High Dividend Value Equity
Q1 2019 Commentary

Market Review:

The US equity market got off to a strong start in 2019 with the S&P 500 returning +13.7% and the Russell 1000 Value +11.9%. It was the best quarter for the S&P 500 in ten years, since the 3rd quarter of 2009, and the best opening quarter of a year since 1998. Equities rebounded from the sharp selloff in the 4th quarter of 2018, when the S&P 500 was down 13.5%. Concerns that caused the 4th quarter decline, including fears of hawkish Fed policy and a worsening trade war with China, largely abated in the 1st quarter.

Every sector finished the quarter in positive territory, with nine of the 11 sectors posting double-digit gains. Information Technology (+19.9%) and Industrials (+17.2%), both significantly impacted by China trade negotiations, were two of the best performing sectors. Real Estate (+17.5%) outperformed as REITs benefitted from a decline in long-term Treasury yields, and is now the best performing sector over the past 12 months. Energy (+16.4%) also posted an outsized gain, aided by a recovery in oil prices after a 4th quarter decline. The worst performing sectors were Health Care (+6.6%) and Financials (+8.6%), although both recorded strong quarterly returns.

After raising the benchmark federal funds rate four times in 2018, Fed Chair Jerome Powell said at the outset of 2019 that the central bank “will be patient” in its approach to monetary policy. The Fed left rates unchanged throughout the quarter, and following its March meeting Powell indicated there would be no increases in 2019. Furthermore, he said the bank will end its balance sheet tightening program at the end of September. This dovish policy and language contrasted sharply with the Fed’s guidance in the 4th quarter and contributed to the rebound in stocks. Equities were also buoyed by progress in trade talks between the US and China, as President Trump announced a postponement of the March 1st deadline to increase tariffs on roughly $200B of Chinese imports. Trump continues to seek an agreement that would increase US exports to China, boost protection of intellectual property and end pressure on US companies to transfer technology to Chinese partners.

Although stocks rose on positive developments in the quarter, the market also overcame a number of headwinds that it will continue to contend with going forward. In the US, although the economy remains strong by historical measures, a number of indicators point to slowing growth. GDP for the 4th quarter came in at 2.2%, well below the 4.2% and 3.4% figures recorded in the 2nd and 3rd quarters, respectively, as manufacturing activity and consumer spending slowed. The situation contributed to the Treasury yield curve inverting in March, as the yield for 10-year Treasuries fell below that for 3-month notes, the first such occurrence since 2007. Outside the US, a slowing global economy led the IMF to reduce its global growth forecast for 2019 to 3.5%, down from its 3.7% forecast last October. In China, the government announced GDP growth of 6.6% in 2018, the country’s lowest growth rate in 28 years. Finally, the UK Parliament and Prime Minister Theresa May failed on multiple attempts to come to a Brexit agreement, a situation that has created significant uncertainty in the European and global economies.

Performance Analysis:

The High Dividend Value Equity strategy composite returned 11.4% (gross) and 11.3% (net) for the first quarter of 2019. The strategy underperformed the S&P 500 and Russell 1000 Value for the quarter.

Figure 1: High Dividend Value Equity Returns vs. Benchmark

	Q1	1 Yr	3 Yr	5 Yr	10 Yr	Since Incept*
High Dividend Value Equity (gross)	11.4	10.6	11.6	9.2	14.2	10.5
High Dividend Value Equity (net)	11.3	10.2	11.2	8.7	13.7	9.8
Russell 1000 Value Index	11.9	5.7	10.5	7.7	14.5	9.3
S&P 500 Index	13.7	9.5	13.5	10.9	15.9	9.5

**December 31, 1993. Performance for periods greater than 1 year is annualized.*

The strong market recovery in Q1, following the precipitous Q4 sell-off, was broad-based with all sectors participating in the rally. Growth outperformed Value in Q1 by 420 basis points (Russell 1000 Growth Index vs. Russell 1000 Value Index). In addition, with the significant decline in volatility, Low Quality stocks (B or worse rated balance sheet) outperformed High Quality stocks (B+ or better) by 440 basis points. Yield sectors lagged with the two highest dividend yielding quintiles underperforming the overall market.

Figure 2: S&P 500 Price Performance by Dividend Quintile

	# of	Wgt in	Absolute Price Performance					BofAML	Proj EPS Growth		Forward	Div.
	Comp	S&P 500	1 Mon	3 Mon	6 Mon	12 Mon	YTD	Adj Beta	2018	2019	P/E Ratio	Yield
Yield Sectors												
0.00 To 0.09	101	22.03	2.56	15.03	-4.42	8.83	15.03	1.10	7	13	22	0.00
0.09 To 1.47	101	15.14	2.58	15.91	-5.48	2.73	15.91	1.04	11	14	18	0.92
1.47 To 2.43	101	24.95	2.14	14.14	-1.28	13.12	14.14	1.03	6	11	16	1.88
2.43 To 3.34	101	19.14	0.33	9.73	-0.95	5.73	9.73	0.94	6	9	15	2.81
3.34 To 15.35	101	18.74	1.51	11.78	-0.90	6.86	11.78	0.91	1	8	13	4.38

Source: Bank of America Merril Lynch, March 31, 2019.

The investment discipline core to the High Dividend Value Equity strategy focuses on the long-term factors that drive superior risk-adjusted returns – investments in high quality companies with attractive relative valuations, sustainable and growing dividends and catalysts to drive earnings growth and improving sentiment. Committing to this process over market cycles has rewarded clients with solid long-term gains and down market protection. At quarter-end:

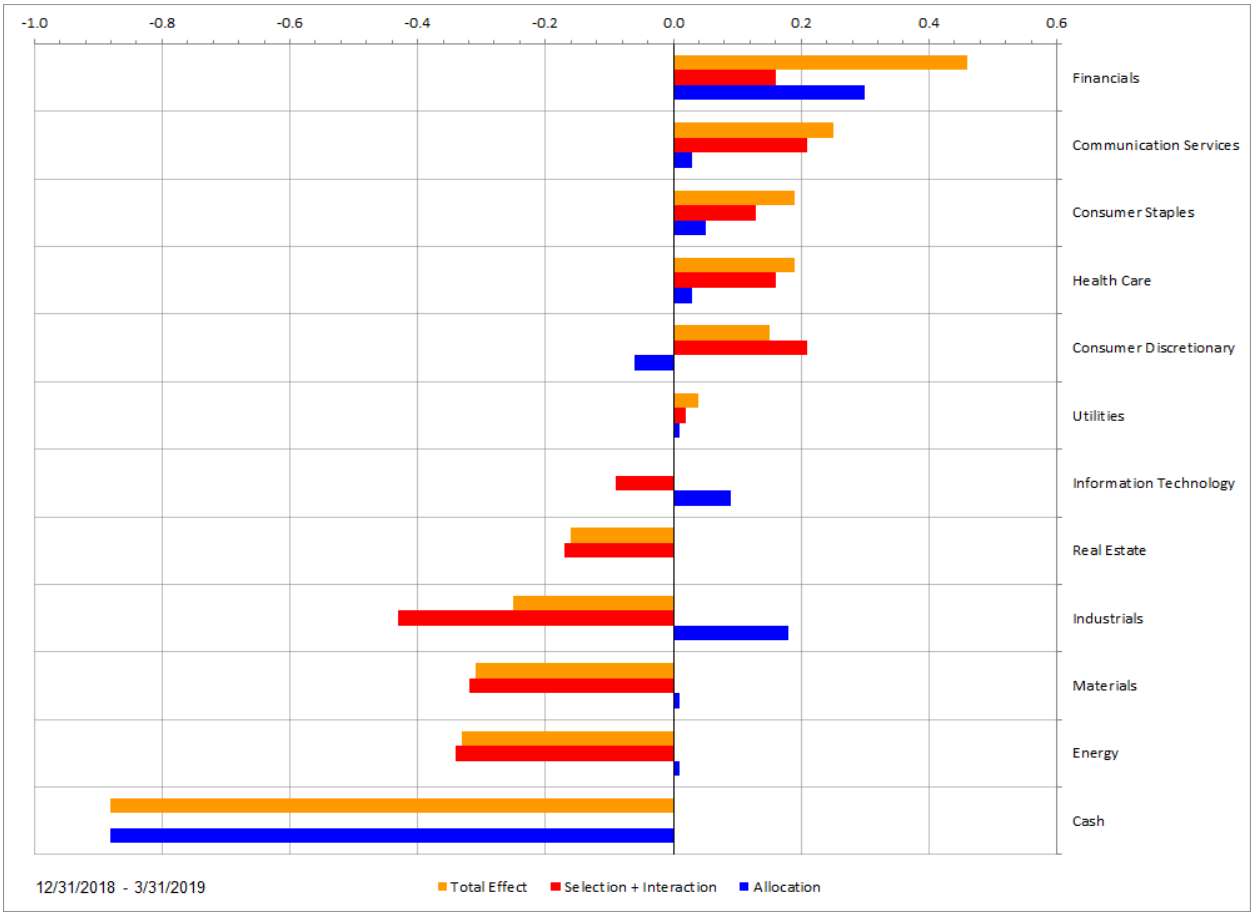
- **Low P/E Valuation Discipline**: The strategy's P/E is 15.7x 2019 earnings versus 18.5x for the S&P 500 and 16.8x for the Russell 1000 Value (Q1).

- **High Absolute Dividend Yield**: The strategy's dividend yield is 3.4% versus 2.3% for the S&P 500 and 2.6% for the Russell 1000 Value (Q1).

- **Strong Dividend Growth**: In Q1, 16 out of 38 portfolio companies raised their dividends with an average increase of 6.6%.

Portfolio Attribution:

Attribution Effects – High Dividend Value vs. Russell 1000 Value 12/31/2018 – 3/31/2019



Source: SCCM/Bloomberg, 3/31/2019.

The following attribution analysis of the High Dividend Value Equity portfolio utilizes the Russell 1000 Value as the benchmark of comparison for the first quarter of 2019.

Our underweight allocation and strong stock selection made ***Financials*** the largest contributor to relative performance for the quarter. Financials underperformed as GDP growth projections declined and the Treasury yield curve inverted. SunTrust Banks (+18.4%) announced a merger with BB&T Corp., a combination that should result in the sixth largest bank in the US based on assets and deposits, and should result in significant EPS accretion from cost savings and economies of scale. Travelers (+15.2%) outperformed as the property and casualty insurer is seeing improved pricing in its business insurance segment as well as better profitability in auto insurance. Stock selection in the ***Consumer Discretionary*** sector aided performance as Genuine Parts' (+17.5%) automotive and industrial parts distribution businesses continue to record strong organic growth, aided by accretive acquisitions. Target (+11.8%), a new position in the strategy, appreciated on strong 4th quarter earnings including same-store sales that were its highest since 2005, and digital sales growth of 31% year-over-year. The portfolio benefitted from underweight allocation and strong stock selection in ***Communication Services***, with the defensive sector underperforming in a rising market. BCE (+13.8%) posted solid organic growth in its wireline, wireless, and media businesses while AT&T (+17.4%) reaffirmed its strategy of utilizing free cash flow to reduce its leverage ratio in 2019. Our overweight allocation and stock selection aided relative performance in ***Consumer Staples***, as Philip Morris International (+34.1%) and Altria (+17.9%) rebounded from difficult 4th quarters as the companies navigate shifting industry trends and regulatory environments. Diageo (+16.4%) also outperformed as the company continues to see growth across all geographies.

Stock selection within the ***Energy*** sector detracted from relative performance as Royal Dutch Shell (+8.3%) and ConocoPhillips (+7.5%) trailed the sector in the quarter. Both companies have reduced debt levels and cut costs and are now reporting improved free cash flow generation. Within ***Industrials***, Siemens (-0.4%) underperformed as European industrials firms cope with a slowing European economy and the fallout from Brexit and US-China trade negotiations. 3M (+9.8%) appreciated but trailed the market, and the company continues to benefit from innovation across its many businesses. DowDuPont (+0.4%) detracted from relative performance in the ***Materials*** sector, as the company begins to execute on its three-way split to unlock potential value across its materials science, agriculture and specialty products businesses.

Portfolio Changes:

Purchases / Additions

A new position in **Target (TGT)** was established in the quarter. Target, one of the largest multi-line retailers in the US, operates about 1,800 stores (84% owned) across the country. Its large-format stores offer general merchandise including: beauty/household (23% of sales), hardlines (18%), apparel and accessories (20%), food (20%) and home furnishings (19%). The company differentiates itself by offering higher-margin private label, signature categories (style, baby, kids and wellness) that currently represent one-third of total sales.

The macro environment within US retail appears to be supportive for continued growth driven by rising wages, healthy employment levels and relatively low rates in the context of deleveraged consumer balance sheets. Target’s growth is being driven by significant investments it has made over the last few years to offer a comprehensive, omni-channel retail experience. Given the rapid growth of e-commerce in the US (digital sales now account for roughly 10% of total retail sales in the country), it is becoming increasingly clear that retailers must establish a significant online presence to survive and ultimately thrive in a competitive landscape led by Amazon. Management’s investment in its digital business has resulted in online sales growth of 31% year-over-year in its last quarter, with digital now accounting for over 7% of total sales, up from 4.2% a year ago. Target aims to create a seamless, multi-channel experience with multiple delivery options, leveraging its distribution centers and physical stores. The company is also in the process of remodeling its existing stores, including the conversion of backrooms to distribution centers that will facilitate online shipments, and launching urban-oriented, small-format stores. Several high profile competitors have entered bankruptcy or closed a large number of stores over the past year, including Toys ‘R’ Us, Sears Holdings, Bon-Ton Stores and others; this wave of consolidation could likely benefit strong incumbents including Target.

At purchase, Target traded at 12.5x earnings, a substantial discount to its historical average and at a 40% lower multiple than its primary competitor, Walmart, which currently trades at 21x. Target yielded 3.6% and its annualized dividend growth over the past five years has been 9.8%. The company has a strong A-rated balance sheet and relatively stable cash flow and earnings in economic downturns, providing a potential margin of safety for investors.

Sales / Reductions

There were no sales in the quarter.

Dividend Summary:

In the first quarter of 2019, 16 out of 38 portfolio companies raised their dividend payments with an average increase of +6.6%:

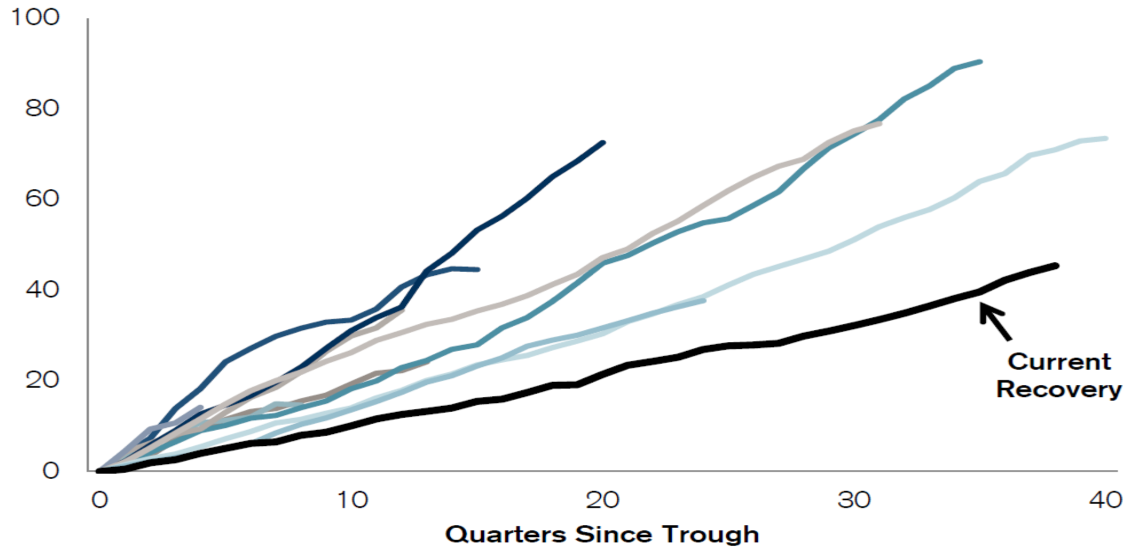
- 3M (MMM) raised its dividend payment by +5.9%
- AT&T (T) raised its dividend payment by +2.0%
- BCE (BCE) raised its dividend payment by +5.0%
- Boeing (BA) raised its dividend payment by +20.2%
- Chevron (CVX) raised its dividend payment by +6.3%
- Cisco Systems (CSCO) raised its dividend payment by +6.1%
- Corning (GLW) raised its dividend payment by +11.1%
- Diageo (DEO) raised its dividend payment by +1.8%
- Genuine Parts (GPC) raised its dividend payment by +5.9%
- Intel (INTC) raised its dividend payment by +5.0%
- Kimberly-Clark (KMB) raised its dividend payment by +3.0%
- NextEra Energy (NEE) raised its dividend payment by +12.6%
- Novartis (NVS) raised its dividend payment by +1.8%
- Pfizer (PFE) raised its dividend payment by +5.9%
- Wells Fargo (WFC) raised its dividend payment by +4.7%
- Raytheon (RTN) raised its dividend payment by +8.7%

This builds on the strength of 2018 where 31 out of 37 portfolio companies raised their dividends with an average increase of +10.6%.

Market Outlook:

The strong equity market rally in the first quarter, driven by the Fed's shift to a dovish policy stance and signs of a resolution to the China trade war, largely ignored deteriorating global economic data and downward earnings revisions. The market's optimism is focused on stabilizing global growth, naturally occurring and through renewed monetary and fiscal stimulus. These periodic mid-cycle consolidations over the past ten years have helped to sustain the length of this now historic bull market. While the current cycle is now one of the longest, the sub-par growth in this recovery can further extend the cycle, especially in light of continued accommodative Fed policy and continued corporate earnings growth.

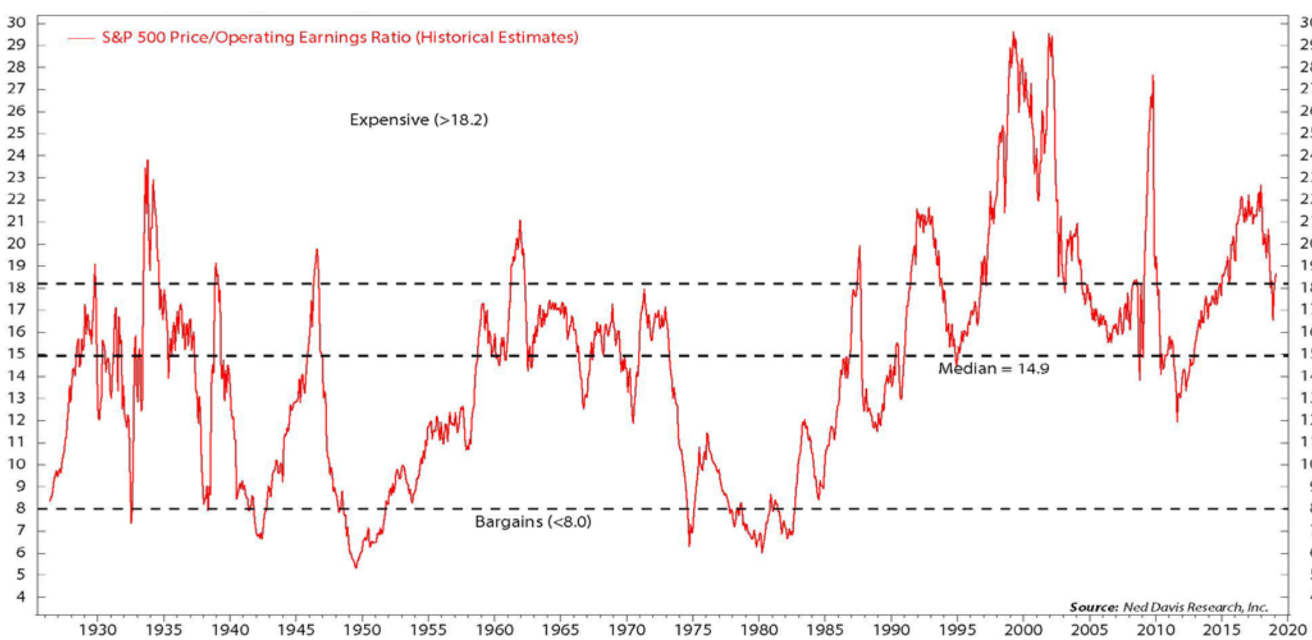
Figure 3: Cumulative GDP Growth Post-Recessions



Note: 1949 to present; Cumulative nominal GDP since trough indexed to 0.
Source: Credit Suisse, "Equity Strategy Navigator," April 2019.

With US equity markets rallying on improving conditions, sentiment has shifted to elevated optimism and favorable technicals and momentum continue to aid the market in its attempt to break through to new highs. Meanwhile, equity risk premiums have declined significantly and should signal a degree of caution. Multiple expansion has been the driver of the rally thus far and while earnings estimates have stabilized, the previous tailwinds of ultra-loose monetary policy and corporate share buybacks are less present and meaningful going forward. Record levels of corporate and government debt and valuation excesses in pockets of the US equity market are factors likely affecting growth and returns ahead. The S&P 500 Index currently trades at 18.5x 2019 earnings while the median price/earnings ratio is 22.2x. Historically, when valuations on the index move into elevated territories, forward returns are more muted.

Figure 4: S&P 500 Price/Operating Earnings Ratio and Forward Index Performance



Median S&P 500 % Gain After Reaching Extremes Analysis Dates: 1926-03-31 - 2019-03-31			
Months Later	**PE >18.2**	**PE <8.0**	**All Periods**
3	-0.1	15.4	2.5
6	-8.4	13.6	4.8
9	-7.7	17.7	7.0
12	-1.7	12.4	9.6
24	0.8	33.6	16.9

Source: Ned David Research, March 31, 2019.

Thank you for your continued support. Feel free to reach out to us if you have any questions.

Best Regards,
Schafer Cullen Capital Management, Inc.