Donaldson
CAPITAL MANAGEMENT

FALL 2023

RISINGDIVIDEND REPORT

Highlights from the **Investment Policy Committee**

1 Historically low interest rates post-2008 have led to a "single-crop" focus on stocks for income.

2 The 10-year U.S. Treasury bond yields over 4.5% and corporate bonds offer 6%, providing new options for income-seeking investors.

3 Fixed income is generating its highest income in over a decade, making it an alternative to high-dividend-yielding stocks with low growth. However, we expect stocks with growing dividends will be prized in the coming years.

4 Blending faster-growing dividend stocks with higher-yielding fixed income may provide both immediate and future income.

5 Higher interest rates create an opportunity for high-quality companies to take market share from lower-quality, highly leveraged companies.

Read the IPC Letter on page 3.

The Future is Bright

One of the most rewarding aspects of investing in individual stocks is studying the business strategies of companies we own in your portfolios. Amazon founder Jeff Bezos took his company public in 1997 guided by a simple but powerful strategy: customer obsession. Bezos has never lost sight of this, and the company size and stock price today reflect his success. At DCM, we've learned from some of these talented titans of industry, who rise to the top with a clear strategy and unwavering commitment to the culture of their business.

DCM has been in a tremendous season of change and growth. Many of you have experienced these changes firsthand. Perhaps you have a new advisor, or visited our Atlanta office, or gotten to know our financial planning team. We have made historic investments in new advisors and staff. We've opened new offices and expanded our real estate in key markets. We've upgraded our technology and partnered with the best in our industry to keep our processes current and our company and its data secure.

Why? A few reasons. First, there are a lot of you now. And frankly, we're obsessed with providing each of you the absolute best we can. As we grow, you deserve the same level of client service you've always been accustomed to. We won't let that slip. We are also focused on transitioning DCM from its founding generation to a talented second generation. DCM is nearing 30 years as an independent investment advisor. We intend to keep that going to 60 years and beyond, even amid the backdrop of an increasingly consolidating industry.

We are building DCM's future with your needs at the center of our growth. If we do that, we know that you will be successful and so will Donaldson. The feedback you shared with us in our most recent client survey will be invaluable in continuing to build our shared future. From where I sit, the future looks bright.

Thank you for your trust in us. We will give our best every day to keep earning it.

Sarah Moore

Sarah Moore, CFP®
President

2023 Year-End Checklist

As 2023 draws to a close, it might be a good time to consider some financial housekeeping. To help, we have prepared a financial checklist with important deadlines and topics to review.

- [ ] **Contributions to your employer-sponsored retirement plans (401(k), 403(b), etc.)**
  - The maximum employee contribution for 2023 is $22,500, plus an additional $7,500 'catch-up' for employees aged 50 and older.
  - Contributions must be made through payroll withholding by December 31. To make an adjustment to your withholding amount, contact your retirement plan administrator.
  - The contribution deadline for IRAs, Roth IRAs, and Health Savings Accounts is April 15, 2024, but we recommend making these contributions in the calendar year they are recorded as in your taxes.
- [ ] **Required Minimum Distributions (RMD)**
  - For those aged 73 and older, RMDs are required in 2023 from qualified retirement accounts (previously this was aged 72 and older).
  - RMDs must be taken by December 31 or receive a 25% penalty on the RMD amount not taken (previously this penalty was 50%).
  - If you give to charity, talk with your advisor about making a Qualified Charitable Distribution (QCD) to satisfy your 2023 RMD.
- [ ] **Tax Loss/Gain Harvesting**
  - Ask your advisor if it makes sense to sell a position at a loss to reduce tax liability or offset gains that were realized earlier in the year. Investment portfolio losses can also be used to offset capital gains outside of your portfolio, such as the sale of an investment property or business.
  - It also may be the right time for you to realize gains in a portfolio. If you have a large loss carry forward, you may want to consider using that loss to offset gains.
- [ ] **529 College Savings Contributions**
  - Contributions of up to $17,000 per person ($34,000 if married filing jointly) can be made in 2023 and fall under the annual gift exclusion rule.
  - Contributions must be processed by December 31 and those made in the last two weeks of December may be counted in the following year for tax purposes due to processing delays.
  - State tax credits and deductions vary. Work with your advisor to find out if you qualify for additional tax benefits.
- [ ] **Charitable Giving**
  - Cash gifts must be deposited by the receiving charity by December 31. Stock gifts must allow for extra processing time. Plan on processing your gift by December 18 to allow time to register the stock in the charity's name.
  - Consider establishing a Donor Advised Fund (DAF) to take advantage of tax benefits today and give later at a time of your choosing.

DCM Collective Investment Trusts *Now Listed on Nasdaq*

Last year, we launched the Donaldson Rising Dividend Cornerstone and Preservation of Capital Collective Investment Trusts. A Collective Investment Trust or "CIT" is an investment vehicle that can be hosted on any 401(k), 403(b), or 457(b) retirement plan platform. These CITs are pooled investment vehicles that behave much like a Mutual Fund or Exchange Traded Fund with minimal fees.

In July 2023, our CITs were officially listed on the Nasdaq stock exchange, a well-known global marketplace for buying and selling securities. Our Nasdaq listing allows retirement plan investors to monitor Cornerstone and Preservation of Capital Performance in real time. You can find our CITs on Nasdaq.com by typing in the following ticker symbols:

Donaldson Dividend Cornerstone Fund – DCMDCX

Donaldson Capital Preservation Fund – DCMCPX

If your workplace retirement plan would be interested in hosting our strategies, please let us know.

The mention of specific securities and sectors illustrates the application of our investment approach only and is not to be considered a recommendation. The specific securities identified and described herein do not represent all of the securities purchased or sold for the portfolio, and it should not be assumed that investment in these securities were or will be profitable. There is no assurance that the securities purchased remain in the portfolio or that securities sold have not been repurchased. For a complete list of holdings, please contact your advisor.

Rotating Income

"A couple of months ago, our Investment Policy Committee initiated Operation Tilt. [...] Our goals in this highly unusual bond market are to preserve capital and continue to provide income for those clients who need it."

–DCM's Quarterly Letter "Dividends Are Forever" published October 25, 2012

George Washington Carver was born in the 1860s. His parents died when he was young, so he took comfort in botany. He learned about natural pesticides and fertilizers to help his caretakers yield plentiful crops. His knack for bringing life to house plants and crops earned him the nickname "plant doctor" as a teenager.

As an adult, Carver realized the industrialization of cotton had depleted the soil; many farmers grew only cotton, which depleted the soil nutrients and rendered the lands less productive. Farmers were struggling to provide enough food.

George Carver was determined to find a way to help them. He discovered that alternating cotton with nitrogen-rich crops, like sweet potatoes, peanuts, and cowpeas, would restore the soil and provide an increased cotton harvest and a food surplus.

He encouraged farmers to break away from the single-crop focus and rotate between multiple types of crops. This enriched the soil, allowing for a greater harvest of both cotton and food—greatly enhancing the quality of life for millions of people both then and now.

George Washington Carver transformed southern agriculture in the United States by improving soil health, increasing harvests, reducing waste, improving nutrition, and generating food surpluses. Carver encouraged farmers to harvest from multiple sources, not just one — an approach that applies not only to farming, but also investing.

A Single-Crop Focus

In the wake of the 2007-09 Great Financial Crisis, the U.S. Federal Reserve (the "Fed") cut its short-term Federal Funds rate to zero. The Fed also decreased longer-term rates by purchasing billions in U.S. Treasuries and mortgage-backed securities.

Ever since, TINA ("There Is No Alternative") to stocks has been the operative word for investors. Interest rates stayed low for over a decade, which forced investors looking for income into higher stock allocations. Not only that, but lower interest rates pushed investors away from higher-quality companies and into more speculative, non-profitable, but fast-growing companies.

The 2020 pandemic exacerbated those trends. The ensuing government lockdowns led to another round of zero interest rates and quantitative easing, driving the 10-year U.S. Treasury yield below 1% for the first time in history. Growth stocks soared as investors, flush with cash, piled into speculative companies that benefitted most from both low-interest rates and stay-at-home lifestyles.

Like the southern farmers' singular focus on harvesting cotton, most investors have harvested income from a single 'crop' since 2008: stocks. Ultra-low interest rates left investors with no choice but to increase their stock allocations for both growth and income.

However, that is no longer the case.

Bye-bye TINA

For the first time in more than two decades, there are meaningful alternatives to stocks for generating income. The 10-year U.S. Treasury bond now yields over 4.25%, the highest in over 15 years.

After adjusting for expected inflation, U.S. Treasury bonds are priced to earn a 2.18% real return over the next decade, higher than the long-term average of 0.86% and higher than the pre-2008 average of 2.06%. As recently as 2022, investors bought Treasuries with the expectation that they would lose money after adjusting for inflation.

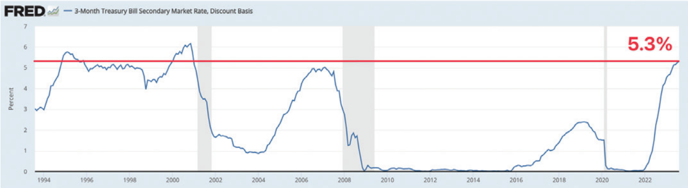
The U.S. government backs Treasury bonds, so there is little risk of default unless politicians decide to stop printing more money to pay debts. (An unlikely scenario, indeed!)

All other financial assets, including corporate and municipal

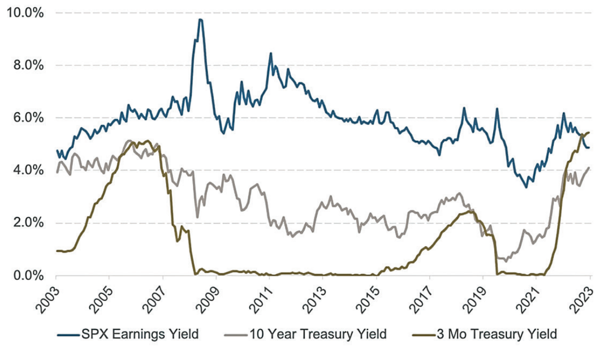
DCM calculations from 2003-2007 and 2003-2023. Data source: Market Yield on U.S. Treasury Securities at 10-Year Constant Maturity, Quoted on an Investment Basis, Inflation-Indexed. Stlouisfed.org. Published 2023. Accessed September 18, 2023. https://fred.stlouisfed.org/series/DFII10

bonds, offer higher yields based on these risk-free rates. At the time of this writing, the Bank of America U.S. Corporate Bond Index offered an effective yield of about 6.0%.

Even returns on cash equivalents are attractive. The 3-month U.S. Treasury bill yields 5.30%, its highest level in over two decades.



For income seekers, those yields are high enough to provide legitimate competition for stocks. The chart below uses earnings yield to convert stocks to a bond-like yield. Earnings yield is simply price-to-earnings flipped upside down. The current S&P 500 earnings yield is 4.3%.



A simple comparison of the S&P 500 earnings yield to the 10-year U.S. Treasury suggests that bonds are as good of a value—relative to stocks—as they've been in more than 15 years.

What Does It Mean for You?

This change in interest rates is significant to your investment portfolio in three ways:

1. Fixed Income Is Generating More Income

In June 2012, the U.S. Federal Reserve voted to extend its 'Operation Twist' program, specifically designed to lower long-term interest rates by selling $667 billion in short-term Treasuries to buy long-term Treasuries.

In response to the Fed's actions, we rolled out 'Operation Tilt'—a broad effort to 'tilt' DCM client fixed income portfolios away from traditional bonds towards stocks, preferred stocks, and bond proxies (stocks with bond-like characteristics). When we rolled this out in October 2012, there were more than 140 stocks in the S&P 500 with a current dividend yield higher than the 30-year U.S. Treasury bond.

In other words, stocks were not only priced based on potential growth opportunities, they were generating more income than many fixed-income securities.

From 2012 to 2023, stocks have outperformed bonds significantly. However, stocks no longer provide an obvious current income advantage to bonds. Today, only 70 stocks in the S&P 500 yield more than the 30-year U.S. Treasury bond.

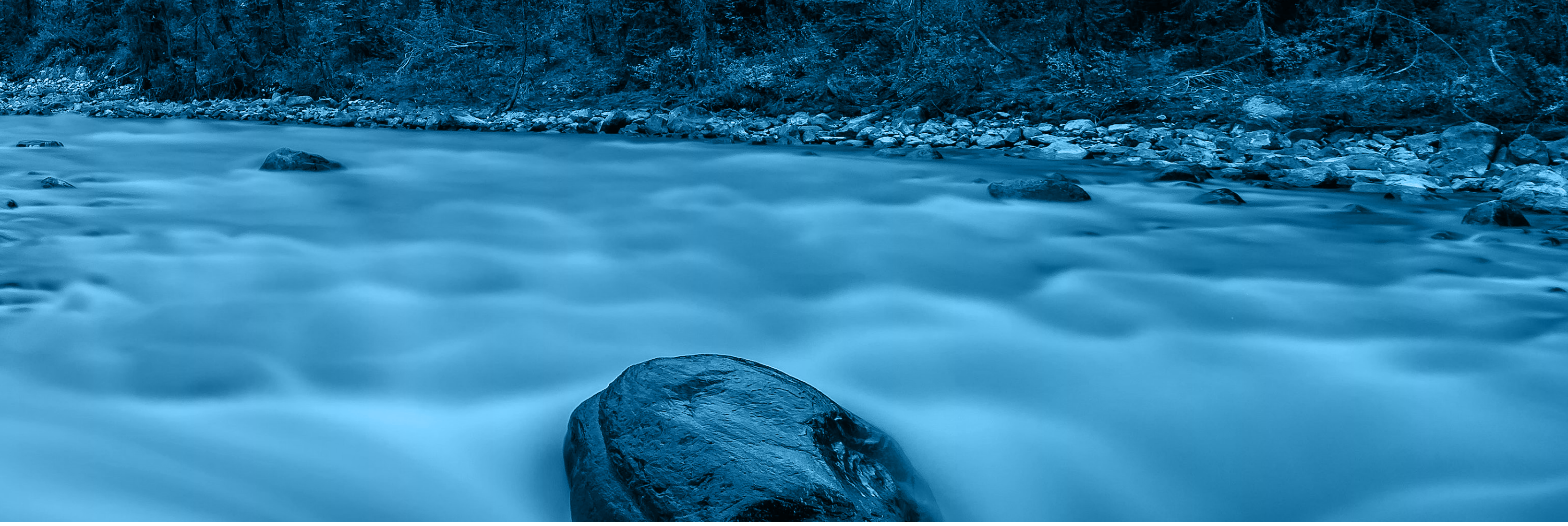
This is not to say that fixed income is now a better option than stocks. While we still expect stocks to generate higher total returns than fixed income over the long term, they are no longer the only option for income. If you are spending more than the dividends being generated, a higher allocation to fixed income may help fill the gaps.

2. Dividend Growth > Dividend Yield

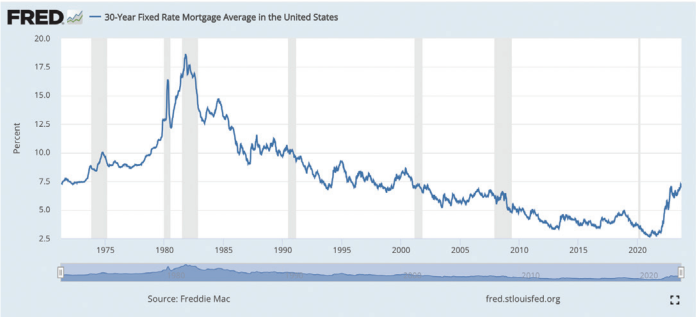
Higher fixed-income yields take the pressure off our stock portfolios—specifically Cornerstone and Income Builder—to generate income. As a result, we are focusing more on dividend growth and future income than maximizing current dividend yield.

Why?

First, we expect growth to become increasingly valuable in the coming years. Higher interest rates are starting to hurt consumers. Mortgage rates over 7% will continue tightening new borrowers'



budgets and reduce discretionary spending.



Variable-interest debt, like credit cards, will also have a negative effect. Consumers drive roughly 70% of the U.S. economy, so any spending reduction will adversely impact growth.

Companies that can grow their sales, earnings, and dividends despite this sluggish economic environment will be prized.

While growth could become increasingly scarce, income has become increasingly abundant. Companies with little to offer other than a large dividend yield may be less enticing. That's shown to be true so far in 2023. The Utility sector, for example, has been a traditionally higher-yielding but slower-growing sector. As we write this, the Utility sector was underperforming the broader market by 25% year-to-date.

A utility with a 3% dividend yield is attractive when short-term rates are 0%, even if the dividend isn't growing quickly. When interest rates are over 4%, stocks with high yields but slow growth are far less compelling.

3. Quality Matters, Again

When interest rates were 0%, and money was plentiful, investors were eager to invest in new bond and equity issuances. That allowed lower-quality companies with low or no profits to continue operating and investing in new growth projects.

Today, however, debt and equity financing costs are much higher, particularly for higher-risk businesses. Any company relying on financial markets to fund ongoing operations and growth projects could be in trouble.

This is a favorable development for the kinds of businesses we invest in. **Not only are dividend-paying companies able to operate and grow with internally generated cash flows, but they also have excess cash to pay dividends.** For these companies, debt is a tool to be used when it makes good business sense—not a requirement to survive.

In a rising interest rate environment, stronger companies can pick up market share as weaker competitors struggle to survive. The cost of capital has increased significantly over the last few years, which raises the bar for all business investments. A growth project with a 7% expected return on investment isn't good enough anymore; the cost of debt and equity capital is higher than that. **Only elite businesses that earn above-cost returns on their invested capital can grow profitably; others will fall further behind.**

While higher interest rates are a net negative for all businesses, high-quality companies have a relative advantage.

An Opportunity To Rotate

The days of 'single crop' investing are over; income-seeking investors now have fixed-income opportunities we haven't seen in over a decade.

Higher interest rates are a welcome development for bond investors, but present unique challenges for many businesses. Highly leveraged and non-profitable companies will face increasing pressures from rising rates. And those with high dividend yields—and little else—are "stuck in the middle" between growth on the one side and risk-free 5% yields on the other.

Carver's wisdom has much to offer here; higher interest rates provide an opportunity to use both stocks and fixed income. This combination of faster-growing dividends with now-higher-yielding fixed income may provide both the current and growing income you will need in the decades to come.

Thank you for allowing us to serve you. If you have any questions about how the current environment impacts your financial situation, please get in touch with your advisor.

Operation Twist. Richmondfed.org. Published 2023. Accessed September 14, 2023. https://www.richmondfed.org/publications/research/econ_focus/2012/q4/jargon_alert DCM calculations. Based on the trailing 12-month dividends divided by market price as of October 31, 2012. Compared with 30-year US Treasury yield as of October 31, 2012. Data source: S&P Global point-in-time data from ClariFi. DCM calculations. Based on the trailing 12-month dividends divided by market price as of August 31, 2023. Compared with 30-year US Treasury yield as of August 31, 2023. Data source: S&P Global point-in-time data from ClariFi.

Artificial Intelligence in 650 Words

If you have ever watched a Netflix series or a Roomba sweep a floor or a Husqvarna mow a lawn, you've witnessed Artificial Intelligence in action. The current AI fever began last November when ChatGPT, an AI-powered chatbot, was launched. Since then, its ever-expanding applications make it feel as though we are peeling this onion from the inside out.

We're told that AI will soon be tracking our well-being and alerting us to health issues. It is already making space exploration safer by predicting weather that could affect spacecraft and astronauts. AI tutoring programs will soon determine students' optimum learning styles and build personalized approaches.

The excitement around AI this past year has incited a dramatic run in the price of every business remotely related to AI. The Tech Sector's performance, up 41% through mid-September this year, has pulled the whole stock market higher. **Beyond the Tech companies that develop AI chips and software, guess which businesses will be using AI in the future? All of them. AI will be as pervasive in businesses as the internet is today and will inspire profound productivity gains.**

AI's extraordinary ability to learn, make decisions, and educate could also give it the potential to destroy life as we know it. Thus, every politician worth their salt wants to be viewed as AI knowledgeable and take credit for legislation that would protect the public without stifling innovation. Those same politicians have made noise over Big Tech and social media with virtually no results. We'll see where they take AI legislation. At least this time around, tech leaders say they want to help the cause. It is in their long-term interest to create a healthy environment for AI development and use.

Stop. What you just read has been reported by every news outlet over the last few weeks. But, where is AI headed? And what will change as its use becomes more pervasive? Even though we don't know, we want to try.

Here goes:

• **In the same way the Industrial Revolution and modern technology left behind workers unprepared for the changes, AI threatens to do the same.** AI has already taken over routine and repetitive tasks – think manufacturing robots, data entry, and paperwork. Have you questioned an insurance claim lately? Odds are you exchanged messages with an AI-powered chatbot. Self-driving trucks and taxis are already here. Automated checkout and robotic stock management are replacing cashiers and stock clerks.

The list of industries where AI can perform repetitive and administrative tasks goes on – Healthcare, Legal, Finance, Entertainment, Agriculture, Education, and it may never stop. In fact, AI can learn as it goes and teach us better ways to accomplish many tasks we do today.

• **While AI will automate certain tasks within these jobs, it will also enhance many roles by performing routine work and allowing professionals to focus on more complex and creative aspects of their work**. For example: Reducing nurses' paperwork will give them more time with patients. Influencing the writing of screenplays to make them more appealing to more people. Keeping minutes of meetings, like the last Portfolio Review with your DCM Advisor, then scheduling and performing follow-up tasks.

• **AI could extend life expectancy.** It promises to speed up scientific research, providing earlier diagnoses of life-threatening diseases; deriving more customized treatments; and by combing masses of data, clearly prescribe actions that will lead to longer and healthier lives.

• **AI could create a broader divide between the Haves and the Have Nots.** Let's pray that doesn't happen. But, it could. Many lower-paying jobs will disappear. Many good-paying jobs will, too. Overall, our economy may become more productive, i.e., more work produced by fewer people.

Stay tuned. AI plans to take the world on a journey that is too early for even it to predict.

New SAVE Plan Offers Relief for Student Loan Borrowers

Last summer, the Biden Administration rolled out several student debt relief initiatives. The headliner of these initiatives was the cancellation of up to $20,000 of student loans for qualifying individuals. In June, the Supreme Court ruled that the Biden Administration did not have the authority to grant the proposed loan forgiveness. While the Biden Administration may pursue further legal strategies for broad student loan forgiveness, the initiative appears to be dead for now.

Furthermore, student loan payments have now resumed. Interest on existing loans began accruing in September and the first monthly payments began in October. A 12-month 'on-ramp' period through Sept. 30, 2024, will allow borrowers to readjust to the cash flow hit from restarting monthly payments. During this 'on-ramp' period, loan interest will accrue. However, missed payments will not be penalized or have an adverse effect on credit scores.

It is not all bad news for Americans carrying student loan debt. A lesser-known part of the Biden Administration proposal is a new Income-Driven Repayment (IDR) plan referred to as the Saving on A Valuable Education (SAVE) Plan. The SAVE Plan could result in significant monthly savings and enhanced future loan forgiveness. The following changes to monthly payment calculations will be implemented under the SAVE Plan:

- The amount of discretionary income excluded from monthly payment calculations has been increased from 150% to 225% of the Federal Poverty Level.
    - o The percentage used for the monthly calculations has been reduced from 10% to 5% of discretionary income for undergraduate loans.
- For example, someone earning $100,000/year with a qualifying undergraduate loan of $50,000 would see their monthly premiums reduced from $651/month to $280/month.

Other important new features included in the SAVE Plan include:

- Original cumulative loan balances of $12,000 or less will be forgiven after 10 years.
- If the required monthly premiums do not fully cover the loan interest for that month, the remaining interest will be subsidized and will not be added to the principal.
- Individuals who file their taxes Married Filing Separately (MFS) can exclude their spouse's income from the monthly payment calculations.

The first wave of implementation for the SAVE Plan has already begun and includes the increase in excluded income, unpaid interest subsidization, and the ability to exclude spousal income for MFS files. Beginning July 1, 2024, all other features of the program will go into effect.

IDR plans are not for everyone, but the SAVE Plan has expanded the potential number of borrowers that could benefit from an IDR. Please reach out to your DCM advisor if you have questions concerning the options available for student debt payments

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