Donaldson CAPITAL MANAGEMENT

SPRING 2024

RISING DIVIDEND REPORT

Highlights from the Investment Policy Committee

1. Research suggests that AI-assisted employees are 66% more productive than those without AI assistance. This could have a profound impact on the global economy.

2. Large AI-related hardware and software companies, referred to as the "Magnificent Seven" (Nvidia, Microsoft, Apple, Amazon, Meta, Alphabet, and Tesla) have seen significant stock market gains due to AI development. Nvidia, whose semiconductor chips are essential to generative AI, has seen its stock price increase 368% since the introduction of ChatGPT.

3. While there are similarities between the current market conditions and the dot-com bubble of the late 1990s, today's technology companies are highly profitable, and the market's expectations are not considered irrationally exuberant.

4. The biggest opportunity in today's market lies with the users of AI. Companies that can leverage AI could see a dramatic rise in productivity and, by extension, profits. With a strong economy, AI-driven efficiencies, stable inflation, and falling short-term interest rates, there are plenty of opportunities.

Cybersecurity Today: Our Investment and Your Vital Role

In our interconnected age, where technology is an inescapable part of our daily lives, the threat of cyber fraud looms large. More than ever before, fraudsters are designing new ways to exploit our reliance on technology to steal account information.

To combat these threats, DCM has taken significant steps to bolster our cybersecurity and safeguard your account information. Over the past year, we've added to our Information Technology team and implemented defense systems to fortify your information. In partnership with Schwab, DCM's leaders participated in an extensive cybersecurity audit to ensure our processes and procedures are strong. We also conduct ongoing cybersecurity training for all employees to stay ahead of evolving risks.

There are additional precautions you can take to secure your information.

- **Visit the DCM website for links to your custodian site.** Never access links to your custodian from an email or text message. Fraudsters have created email and websites that look similar to the bank's email and website. By going to **www.dcmol.com** to access your accounts, you'll know you are clicking on the correct link.

- **Report any unexpected withdrawals** in your account. If you suspect your account has been compromised, contact DCM immediately to investigate and secure your information.

- **Use two-factor authentication** when possible. Two-factor authentication requires you to enter a code, which is messaged to you each time you access your account. This extra layer of protection confirms you are the person attempting to log in.

- **Create a unique password** for each account. Use long passwords that contain a combination of characters, numbers, and symbols. Consider using a password manager to create and store passwords securely, such as LastPass or 1Password.

Being cybersmart is a collective effort. DCM is committed to protecting your information so you can navigate the digital landscape with confidence. By adhering to best practices and staying vigilant, you'll reduce the chances of falling victim to cybercrime.

The SWR Conundrum: How Much Do You Really Have to Spend in Retirement?

SWR, or **Safe Withdrawal Rate**, is a critical consideration for retirees. It refers to the sustainable rate at which you can withdraw funds from your retirement accounts without depleting them prematurely. Think of it as the delicate balance between enjoying your golden years and ensuring your money lasts throughout your retirement journey.

Picture this: You've diligently budgeted, estimating that your IRA balance will sustain your lifestyle throughout retirement. But when the time comes to spend, you're in for a shock. Instead of the expected $75,000 annually, you find yourself with only $60,000 (or even less in high-tax states). It can be a rude awakening for many.

Market Value vs. Spendable Value

Here's the crux: The market value of your IRA might look impressive on paper, but the real question is, how much of that money can you actually spend? The answer lies in understanding the tax implications. Let's break it down:

1. Traditional IRAs: Contributions to traditional IRAs are tax-deductible up front, reducing your taxable income. However, when you withdraw during retirement, Uncle Sam collects his share. Those withdrawals are taxed at your current income tax rate. In other words, your IRA's market value isn't the same as its spendable value.

2. Roth IRAs: Roth IRAs take a different route. You contribute with after-tax dollars, meaning no upfront tax deduction. But here's the good part: Your earnings grow tax-free, and qualified withdrawals in retirement avoid taxation. It's like having a stash of tax-free cookies.

3. 401(k)s: These employer-sponsored accounts offer pre-tax contributions, reducing your taxable income today. In addition, 401(k)s often come with employer matching — that's free money you don't want to miss! However, when you retire and start withdrawing, that's when your distributions face ordinary income tax rates, similar to traditional IRAs.

The After-Tax Showdown: IRA vs. Taxable Account

Imagine you have $250,000 in your Roth IRA. Since it's after-tax money, you've already paid taxes on it, and the growth is tax-free. Now, let's compare it to a taxable account:

- **Taxable Account:** Here, you invest with after-tax dollars. If you're in the 25% tax bracket, that $250,000 came from $312,500 in earnings (taxed at 25%). Long-term gains from selling investments in taxable accounts face a 15% capital gains tax.

- **Roth IRA:** Your $250,000 grows tax-free. No upfront tax deduction, but no tax on the withdrawals either.

The Verdict: Retirement Accounts Are Still a Great Deal

As you can see, retirement accounts remain a powerful tool. They offer tax-free growth, employer matches, and a path to financial security. But remember, the market value isn't the whole story — know your spendable value.

So, next time you budget, consider the differences between market value and spendable value. Retirement accounts are like well-crafted puzzles — each piece matters. Whether it's a Roth IRA, a 401(k), or a taxable account, be cognizant of the tax implications so you can be better prepared for retirement.

Rational Exuberance

In the darkest days of World War II, the Axis powers seemed unstoppable. At the center of their war machine was the Enigma, a sophisticated communication device that decrypted top-secret messages. Many believed its code was unbreakable.

Enter Alan Turing and Gordon Welchman. These brilliant mathematicians led the Project Ultra team, who did what many thought impossible: they broke the Enigma code, allowing Axis' messages to be decoded. That they broke the Enigma code changed the course of World War II, but how they broke it changed the course of history.

Turing and Welchman created an electromagnetic device called "the Bombe machine" that deciphered the Enigma code's settings. The Bombe demonstrated that machines could simulate human thought processes, a concept at the essence of modern computing and artificial intelligence (AI).

What Is Artificial Intelligence?

AI takes enormous amounts of information and then learns from it. Facial recognition software, a form of AI, has been used in phones for years. It analyzes thousands of data points on your face, so your phone automatically unlocks for you and only you.

AI has been around for a long time; on Nov. 30, 2022, OpenAI's ChatGPT — now partially owned by Microsoft (MSFT) — introduced the public to generative AI, which uses existing information to generate something new, not just recognize or recall something that already exists. For example, when prompted with "Create a picture of a dragon throwing a football," generative AI uses its knowledge of dragons and throwing footballs to design this:

Digital illustration generated by OpenAI's ChatGPT 4

If you feel like you're living in a science fiction movie, welcome to the club.

47 Years of Productivity

AI is like having a creative virtual assistant at your fingertips. According to initial research, AI-assisted employees are 66% more productive than those without AI assistance.[1] The potential impact on the global economy is profound. If all 209 million working-aged people benefitted that much from AI assistance, the U.S. economy would add the equivalent output of 138 million employees and 47 years of productivity gains.[2,3] Output would surge without a commensurate increase in costs, pressuring prices lower.

The Magnificent Seven

AI's impact on the economy is uncertain, but its impact on the stock markets is clear. Large AI-related hardware and software companies have been the biggest winners.

Nvidia (NVDA)'s semiconductor chips are essential to generative AI. Since ChatGPT was announced at the end of November 2022, NVDA's stock price has jumped 368%.[4] In February, Nvidia's market cap increased $277 billion — adding more than the entire market value of McDonald's (MCD) in a single day.

Nvidia has benefitted most from AI, but they aren't alone. The other members of the so-called "Magnificent Seven" (Microsoft, Apple, Amazon, Meta, Alphabet, and Tesla) have increased by an average of 128% in 15 months. [5]

There are always a handful of exceptional stock performers; that's nothing new. What is so unique about today is the size of the winners. Most stock indices are "market-cap weighted" — meaning they own more of a stock as its value increases. The most valuable company in the world, Microsoft (MSFT), makes up 8.9% of the Nasdaq 100 and 7.3% of the S&P 500. [6]

The "Magnificent Seven" make up 40% of the Nasdaq 100 and 29% of the S&P 500. [7, 8] Non-market-cap weighted portfolios have struggled to keep up. Consider the S&P 500 equal-weighted index. It holds the exact same stocks as the S&P 500 market-cap weighted index, only it equal-weights each stock at 0.2%. The "Magnificent Seven" only comprise 1.4% of the equal-weight index.

[1] *Nielsen, Jakob. 2023. "AI Improves Employee Productivity by 66%." Nielsen Norman Group. July 16, 2023. www.nngroup.com/articles/ai-tools-productivity-gains/.*
[2] *Assuming there are 209 million working age people in the US (source: FRED) and multiplying by 66%.*
[3] *Nielsen, Jakob. 2023. "AI Improves Employee Productivity by 66%." Nielsen Norman Group. July 16, 2023. www.nngroup.com/articles/ai-tools-productivity-gains/.*
[4] *Source: S&P Global's ClariFi. Monthly data total return and dividends from 11/30/2022 through 2/29/2024.*
[5] *Total returns from 11/30/2022 through 2/29/2024. Microsoft (MSFT): 63.9%, Apple (AAPL): 23.0%, Amazon (AMZN): 83.1%, Meta (META): 315.5%, Alphabet (GOOG/GOOGL): 37.1%, Tesla (TSLA): 3.7%. Data source: S&P Global's Compustat.*
[6] *"S&P 500 Companies by Weight." 2024. Slickcharts.com. 2024. https://www.slickcharts.com/sp500.*
[7] *"Nasdaq 100 Companies by Weight." 2024. Slickcharts.com. 2024. https://www.slickcharts.com/nasdaq100.*
[8] *"S&P 500 Companies by Weight." 2024. Slickcharts.com. 2024. www.slickcharts.com/sp500.*

The chart below shows how important the weighting scheme has been. The blue bars represent the market-cap weighted S&P 500 Growth, S&P 500, and S&P 500 Value indices. The grey bars show the performance since November 2022 if those indices were equal-weighted rather than market-cap weighted[9]:

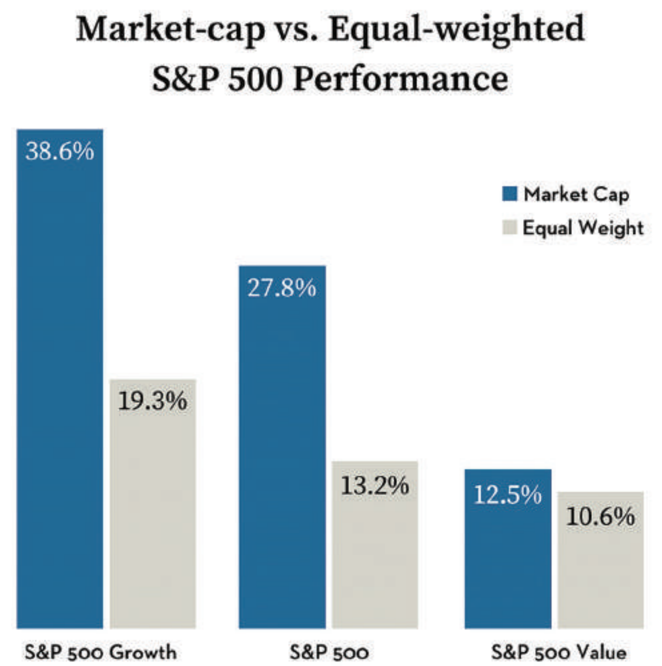

Fig. 1: Performance of market-cap vs. equal-weighted S&P 500 indices since November 2022.

The gap between the market-cap weighted and equal-weighted versions of the three indices above are 19.3%, 14.6%, and 1.9%, respectively.

Figure 1 above also shows the massive gap in performance between Value and Growth strategies. The S&P 500 Growth Index has outperformed the S&P 500 Value Index by a whopping 26.1% since ChatGPT was announced.

What are we to make of this extraordinary performance gap between the largest Growth stocks and everything else? Is this the start of an AI revolution, where only a handful of stocks continue to dominate the market? Or are we repeating the dot-com bubble for these high-flying stocks?

Irrational Exuberance

"But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?"

- Alan Greenspan, former Federal Reserve chairman
December 5, 1996

Long before Facebook, Instagram, Twitter (now "X"), or TikTok, there was theGlobe.com. In 1995, Stephan Paternot and Todd Krizelman created one of the first websites offering users the ability to publish their own content and interact with other members. It was a virtual community.

On November 13, 1998, theGlobe.com held its initial public offering ("IPO") at $9 per share. On its first day of trading, the stock opened at $87 — a nearly tenfold increase in a single day.

theGlobe.com was one of many examples of the investment euphoria that dominated the 1990s. The Internet was gaining widespread popularity, and investors were giddy about buying into technology stocks of all kinds, regardless of whether they had any fundamentals to back them up. Between 1995 and March 2000, the technology-led Nasdaq index increased by 800%.

Things didn't end well.

At its peak, theGlobe.com traded at $97 per share—valuing the company at over $1 billion. Other than a great idea, there was nothing to justify this market value; the company had minimal revenues and substantial losses. By the early 2000s, theGlobe.com folded its social media operations entirely. Investors' $1 billion evaporated in a matter of months.

theGlobe.com wasn't the only casualty of the dot-com bubble. From its peak in 2000 to October 2002, the Nasdaq declined by a staggering 78%.

The dot-com bubble serves as a painful reminder of what happens when excessive speculation about a transcendent idea—such as the Internet — takes over. In these manias, investors forget that buying a stock is buying a business, which requires actual revenues and profits — not just good ideas.

Investors argued that we were at the dawn of a new era. The Internet would revolutionize the world and lead to unprecedented economic growth. Ironically, that was accurate beyond anyone's wildest expectations. But that didn't automatically make it a good investment; **the starting price was too high.**

John Burr Williams' Guide to Valuing Nvidia (NVDA)

The similarities between now and the 1990s are clear. Like the Internet, AI offers spectacular promises in the years to come. And, like the 1990s, the stock prices for these companies are skyrocketing.

Unlike the 1990s, however, the companies underlying the stocks are highly profitable. In its most recent four quarters, Nvidia earned $29.8 billion — a staggering 400% increase in profits from the prior year. [10]

Nvidia (NVDA) has an extremely bright future; there's no doubt about that. Unfortunately, being a good investor is not as simple as identifying clear and obvious economic trends; it's about evaluating the market's expectations against your own.

Will NVDA be a good investment at today's prices? Let's figure out what a reasonable businessperson would be willing to pay for Nvidia's entire business today, assuming they want to earn at least a 10% return on their investment.

John Burr Williams correctly concluded that the value of a business today is the sum of all future dividends it will pay out to its owners over its lifetime, discounted back to the present.

[9] *Total returns from November 30, 2022 to February 29, 2024. Data source: S&P Global's Compustat.*

[10] *Nvidia's net income (excluding extraordinary items) was $29.8 billion for the four quarters ending 2/29/2024 compared with $6.0 billion in the four quarters ending 2/28/2023. Data source: S&P Global's Computstat.*

One of the methods we use to value companies, particularly extremely fast-growing companies, is our Reverse Dividend Discount Model. Rather than trying to estimate what the company is worth, we estimate what future dividends the company needs to pay to justify what investors are paying for it.

How fast does Nvidia need to grow its dividends to be worth $2.1 trillion? Then, once we figure that out, the decision on whether to buy comes down to whether we believe it can grow as fast as the market is implying.

Nvidia is currently in a fast-growing phase; over the last decade, they have grown earnings at 50% per year. That can't continue forever; if it did, Nvidia would eventually be the entire economy.

Like all companies, Nvidia will eventually reach a mature state where their growth slows to match the economy's growth. At that point, they should begin to pay larger dividends than they are today. As of March 2023, Nvidia's dividend payout ratio was around 1%; so, 99% of their earnings are going towards reinvesting for future growth. As growth opportunities slow, they will likely increase that payout ratio. More mature companies, such as Texas Instruments (TXN), currently pay out 71% of its earnings as dividends.[11]

We'll assume Nvidia is currently in a high-growth phase, which eventually transitions to a steady-state growth of 5% — roughly equal to nominal GDP growth. Using Nvidia's trailing 12-month data plus our estimates for payout ratio, **we can estimate the market is pricing in a 20% annual growth rate for Nvidia over the next 15 years.[12]**

Can Nvidia grow its cash flows at 20% per year for the next 15 years?

Let's go back to 2007 when another company introduced the most successful product of our generation: the iPhone. As Steve Jobs rolled out the world's first smartphone, Apple's free cash flow was at $3.1 billion. That revolutionary product, and all the services around it, have grown free cash flows to $105 billion in 2023 — a compound annual growth rate of 26.5% over 15 years.

The market is, in effect, forecasting that Nvidia's AI chips are "the next iPhone." Is that possible? Certainly. Nvidia itself grew revenues by about 21% over the last 15 years — from $3 billion to $61 billion.

Is it a sure thing? Certainly not. Growth is easier for smaller companies than larger ones. The competition — including other technology giants — will want a piece of Nvidia's profits. If competition erodes Nvidia's market share or profit margins, it may not be able to grow as quickly as the market is forecasting.

While there are downside risks to Nvidia, it's hard to argue they are in a bubble. The market pricing in a 20% growth rate, while exuberant, is certainly not irrational like it was in the 1990s. Nvidia is a dominant company in an industry with a huge runway for growth, so current prices could easily be justified.

Whether you're an Nvidia bull or bear, the weight of evidence suggests we're not in a speculative bubble. At least, not yet.

The financial media has been calling the market overvalued for years; we have consistently argued that stock prices were undervalued in the context of the ultra-low interest rate environment. For the first time in more than a decade, fixed income offers an attractive alternative to stocks.

So, while valuations are a bigger concern today than they've been, we are nowhere close to a bubble. Compared to the late 1990s, today's market looks downright cheap. At the start of 2000, the forward earnings yield for the S&P 500 was less than 0.5% higher than the real 10-year yield — in other words, bonds were more attractive relative to stocks than they have been at any point since 1990.

Figure 2: S&P 500 Expected Earnings To Price Ratio vs. 10-Year Treasury Yield Minus 5-Year Expected Inflation and 10-Year Treasury Inflation-Protected Securities, weekly.

If that same relationship were to hold today, the price-to-earnings ratio for the S&P 500 would need to roughly double — driving the S&P 500 index price from $5,200 to $10,000 without a commensurate increase in earnings power.

That would be a bubble.

What Does It Mean for You?

Comparisons between 2024 and the late 1990s dot-com collapse are overblown. Today's technology companies are trading at a premium to other stocks, but they should be. Nvidia and the other Magnificent Seven are highly profitable businesses, with visible growth for as far as the eye can see.

However, the tech giants' rosy outlook is largely priced in. As we showed with Nvidia, they need to produce incredible growth — near iPhone-level — to justify their market value. The biggest opportunity in today's market are the users of AI. Companies that can leverage AI could see a dramatic rise in productivity and, by extension, profits.

With the backdrop of a strong economy, AI-driven efficiencies, stable inflation, and falling short-term interest rates, there are plenty of opportunities. Rational exuberance is here for the Magnificent Seven; the other 493 could be next.

[11] Source: "Texas Instruments (TXN)." Google Finance, accessed on March 18, 2024.
[12] This reverse dividend discount model is a valuation model, not a forecast of hypothetical investment results or a guarantee of any future growth in price, earnings, or dividends. Knowing the exact discount rate, earnings growth, or length of earnings growth is impossible; therefore, no dividend discount model is perfectly accurate. This is merely an estimate of what expectations the stock market may be pricing into Nvidia's stock today. Here are the assumptions behind that valuation model: we used NVDA's trailing 12-month earnings of $29.7 billion, which the market is implying need to grow to $480 billion in 15 years, then slow to a 5% constant growth rate for perpetuity. Also, the market seems to be implying NVDA's 1.3% payout ratio increases evenly each year to 71% in 15 years. All future dividends are discounted at a rate of 10%.

Gift Bunching:

How to Maximize Your Charitable Impact

Many of you give generously to causes you care deeply about, including charities, churches, and other non-profit organizations. Beyond the positive impact of these donations, there are potential income tax benefits for donors. Gift bunching is one strategy you can use to optimize charitable contributions while maximizing tax savings.

What Is Gift Bunching?

The concept of gift bunching is simple: instead of spreading your donations evenly across several years, you concentrate them into a single tax year. Why does this matter? Before 2018, standard deduction amounts were much lower than they are today. It was easier for tax filers to itemize tax deductions — such as charitable gifts, mortgage interest, and state and local taxes — to surpass the standard deduction amount, resulting in lower federal taxes.

When the Tax Cuts and Jobs Act (TCJA) was passed in 2018, the standard deduction amount was almost doubled. The percentage of tax filers who itemized deductions dropped from roughly 30% to around 10%. By bundling your charitable contributions into a single tax year, you can itemize your deductions more effectively and exceed the standard deduction threshold.

Here's how it works. Let's say you donate $15,000 annually over three years to a charitable cause. Instead of donating $15,000 each year (and taking the standard deduction), you contribute $45,000 in a single year. By bunching your donation and itemizing your deduction, you can save more money on your overall taxes. In the next column is a table that shows the tax advantages of using gift bunching. For tax year 2023, the standard deduction is $14,600 for single filers and $29,200 for married couples filing jointly.

Without Bunching	Year 1	Year 2	Year 3	Total
Charitable Gifts	$15,000	$15,000	$15,000	$45,000
Deduction	$29,200	$29,200	$29,200	$87,600

With Bunching	Year 1	Year 2	Year 3	Total
Charitable Gifts	$45,000	$0	$0	$45,000
Deduction	$45,000	$29,200	$29,200	$103,400

Tax Savings at Various Marginal Tax Rates	12%	22%	24%	32%	35%	37%
	$1,896	$3,476	$3,792	$5,056	$5,530	$5,846

You may notice that the charities of your choice won't receive any donations in the 'off' years of this strategy, but this can be easily solved by setting up a donor-advised fund. While contributions would be made to this account in the 'bunch' year, funds do not need to be distributed to charities in the same year. Instead, distributions can be made on an annual basis, or however often you direct.

If you would like to learn more about gift bunching or are interested in setting up a donor-advised fund, please reach out to your DCM advisor. They can help you determine if these are the appropriate strategies for you.

Beyond The Basket

Some Thoughts About Inflation Measures

When you're visiting a new city, it may take a little while to catch on to the directions people provide. Are all those tall buildings uptown or downtown? Until you're familiar with the local shorthand, you may have trouble keeping up.

There are many types of shorthand; for example, the Federal Reserve Board uses the Consumer Price Index (CPI) as a shorthand measure of inflation while following its mandate to keep it under control. The Bureau of Labor Statistics (BLS) regularly updates the CPI and publishes a monthly report that the Fed (and many others) watches closely. An unexpectedly small or large change in the report can be counted on to provoke sudden moves in the stock and bond markets.

The CPI tracks changes in the cost of a 'market basket' of goods thought to be representative of items consumers regularly purchased in seventy-five urban areas. The BLS' methodology seems sound, and the CPI does a good job of painting a broad picture of overall inflation across the country. What it does not do is capture inflation as experienced by any specific family, including your own. There are several reasons for this.

- **The CPI focuses on urban dwellers, which makes sense from a data-collection perspective but generally ignores the spending of those living in smaller communities.**

- **The contents of the 'market basket' are rarely changed in hopes of maintaining consistency. However, spending habits do change, tending to move to cheaper substitutes with rising prices and purchasing more premium items as prices fall.**

- **The CPI can't track improvements or declines in product quality. Technology has made many electronic items less expensive while durable consumer products have become less reliable in recent years and more likely to need replacement.**

- **As inflation has risen, many consumer products now come in smaller quantities. A pound of butter still weighs 16 ounces but most bags of ground coffee, once a pound, now weigh only 12 ounces. The BLS has difficulty accounting for this effect, often referred to as 'shrinkflation.'**

In addition to the challenge of measuring inflation objectively, its effects are experienced differently depending on individual situations. For instance, if you are retired, you may live in a house with a paid-off mortgage and rooms full of furniture, so credit card and mortgage interest rates are not a major concern. However, you may frequently have to contend with rising healthcare costs. Conversely, if you are still working, you generally spend less on healthcare but are often paying more for air travel and children's college education, while simultaneously needing to fund your own retirement.

DCM can create a custom financial plan to respond to each client's personal rate of inflation before turning to our range of investment strategies. While there's no harm in reading the CPI press releases, please don't let the headlines concern you. You can always contact your DCM team for reassurance that your plan remains on track.

Sharing Your Tax Return with Your Advisor

Your tax return serves as a unique snapshot of your financial situation that can be used to strengthen your financial well-being. By sharing your return with us, we can help make better investment decisions, optimize your financial plan, spot missed opportunities, and plot out your long-term financial goals.

Sharing your latest return helps us:

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

How to Share Your Return

Once you receive your completed return, you can submit 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 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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