of market timing. It can often result in selling low and buying high – the opposite of your intent.

It's simple, right? When the market looks too risky, sell. Your timing may not be perfect, but at least you're out. No more sweating the market. Still, you're probably down 10%, 15%, or more.

Now, you're committed to the next decision – the really hard one. If you sold near the market's bottom, and a surprising number of people do, you've already lost.

If the market continues falling, at least you have a chance. But, psychology works against you. A continuing fall confirms you're a good judge of risk, right? Your confidence rises, along with your comfort in sitting out.

However, markets can fool you. During the 2008-2009 bear market, the S&P 500 Index fell 57% over 188 trading days. During that time, there were 5 so-called "bear market rallies." The market rose significantly, once by 24%! Each rally was a false hope. The market soon resumed its plunge.

Remember how well you judged risk? You won't take the bait. You'll wait until the bear market is stone cold dead.

Unfortunately, the end of the market's fall can only be confirmed months later. And, the bull market recovery is erratic. During the bull market following the March 6, 2009, bottom, prices fell 5% multiple times, 8% twice, 16% once, and finally almost 20%!

Fear of loss took you out of the market, so you're cautious as you wait for proof it's safe. Each drop confirms your suspicions. After all, at the beginning of that bear market, prices fell nearly 20% in just 5 trading days. Trends can reverse quickly, and you don't want to get back in prematurely.

Markets bottom in the middle of recessions, not at the end. And, the market anticipates recoveries before they start. But most investors going to cash won't join possibly false rallies until the economy is clearly recovering.

However, some of the biggest gains happen early in bull markets when it's still scary. In March 2009, the market rose 23% in just a week. The recession didn't end until 3 months later.

Missing just the 10 best days during a 20-year period (1 of every 400 trading days) can reduce your average return by 40%. Those days have often happened when the economy is still bleak. The fear that took you out keeps you from getting back in precisely when you should.

It's nearly impossible for even the best investors to overcome a 40% deficit.

We believe it's better to stay invested in strong companies that have survived, even thrived, during many dark days. Only then can you benefit from those big days that come without warning.

Because you can't catch them from behind.

Company Spotlight: Merck

At DCM, we often say we invest in companies that the world could not live without. Nowhere does this ring truer than in the pharmaceutical industry. Merck is one of our favorite names in the pharma space. It manufactures drugs and therapeutics in cancer and diabetes that are quite literally life-saving. Talk about essential!

Merck is primarily a leader in immuno-oncology. Its blockbuster drug, Keytruda, has first-mover advantage in non-small cell lung cancer, which is one of the largest cancer indications. The company has built significant patent protections around the drug and continuously seeks approval for new indications. We expect Keytruda will continue to be a strong driver of the company's cash flow.

In addition, the company is also a leader in diabetes treatments and a handful of vaccine regimens. Its diabetes drugs and vaccines serve as excellent complements and are growing quickly in their own right. The HPV vaccine Gardasil has picked up steam in international markets and is also a measurable driver of the company's overall growth.

The cash flows generated by the current lineup of drugs should allow Merck to invest in its pipeline development. With ample funds to contribute to acquisitions and internal research and development, the next blockbuster therapeutics or life-changing drug could be just around the corner.

The pharmaceutical sector also stands out in times of economic stress. When disposable incomes fall, expenditures on discretionary items are the first to go. Health care spending sits much higher on the priority list by comparison. Companies like Merck are built to weather the storms. This level of security, combined with the long-term growth potential, makes it an excellent fit in our strategy.

Thank You for Joining Us for Our DCM Atlanta's Kentucky Derby Social

Pat Alexandro (right) and friend Charlotte (left)

Barry Arnold and DCM's Sarah Moore

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20 NW First Street, Fifth Floor ▪ Evansville, IN 47708
800-321-7442 ▪ www.dcmol.com