Donaldson CAPITAL MANAGEMENT

SPRING 2023

RISINGDIVIDEND REPORT

Highlights from the Investment Policy Committee

1. Bank failures in March 2023 are unlikely to cause another financial crisis. The largest of these failures, Silicon Valley Bank (SVB), collapsed for two main reasons, neither suggesting broad economic weakness. SVB made a significant bet on long-duration bonds, which lost billions and left them with a negative net worth to begin 2023. Once those financial problems became clear, SVB's depositors – 95% of whom were not covered by FDIC insurance – withdrew $42 billion, prompting the FDIC to take over on March 10.

2. Investors are now living in a new paradigm. Investing in stocks was all that mattered from 2009-2021. Now, it's all about investing in the right stocks. Ultra-loose monetary policy died in 2022; it isn't coming back anytime soon. The investment framework that worked so well since 2009 – buying speculative, high-growth, cash flow negative stocks – isn't likely to work as well going forward.

3. While our core strategy never changes, we make small tweaks based on the environment we see over the next several years. We've developed a six-part framework we call S-T-R-O-N-G. Businesses that should do well in this new environment have a Sustainable Competitive Advantage, Thoughtful Debt, Resilient Cash Flows, Outstanding Management, Necessary Goods & Services, and are priced at a Good Value.

Read the IPC Letter on page 3

Securing Your Retirement

Many Americans struggle to meet their retirement goals. To address this problem, Congress passed the Setting Every Community Up for Retirement Enhancement (SECURE) Act in 2019, designed to enhance retirement savings and planning.

Chad Lange, CFP®
Director of Wealth Solutions

In 2022, the federal government went a step further in confronting the retirement crisis, passing a follow-up to the SECURE Act (cleverly named SECURE Act 2.0) in late December. The act creates new opportunities in retirement planning via delayed Required Minimum Distribution (RMD) ages, higher contribution limits, and increased flexibility among accounts.

A few of the most significant provisions of the SECURE Act 2.0 include:

Increased Ages for RMDs from Retirement Plans

Beginning this year, individuals who turn 72 will have their RMDs delayed until age 73. Additionally, those turning 74 in 2033 or later will have their RMD age delayed until 75.

Increased Catch-Up Contribution Limits for Individuals Ages 60-63

Effective in 2025, individuals enrolled in a 401(k) or 403(b) plan will be able to contribute the greater of $10,000 or 50% more than the 2025 catch-up amount and the greater of $5,000 or 50% more than the 2025 catch-up amount for IRAs. These increased contribution limits will also be indexed for inflation.

529 Account Fund Can Be Rolled Into Roth IRAs

If certain criteria are met, beginning in 2024, funds from a 529 college savings plan can be transferred to a Roth IRA.

There is *a lot* to digest in this legislation. DCM's Financial Planners can guide you through the noise to help you understand how these changes affect your personal situation.

Nothing brings us greater satisfaction than helping our clients navigate the road to and through retirement. If you would like to get started with a custom financial plan, we're ready. Give us a call.

Chad Lange

Estate Planning: A Call To Action

"There is no alternative to advanced planning!"
– Colonel George Goodwin, Former INDOT Executive Director, Purdue Alumnus and donor.

This call to action, epitomized by the Colonel's decisive charitable strategy for his beloved Purdue University, stands out as extraordinary in contrast to many who have yet to document their own estate planning preferences.

To get us on the same page, think about your circumstances:

What do you own?
Who are your heirs?
What impact do you want these assets to have on these heirs?

That is estate planning – ensuring that your assets accomplish in the future what your heart desires efficiently and economically.

The most common estate planning error is doing nothing.

Less than half of Americans have a will. That is a lot of folks who are expecting, or at least hoping, that their life's savings will pass to their preferred heirs. It is true that if you die without a will, then your state's law will intervene, but numerous factors determine who gets what.

So, why take the risk? Let's examine.

The Foundation.

You should have:

Last Will & Testament
Power of Attorney
Health Care Directive

Your **will** should cover several "housekeeping" details, such as paying final expenses (bills, debts, and taxes), who will serve as the executor, and what to do if an heir has predeceased you or is a minor. A well-drafted will not only spells out your preferences, but also anticipates potential circumstances.

If you cannot make business decisions or manage your property, someone you trust should have discretion over your financial affairs. This document also controls under what circumstances the **power of attorney** can act on your behalf.

Health care directives should be in place when medical decisions need to be made on your behalf. You should make these decisions about your health and about your assets. That requires advanced planning.

But Wait, There's More!

Revocable living trusts are your friend. For many, the creation of a revocable trust (as opposed to an irrevocable trust) is a better mousetrap.

With a revocable trust:

No loss of control over your assets
More privacy than a probate estate
More economical
More efficient than just a will; both during and after one's lifetime

Who?

You will need an **attorney**; one with broad estate and tax expertise, an excellent "bedside manner" and a long-term focus on you and your family. Like most things in life, cost is usually associated with value.

Your will needs an **executor**; one with sufficient time, expertise, and objectivity. Serving as the executor for a family member or close friend can be a brutal, thankless job. An estate settlement with no family conflict is rare. My advice: use a professional.

If you create a revocable trust, you can be your own trustee during your life while you have the physical, emotional, and intellectual capacity. However, eventually, a **successor trustee** must step into your shoes.

Your successor trustee will be the quarterback, coordinating the settlement process or the ongoing administration of your assets with your trusted advisors (attorney, CPA, investment advisors, insurance agent, business partners, etc.) and your family.

Estate planning is not a singular event. You should plan to meet with your attorney every 3-5 years or if any significant changes occur with your assets or your family.

The cost of **not planning** can be substantial, both in money and family peace of mind. Plan ahead, be intentional, and make it a priority.

And we are here to help, always just a phone call away.

Remember, "there is no alternative to advanced planning."

Key Terms You Should Know

Last Will & Testament (Will) – legal document which controls the distribution of estate assets following the creator's death.

Intestacy – this means dying without a will.

Estate Assets – everything that you own in your sole name at death.

Probate – the court-supervised process of settling an estate.

Taxable Estate – everything you own for federal estate tax purposes; this includes joint assets, retirement funds, and most insurance policies.

Revocable Trust – a legal document which directs how its assets will be managed and distributed, both during and after the creator's life, even for the benefit of future generations.

Grantor – creator of a will or trust.

Executor/Personal Representative – the manager of an estate.

Trustee / Successor Trustee – the manager of a trust.

Power of Attorney – a legal document which specifies who can sign on your behalf, but only during your life.

The Strong Will Survive

In a scene from the classic movie, "It's a Wonderful Life," a group of anxious customers gathers outside the Bailey Building and Loan Association, demanding to withdraw their money from the bank. The customers fear the bank is going to fail.

George Bailey, the bank manager, explained that their money wasn't in the vault; it had been loaned out to other people in the community for mortgages and other loans.

"You're thinking of this place all wrong," George explains, "As if I had the money back in a safe. The money's not here. Your money's in Joe's house...right next to yours. And in the Kennedy house, and Mrs. Macklin's house, and a hundred others."

The customers insisted on withdrawing their money. George then used his personal savings that were intended for his honeymoon to calm the situation.

"Why, you're lending them the money to build, and then, they're going to pay it back to you as best they can," George appealed. "Now what are you going to do? Foreclose on them?"

The customers slowly grasped the situation and agreed to withdraw only the money they needed, saving the Bailey Building and Loan Association.

There was no George Bailey to save Silicon Valley Bank (SVB).

In a single day, Silicon Valley Bank's depositors withdrew $42 billion, bringing the bank to its knees. On March 10, SVB – the country's 16th largest bank – was taken over by the Federal Deposit Insurance Corporation.

Why did this happen and what does it mean for you?

How Banks Work

When money is deposited at a bank, it invests the money in business and personal loans. If there isn't enough demand for these loans, it can invest in U.S. Treasuries and other investments. A bank profits when its loans and investments earn more in interest than it pays depositors.

Banks maintain a certain percentage of cash to satisfy reserve requirements and for normal customer withdrawals. As long as there is not a massive outflow of deposits, known as a bank run, the system works. Unfortunately for SVB, that is exactly what happened.

But why did depositors take out $42 billion in one day?

Reason #1: SVB's Client Base Was Largely Uninsured

Bank runs were more common in the past than they are today. The main reason for that is FDIC insurance. As previously mentioned, banks use customer deposits to make loans and other investments. If they lose money on investments, as SVB did, the bank may not have enough assets left to pay back all of the depositors.

If a bank can't pay its depositors back, FDIC insurance covers $250,000 per *person* per *account type* per *institution*.

Most banks are made up of millions of individual depositors who have less than $250,000. Banks such as these have little risk because their customers are fully insured and have no reason to fear a bank failure. SVB was different: 95% of their depositors – mostly businesses, private equity funds, and other institutions – had well over $250,000 and, thus, were *not* fully covered by FDIC insurance. Most of SVB's clients *did* have to worry about the bank's solvency, setting the stage for a bank run. SVB's exposure to non-FDIC insured depositors was second highest amongst the top 100 banks.[1]

Reason #2: SVB Made Some Risky Investments

SVB's deposits exploded from 2019 to 2021 as a result of pandemic-related stimulus and massive inflows into tech and biotech start-up companies. In two years, their total deposits ballooned from $61.7 to $189.2 billion – a staggering 206% increase. SVB's management invested a significant amount of these deposits in long-term U.S. Treasury bonds.[2]

How could investing in U.S. Treasuries, a supposedly risk-free investment, do enough damage to take down one of the most important financial institutions in the United States? To understand why those investments were so risky, we first need to explore the concept of duration.

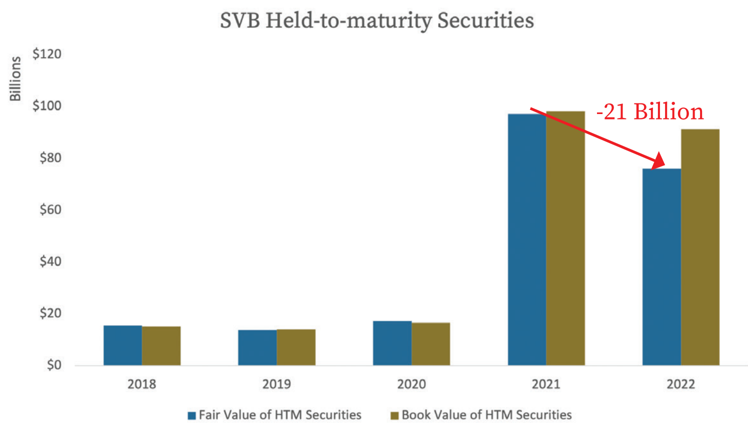
What is "Duration"?

Duration is a measure of how sensitive a bond's price is to a change in interest rates. A bond that matures in two years will have low duration, meaning a low sensitivity to interest rates. A bond that matures in 10 or more years will be much more sensitive to changes in interest rates.

SVB's egregious blunder was investing 95% of their portfolio in bonds with maturities of 10 years and beyond. The weighted average coupon was a paltry 1.61%.[3] The duration for a bond like this would be around 9. In other words, for every 1% increase in 10-year U.S. Treasury yields, the value of SVB's bond portfolio would have fallen by about 9%.

SVB's huge exposure to long-duration U.S. Treasury bonds backfired when 10-year Treasury yields rose from 1.5% to 3.75%. As of year-end 2022, they had $17 billion in losses in these held-to-maturity investments compared with $11.35 in book value.[4]

[1] Another One Bites the Dust: Banking Saga Continues. Schwab Brokerage. Published 2023. Accessed March 24, 2023. https://www.schwab.com/learn/story/another-one-bites-dust-banking-saga-continues [2] Another One Bites the Dust: Banking Saga Continues. Schwab Brokerage. Published 2023. Accessed March 24, 2023. https://www.schwab.com/learn/story/another-one-bites-dust-banking-saga-continues [3] According to SVB's 2021 annual report, they had $98.2 billion in bonds, of which $93.1 billion had a maturity of 10+ years. [4] SVB's Tangible Book Value was $11.35 billion as of 12/31/2022. Data source: Portfolio123.



However, this massive loss was hidden within SVB's financial statements. Since these securities were classified as "held-to-maturity," they only disclosed losses at the point they sold the assets. SVB's financial statements showed the value of these bonds at $91.3 billion when, in reality, the value was only $76.1 billion.

The difference between those two numbers is the difference between a bank failing and not failing. SVB *appeared* to have a positive net worth of $11.3 billion – plenty to cover their depositors with some left over. However, their *actual* net worth was *negative* $3.8 billion. Even if SVB had sold off all their assets, they would not have been able to pay back their depositors.

It was only a matter of time before depositors found out that the emperor had no clothes.

On March 8, SVB disclosed they had taken a $1.8 billion loss to raise cash. At the same time, they announced a plan to raise $2 billion in additional funding. This raised red flags to depositors about how bad SVB's financial condition really was. The stock fell by 60% on Thursday and another 60% on Friday before the FDIC took over.

What does SVB's failure mean for the broader economy, the financial markets, and your portfolio?

Is This a Repeat of 2008?

The financial crisis of 2008-09 happened because of widespread defaults on millions of mortgages that impacted nearly every financial institution. SVB failed for a number of reasons, but largely due to its $93 billion bet on long-duration bonds that backfired massively when interest rates skyrocketed. **However, SVB's failure has little to do with the creditworthiness of its customers.**

Economic underpinnings remain strong, so we are not concerned with widespread loan defaults. Unemployment remains near historic lows, while consumer spending is resilient. If the economy were to stumble, we would expect the Fed to act quicker than they did in 2008, which further reduces risks for a severe recession.

While we don't expect SVB's failure to have widespread economic consequences, we do expect major changes in the banking sector, particularly among regional banks which are likely to see an increase in regulations. We would also expect banks, as a whole, to tighten their lending standards. That will put more downward pressure on economic growth.

A Strong Framework for Stocks

Does SVB's failure impact how we're thinking about specific stocks and sectors? Not necessarily. Our strategy of buying high-quality businesses that we expect will be able to pay and increase their dividends over the long term has remained consistent for decades. **The foundation of that strategy does not change based on last quarter's performance or today's headlines.** We make *tweaks* based on the environment, but the core strategy remains fixed on generating a growing stream of income for you.

SVB's failure is not a cause for any major changes. It is, perhaps more than anything, symbolic of the end of an era. Ultra-relaxed monetary policy died in 2022 and it isn't coming back anytime soon. That means that **some of the investments – buying speculative, high-growth, cash flow negative stocks – that have worked so well over the last decade won't work so well in the next decade.**

While our core strategy that goes back decades remains the same, we do shift our emphasis *within* the universe of excellent, rising dividend companies as major economic conditions change. We've developed a six-part framework to shape our current emphasis. Rising dividend stocks with these characteristics should perform relatively well in an era of tighter bank lending standards, higher inflation, and higher interest rates.

Sustainable Competitive Advantage

If two businesses compete to sell the exact same good or service, the only thing separating them is price. Gas stations are a good example. If one station cuts the gas price by $0.10 per gallon to gain customers, the gas station across the street will quickly match it. Neither can earn particularly high returns on their investment. These are average businesses that can only expect to earn an average profit.

A great business makes a good or service that is unique and difficult for competitors to match. There is a special advantage that allows this great business to earn more money on their investment than others in the same industry.

Costco is an example of a great business. They earn more than 20% on every dollar reinvested into their business to open new stores. What's special about Costco is their unwavering commitment to providing high-quality products at the lowest possible price. (The hot dog combo has been $1.50 since 1987.) Their membership model allows them to make a profit even while selling items nearly at break even.

Customers grow to trust that Costco has the lowest price on everything from tires and vacations to cars and gutter guards. Since they trust Costco to help them save money, 90% of members renew their membership. As Costco gains members, they increase their purchasing power, which allows them to drive prices lower. This creates a positive flywheel that strengthens their competitive advantages each year.

Thoughtful Use of Debt

Debt is a tool that can magnify profits. Unfortunately, the reverse is also true. Having too much debt creates fragility when the business cycle inevitably turns. You can fire employees, but you can't fire debt. We want to own businesses that use debt *strategically*, not because they *need* to.

Despite having a massive cash pile, Apple (AAPL) has issued billions of dollars in bonds at low interest rates. In 2021, for example, they issued a $3 billion bond at a 2.65% (!) interest rate.[5] They don't have to pay this back until 2051.

Did they need the cash? No. But, it was good business to take out long-term debt at ultra-low rates. By taking advantage of the low-interest-rate environment, Apple has funded share buybacks, dividend payments, and acquisitions while preserving its overseas cash reserves and minimizing repatriation taxes.

Resilient Cash Flow

When interest rates were at near-zero, it was easy to fund a business. Any company that could show growing revenues and have a compelling story could easily borrow money and issue equity, even if they were losing money.

Those days are over.

Companies that generate more cash than they need will be increasingly valuable in a world where liquidity is scarce.

Dividend-paying stocks tend to generate liquidity, even in difficult economic periods. For example, **only one of our current Cornerstone holdings posted a loss in any calendar year from 2007-10.** The kinds of companies we own remained profitable, despite being in the worst economy since the 1930s.

Outstanding Management

SVB is a painful example of what happens when top management focuses more on maximizing their best interests instead of those of their shareholders. *The Wall Street Journal* reports that the Justice Department and SEC are examining stock sales that SVB's officers made in the days immediately prior to the bank's failure.

One example of the kind of manager we look for is Seifi Ghasemi. In July 2014, Mr. Ghasemi became the CEO of Air Products & Chemicals (APD). The next month, he spent $3.3 million of his own money buying APD stock at $132 per share. With the stock selling at $279, those shares are now worth $7 million, plus he received over $1 million in dividends paid since 2014. He has continued to buy over the years, aligning his own long-term interests with that of the shareholders he works for.

Necessary Goods and Services

Our focus is on companies that provide essential goods or services, which have more stable demand regardless of economic conditions.

Bristol-Myers Squibb (BMY) is a great example. They focus on discovering, developing, and delivering innovative medicines for patients with serious diseases. Those include cancer (Opdivo, Yervoy, Sprycel), stroke prevention (Eliquis), and arthritis (Orencia).

These products play a critical role in maintaining and improving public health, making them indispensable in the global market.

Good Value

In his book, "The Theory of Investment Value," John Burr Williams makes the simple but profound observation that "a stock is worth only what you can get out of it." Williams concludes that the value of a business today is the sum of all its future dividends discounted back to a present value.

A business whose prospects for future dividend growth are rising should expect its stock price to rise as projected dividends become a reality. **Just because a stock is trading at an all-time high doesn't mean it is expensive, so long as the value of the business is also hitting new all-time highs.** Conversely, a stock that is trading at an all-time low doesn't mean it is a good value if the trajectory of future dividend growth is declining.

Regional banks are a good example. The sector is down over 25% year-to-date. Does that make them a good value? Not necessarily; banks likely face increased regulations in the future, which will reduce their ability to grow dividends.

We want to own businesses that consistently build value year after year; those businesses should eventually be rewarded with increasing stock prices.

Investing in *stocks* was all that mattered from 2009-2021. The next decade is likely to be all about investing in the *right stocks*. It will be more important than ever to pick companies that can survive, and even thrive, in this new environment.

If you have questions or comments about this letter, please reach out to us. We're here to serve you however we can.

Blessings,

Your Investment Policy Committee

Are Your Investments Safe at a Brokerage Firm?

A brokerage account is fundamentally different from a bank. The SEC's Customer Protection Rule prevents brokerage firms from using customer assets to finance their own businesses. The stocks, bonds, and funds held with a broker are more like digital safety deposit boxes. The brokerage firm can't crack open its customers' safety deposit boxes to make loans, unless you give them permission to do so. **When you hold stocks and bonds in a brokerage account, those assets are yours, not the broker's.**

If a brokerage company fails, the FDIC says, "customer assets are safe and typically are transferred in an orderly fashion to another registered brokerage firm." In the event of both a failure *and* theft or fraud, investors are covered by the Securities Investor Protection Corporation (SIPC) insurance up to $500,000. Many large brokerage firms have additional insurance coverage above that limit.

[5] APPLE INC.DL-NOTES 2021(21/51) Bond | Markets Insider. markets.businessinsider.com. Published 2021. Accessed March 28, 2023. https://markets.businessinsider.com/bonds/apple_incdl-notes_202121-51-bond-2051-us037833ef38

SMARTMap®

Elevating Your Retirement Plan Experience

Employee wellness and retention is crucial in today's workforce. Research shows that a healthy and happy employee is more productive, engaged, and fulfilled. For those reasons, DCM's Retirement Plan Services division has partnered strategically with Pensionmark, a national network of professional financial planning consultants, to enhance the plan sponsor and participant experience. Pensionmark's SmartMap Financial Wellness and Planning service is now included as a part of our service offering for all DCM-managed 401(k) plans. Through this partnership, companies and their employees receive access to a suite of complimentary financial wellness and planning tools, which include:

A one-stop website for financial wellness
Access self-guided learning resources, including newsletters, webinars, articles, videos, and financial calculators. Topics include investing, retirement planning, financial planning, budgeting, and more.

One-on-one foundational planning
Receive custom financial planning from our Financial Advocates team. Our Financial Advocates work with individuals to craft an idyllic retirement and assist in developing a plan that aims to make these goals your reality. This includes budgeting, goal tracking, investment monitoring and allocation, mobile access, and a secure document vault.

If you have any questions about the SmartMap services or our partnership with Pensionmark, let us know. We are committed to supporting you with valuable retirement plan resources.

Adding a Trusted Contact on Your Account

No one likes to think about emergency situations, but they happen. To help you prepare for the unexpected, DCM recommends you complete a **Trusted Contact Authorization Form** and have it on file with your custodian. This is a protective measure to ensure that TD Ameritrade, Schwab, or Fidelity can reach out to someone you trust if there are any concerns for your health or you are unreachable.

To clarify, this authorization does not allow the designated person or persons to make any decisions regarding your account. This document only allows the custodian or DCM to reach out to the trusted contact to find out if anyone else has the legal authority to act on your behalf, such as a power of attorney, trustee, conservator, etc.

The trusted contact must be at least 18 years old, cannot be your advisor, and is the person that can be trusted with your account information by providing details about how to contact you and disclosing information on your health status. Again, this person cannot make any decisions on your behalf for your account.

DCM and the custodian will always attempt to reach you directly before approaching the trusted contact. In rare scenarios where you are unreachable, or there are concerns about your well-being, your custodian and DCM would have authorization to reach out to your trusted contact to make sure you are safe.

If you have any questions or need more information about the benefits of identifying a trusted contact for your accounts, please reach out to your advisor.

Dividends – A Solid Foundation

How Foundations Benefit from Rising Dividend Stocks

Similar to individual investors, a portfolio of rising dividend stocks may offer real benefits for charitable foundations by offering relative security, helping to moderate volatility, and providing a dependable stream of cash income.

Charitable foundations generally are intended to be perpetual. That is, they promise to shepherd their donors' portfolios so that the gifted assets can support annual cash gifts for many years to come. Those dual promises – long-lasting contributions and dependable annual gifts – are why foundation boards must invest in high-quality, durable companies. Most foundations will not want to "bet" their donors' gifts on more speculative assets.

We believe only strong companies can sustain their financial success long enough to consistently make generous annual dividend awards, increase those dividends every year, and continue increasing them, sometimes for 50, 60, or 70 years. In fact, some companies like Eli Lilly, Coca-Cola, Procter & Gamble, and Colgate – Palmolive have paid a dividend every year for more than a century.

Investing in a diversified portfolio of such solid companies helps foundation boards sleep at night, knowing their portfolio should still be creating new value long into the future.

Some foundations must withdraw annually from their investment portfolios to fund annual grants. A substantial portion of those withdrawals, usually 5% or more of market value, can be funded by growing dividend cash flows, often equal to half or more of that 5%, reducing the need to cash in shares. Minimizing the sell-off of portions of the portfolio helps extend its lifespan. In contrast, selling relatively more shares when the market is down can shorten the portfolio's lifetime and reduce its ability to grow in value as the market rebounds.

Some foundations are fortunate enough to fund their annual giving from new contributions rather than security sales. Rising dividend investing benefits these foundations too. Annual required grants are often set at a consistent percent of market value (like 5%). If a portfolio's market value falls significantly, such as from normal market volatility, annual grant dollar amounts will also fall, which can jeopardize multi-year grant commitments. Contributions also rise and fall. During a below-average contribution year, the foundation may have to resort to security sales to generate the cash required to fund grants. A portfolio of quality rising dividend stocks commonly experiences below-average market value volatility, smoothing out the annual grant calculations and helping reduce or avoid those problems.

A rising dividend investment strategy can potentially be a foundation's best friend through good and bad markets. Our concentration on security, income, and growth — in that order — seeks to ensure our clients receive reliable results even in the toughest markets.

Sharing Your Tax Return with Your Advisor

Your tax return is your unique financial fingerprint, providing a holistic view of your situation that can be used to strengthen your financial health. By sharing your return with us, we can help make better investment decisions, spot missed opportunities, and plot out your long-term financial goals.

Having a copy of your latest return helps us:

- Implement potential tax-mitigating strategies such as Tax Loss Harvesting and Roth IRA conversions
- Suggest charitable giving strategies or estate planning techniques
- Manage IRA Required Minimum Distributions across qualified accounts

Once you receive your completed return, you can send it to us securely by uploading it to the DCM Client Portal, mailing a hard copy, or — with your permission — having your tax preparer provide us with one.

Please notify your investment advisor if you'd like us to contact your tax preparer to obtain a copy of your return. We will take it from there.

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