Brookmont Capital Management- Third Quarter Review

The markets are going through a transition from outright complacency to fears that interest rates may rise, China's economy may slow down, Europe may fall back into a recession, and the Ebola virus will lead to a worldwide health epidemic. We have gone from one extreme to the other and never stopped to find a balance along the way.

We know that interest rates will eventually rise and it has been predicted for several years. China's economy cannot continue to grow by 10% on an annual basis and will slow to single digits. Europe always finds a way to fall into a recession. It is inevitable when you have Germany's strict financial standards on one side and loose monetary policies in Spain and Greece on the other. Over time we have faced major health scares but always found a way to stop it before it was too late.

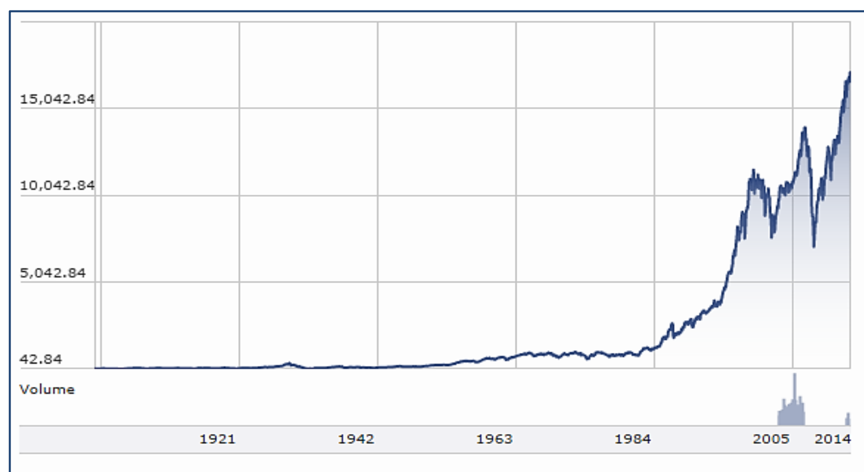
In other words, the expression "there is nothing new under the Sun" is as relevant today as it was when the cliché was spoken for the first time. Economies eventually slow down, interest rates will rise and fall, and health scares will bring medical advances and new pharmaceuticals. That does not mean that the markets acted rationally in the past or will do so in the future. During this new millennium, investors have experienced the bursting of two asset bubbles (technology stocks and real estate), a meltdown in the global financial sector, terrorist attacks on US soil, two major wars, and two bear markets.

Market performance can be viewed over a long period of time or by monthly returns, but not both. We honestly cannot tell you what is going to happen next month, or even the following month, with any degree of certainty. No investment manager can do that with a high level of accuracy. On the other hand, we can develop longer term economic forecasts based on highest probability and then position our portfolios with the market cycle. This is the basis of top down management and why we emphasize long-term performance over short-term returns.

Investment managers will never admit that monthly and quarterly performance include variables that are beyond our control and a fair amount of luck. We do not know what the Federal Reserve will do next month, which companies will miss their third-quarter earnings target, or what unknown shock will hit the markets by the end of the year. When investors look back at their portfolio's performance, quarterly returns suddenly take a much smaller importance. How did your portfolio perform during the 2001 recession, the 2008 meltdown in the financial sector, or during the first Gulf War? Probably not very well. On the other hand, how has your investment portfolio performed since 1994 when the Dow was trading at 3,700, or since June 2004 when the Dow was trading at 10,420?

The important argument is that the markets have had an upward bias since 1901 when the Dow was trading at 71 points. The chart below shows the market's progress over the past 114 years as the Dow rose from 71 to above 17,000. It was not a smooth ride but the market always found a way to recover and move higher. The doomsday projections that you hear in the media have only gotten worse with the introduction of social networks. Online commentary may include hidden agendas (blogs are particularly dangerous) or may not be supported by the facts. This "noise" makes it even harder to distinguish fact from fiction.

HISTORY OF THE DOW JONES INDUSTRIAL AVERAGE



This historical price chart of the Dow Jones Industrial Average should remind you that the markets have always survived recessions, corrections, depressions, and other menacing descriptions. The chart of the Dow Jones' price history clearly indicates periods of volatility and sharp declines. It also shows periods of dramatic upward performance. We have become so focused on short-term performance that we only see a lot of trees and not the forest. If you step back and look at the graph, the forest becomes obvious and the trees fade into the background.

We understand investor angst. This is your life savings and your retirement. The following bullet points are what we recommend to our clients when the markets are volatile or quiet. The rules never change.

- Never invest in fads, bubbles, or anything that sounds too good to be true
- Never reach for yield when it includes taking considerable risk
- Diversification does not mean buying a basket of individual securities that are highly correlated
- Budget for one-year of required minimum distributions, expected expenditures, or a major purchase and hold that amount in cash
- Be realistic about your risk tolerance. It is very easy to roll the dice when the markets are moving higher, but no so much when Washington makes bad monetary policy and sends our economy into a recession
- Be realistic about your time horizon. If you just reached 55 and your parents are 80 years old and healthy, chances are you are looking at another 30 to 35 years – maybe even longer
- Keep in mind that if you own high-quality fixed income and individual equities, your stream of income is not going to be reduced when the markets decline
- Cash is always an alternative, but your purchasing power is going to decline by 3% each year

As investment advisors, we have a tendency to make financial planning and portfolio management more complicated than it needs to be. We want to believe that investors are making daily decisions based on dividend discount models, present value tables, and other efficient market philosophies. The truth is, individual stocks trade on earnings announcements, management's future projections, and whatever data announcement was made before the opening bell. I have never seen an advisor take out a pricing model and decide whether to buy or sell when the markets are falling by 300 points. The markets are more emotional than we will admit even with sophisticated computer models.

On the other hand, trading strictly on emotion never ends well except for the person on the other side of the trade. The key is to remember that economies go into recessions, countries go to war, but somehow the markets always find a way to move higher.

Third Quarter Remarks

This brings us to the Strategy's third-quarter performance. Those who have been invested in the Dividend Equity Strategy over the years know that the portfolio has included a consistent 35-40% allocation in mid-cap stocks. This has included names like H.J. Heinz, Lubrizol, and Tupperware. It is one of the things that distinguish the Strategy from other dividend-centric managers. While most dividend managers only hold large-cap value stocks, the Strategy is able to search for attractive companies across the entire spectrum. The Strategy is not restricted by market capitalization, equity style, or domicile.

Worthington Industries is a respected steel processor and has been a Strategy holding since 2008. The company provides specialized steel products to numerous industries that include automotive, construction, and appliance manufacturers. With a market cap of $2.5 billion, Worthington is classified as a smaller, mid-size company.

In 2009 and 2010, Worthington's stock rose by 79% and easily outperformed the major indices. In 2011, its stock price fell by 8% and trailed the S&P 500 by 1,000 basis points. We continued to own the stock and were questioned why we did not sell it to avoid an 8% decline. Worthington rebounded the following year and posted a 64% return in 2012 and a 63% return in 2013. In 2014, Worthington has declined by more than 10% and we have been questioned once again about our decision to retain the stock.

If we had sold Worthington in 2011, our investors would have missed out on a 132% cumulative return from January 2012 through September 2014. The Strategy has experienced the same issue with other mid-cap stocks in the portfolio. After posting strong returns over the past two years, the portfolio's mid-cap stocks are underperforming in 2014. This is not the first time it has happened.

The chart on the following page includes the mid-cap stocks that are currently in the Dividend Equity Strategy. Their annual performance is compared against the S&P 500 and Russell 2000 (small and mid-cap stocks). While the financial media has discussed the poor recent performance among small and mid-cap stocks, they have failed to see that the same situation occurred exactly three years ago. Mid-cap stocks underperformed the S&P 500 by nearly 1100 basis points during the third-quarter of 2011, and underperformed the S&P 500 by 1200 basis points during the third-quarter of 2014. There is no guarantee that we will see a rebound in mid-cap stocks as what occurred in 2011. However, the situations are very similar and should not be ignored.

	2009	2010	2011	Third Qtr 2011	2012	2013	2014	Third Qtr. 2014	Cumulative Return
CBS	77.0%	37.0%	45.0%	-28.0%	42.0%	69.0%	-15.6%	-13.7%	
Ennis	45.0%	5.7%	-19.1%	-25.0%	24.0%	16.0%	-23.4%	-12.6%	
Microchip	57.0%	24.0%	10.0%	-18.0%	-7.2%	42.0%	8.0%	-2.3%	
National Fuel Gas	65.0%	35.0%	-13.0%	-34.0%	-6.1%	44.0%	-0.4%	-10.2%	
Tupperware	112.0%	5.0%	19.9%	-27.4%	17.3%	51.9%	-25.2%	-16.9%	
Sonoco	32.0%	19.0%	1.4%	-20.9%	-6.3%	45.2%	-3.6%	-9.8%	
Worthington	24.0%	44.0%	-8.6%	-39.7%	64.0%	63.0%	-10.6%	-13.2%	
Packaging Corp	77.0%	15.0%	0.6%	-18.2%	57.0%	69.0%	2.4%	-10.3%	
Average Return	**61.1%**	**23.1%**	**4.5%**	**-26.4%**	**23.1%**	**50.0%**	**-8.5%**	**-11.1%**	**250.0%**
S&P 500	26.5%	15.1%	2.1%	-15.1%	16.0%	32.4%	8.3%	1.1%	146.3%
Russell 2000	27.2%	26.9%	-4.2%	-19.6%	16.4%	38.8%	-5.3%	-7.7%	136.4%

We never allowed the significant gains to evaporate. Since 2009, the Strategy has been rebalanced on nine separate occasions and long-term gains (including the stocks listed above) were harvested in our clients' portfolios.

Dividend Equity Strategy vs. the Russell 1000 Value

The Strategy has several unique qualities that set it apart from other dividend managers and the Russell 1000 Value Index. The Strategy is able to own securities from every market capitalization and is not restricted by stock style (value/growth) or domicile. This flexibility has allowed the Strategy to own the names listed above that are not found in other dividend products.

On the other hand, the Strategy's Investment Policy includes strict guidelines on how much the portfolio can own in a specific sector and individual holding. The Policy Statement does not allow more than 20% of the portfolio to be invested in a specific sector or 5% in an individual holding. These restrictions prevent the Strategy from taking large bets in a sector or in a single holding.

These various restrictions have always made the Dividend Equity Strategy a unique portfolio. While we are allowed to search for opportunities that other dividend managers ignore, we also are conservative in that we do not take large positions in a sector or individual holding. Normally this investment policy is very beneficial in that we can own more dynamic names in the portfolio but do so without taking significant risk.

There are certain times when these policies work against us. We are constantly asked "when would your Strategy underperform the benchmark?" The answer has always been "when the markets are led by the finance or energy sectors, low-yielding stocks, or when mid-cap stocks are sharply underperforming large-cap names."

The Strategy’s benchmark is the Russell 1000 Value Index. The benchmark does not include any foreign domiciled companies while the Strategy has a 15% weighting in ADR’s. The Index holds very few mid-cap stocks while the Strategy has a 32% allocation to this area of the market. The Russell 1000 Value Index includes a 29% weighting in the finance sector, while the Strategy has a 20% maximum weighting in any sector and currently includes 15% in financial stocks. Finally, the benchmark includes a 12% weighting in the energy sector but only a few companies provide the required minimum dividend to be included in the Strategy. As a result, the Strategy is always going to be underweighted in financial and energy-related securities – which are the two largest positions in the Russell 1000 Value and most dividend-centric portfolios.

We have always told our clients that the Dividend Equity Strategy is neither a true large-cap portfolio nor a true value stock portfolio. The Russell 1000 Value Index is the published benchmark since reporting services such as Morningstar place the Strategy among Large-Cap Value managers. A more appropriate benchmark would be a blend that reflects the portfolio’s weighting in large and mid-cap stocks. Based on current allocations, the benchmark would be 70% Russell 1000 Value/30% Russell 2000. To keep our benchmark in-line with third-party reporting services, the Strategy’s returns are always compared to the Russell 1000 Value.

Summary

Conflicting economic data has made the current investment environment more uncertain and explains the increased market volatility. If early indications are true, third-quarter earnings announcements will not bring much clarity and market volatility will continue. These are short-term movements and not long-term trends.

We believe that the U.S. economy is still improving and is reflected in the labor and housing markets. Concerns about the strong dollar are valid and can be seen in lower oil prices. Interest rates should remain very low as inflation is the least of our concerns. Corporate earnings will continue to grow as we enter 2015 and may be stronger than current expectations.

The Strategy’s holdings have been aggressive in raising their quarterly dividends and we expect every company in the portfolio to increase its payout. During the past twelve months, the Strategy has experienced a 17% increase in dividend income.

We always welcome your questions and comments as it relates to the Dividend Equity Strategy and our outlook for the market and economy. Brookmont Capital is celebrating its seventh anniversary next month and it would not have been possible without your support and confidence in our firm. Neal and I thank each of you and look forward to success in the future.