SCHAFER | CULLEN
CAPITAL MANAGEMENT

**High Dividend Value**
Q2 2020 Commentary

## Market Review:

The 2nd quarter marked the best quarter in over 20 years for the US equity market, a remarkable rebound from one of its worst quarters in history. The S&P 500 returned 20.5%, while the Russell 1000 Value returned 14.3%. For the S&P 500, it was the best quarter since 1998, following its worst 1st quarter ever. Only three months ago, investors were gripped by fear of the consequences of the coronavirus pandemic, worldwide lockdowns, record unemployment claims, and a plunge in economic growth. Yet investor sentiment reversed just as quickly as it declined, thanks in part to unprecedented fiscal and monetary stimulus from governments and central banks worldwide.

Globally, Covid-19 cases reached 10.5 million with over 500,000 fatalities. The US alone recorded 2.7 million cases with approximately 130,000 fatalities. Weekly unemployment claims smashed the previous record at 6.9 million in March and have since declined to just under 1.5 million. In April, U.S. retail sales declined a record 14.7%, then rose 17.7% in May, a record increase (The Wall Street Journal, 6/16/2020). The crisis facing the country was compounded with widespread protests and unrest in nearly every major city following the death in Minneapolis of George Floyd.

Consumer Discretionary (+32.9%) was the top performing sector, as retailers benefitted from consumers stocking up on essential items, a gradual re-opening of non-essential stores, and an enormous surge in online shopping. Information Technology and Energy were the next best performing sectors, both returning 30.5%. Technology continued to benefit from the lockdown, particularly cloud computing applications related to workplace collaboration and online entertainment. In April, leading oil producing nations including the US, Saudi Arabia and Russia agreed to a record cut in daily production of 9.7 million barrels per day, a pact that was extended in June. The WTI oil benchmark nearly doubled in the quarter to $39 after an unprecedented and chaotic dive into deeply negative territory in April. Utilities (+2.7%) and Consumer Staples (+8.1%) were the two worst performing sectors, as defensive, lower volatility stocks lagged. Financials (+12.2%) also underperformed largely due to the uncertain recovery for banks. The Federal Reserve released the results of its annual stress tests, ordering the largest banks to suspend share repurchases in the 3rd quarter and also capping dividends at their 2nd quarter levels.

Although every state began phased re-openings, with most non-essential retail and manufacturing resuming operations, investors are clearly relying on the Federal government to help bridge the gap until the economy fully reopens. Assets on the Federal Reserve's balance sheet now exceed $7 trillion, up from $4 trillion at the beginning of the year, and the Federal budget deficit is now forecasted to be $3.8 trillion for the 2020 fiscal year. Lawmakers are discussing a second stimulus bill for July, following the $2.2 trillion stimulus passed in March. Internationally, European Union members are discussing an $840 billion stimulus plan on top of a roughly $1.5 trillion stimulus effort from the European Central Bank.

## Performance Analysis:

The High Dividend Value Equity strategy composite returned 13.0% (gross of fees) and 12.9% (net of fees) for the second quarter of 2020 versus 14.3% for the Russell 1000 Value and 20.5% for the S&P 500. Year-to-date, the strategy returned -15.6% versus -16.3% for the Russell 1000 Value and -3.1% for the S&P 500.

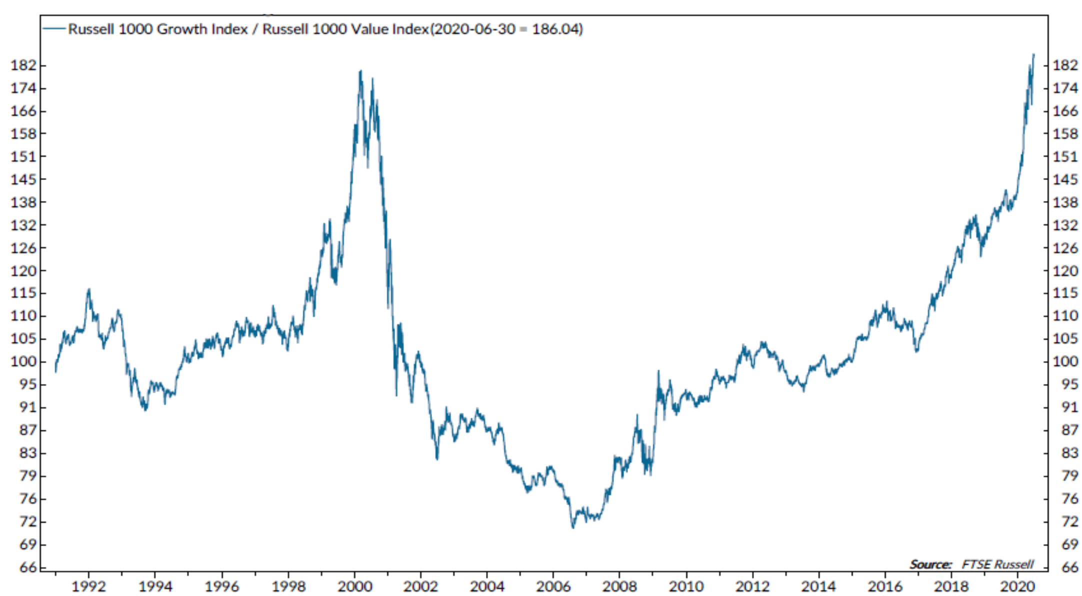
**Figure 1: High Dividend Value Equity Returns vs. Benchmark**

| June 30, 2020 | MTD | QTD | YTD | 1 Yr | 3 Yr | 5 Yr | 10 Yr | Since Incept* |
|---|---|---|---|---|---|---|---|---|
| High Dividend Value Equity (gross) | 0.0 | 13.0 | -15.6 | -9.6 | 2.2 | 6.0 | 10.6 | 9.6 |
| High Dividend Value Equity (net) | 0.0 | 12.9 | -15.7 | -10.0 | 1.8 | 5.6 | 10.2 | 9.0 |
| Russell 1000 Value Index | -0.7 | 14.3 | -16.3 | -8.8 | 1.8 | 4.6 | 10.4 | 8.7 |
| S&P 500 Index | 2.0 | 20.5 | -3.1 | 7.5 | 10.7 | 10.7 | 14.0 | 9.5 |

**12/31/1993. Performance for periods greater than 1 year is annualized.* ***Past performance is no guarantee of future results***

The flattening of Covid-19 case curve in developed markets and re-opening of economies in the second quarter fueled markets higher. Growth and Technology stocks, viewed as safe havens, led markets driven by continued uncertainty on the path of recovery and a dramatic rise in retail trading. In the first half of 2020, the NASDAQ surged 12.7% vs. the S&P 500's decline of 3.1%, the widest spread since 1983. The largest five stocks in the S&P 500 (Apple, Microsoft, Amazon, Google, and Facebook), all Technology stocks, were up on average 24.1% YTD driving the indices higher; the S&P 500 total return YTD without the largest five stocks was -8.6% (Bloomberg). In the quarter Growth outperformed Value (Russell 1000 Growth – Russell 1000 Value) by 1,360 basis points and 2,600 basis points for the year, the widest annual spread in Russell history (1979). Figure 2 shows the significant outperformance of Growth over Value, with levels currently reaching that of the 2000 Technology peak. Subsequent to the 2000 market collapse, Value enjoyed nearly a decade of outperformance.

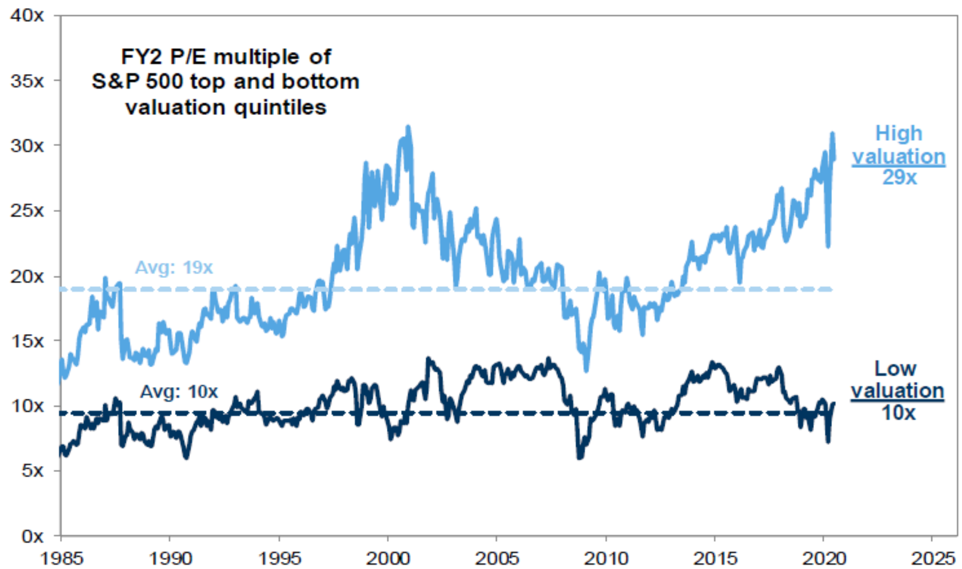
**Figure 2: Relative Performance Russell 1000 Growth / Russell 1000 Value Indices**




Source: Ned Davis Research, 6/30/2020.
**Past performance does not guarantee future results.** Investors cannot invest directly in an index

Figure 3 shows the valuation of the S&P 500 Highest and Lowest Price/Earnings quintiles – with current dispersion levels at their highest in 20 years. The Highest P/E quintile currently trades at 29x versus the long-term average of 19x and the Lowest P/E quintile at 10x.

**Figure 3: Valuation of the S&P 500 Highest and Lowest P/E Quintile**




Source: Goldman Sachs, US Weekly Kickstart, 6/26/2020.

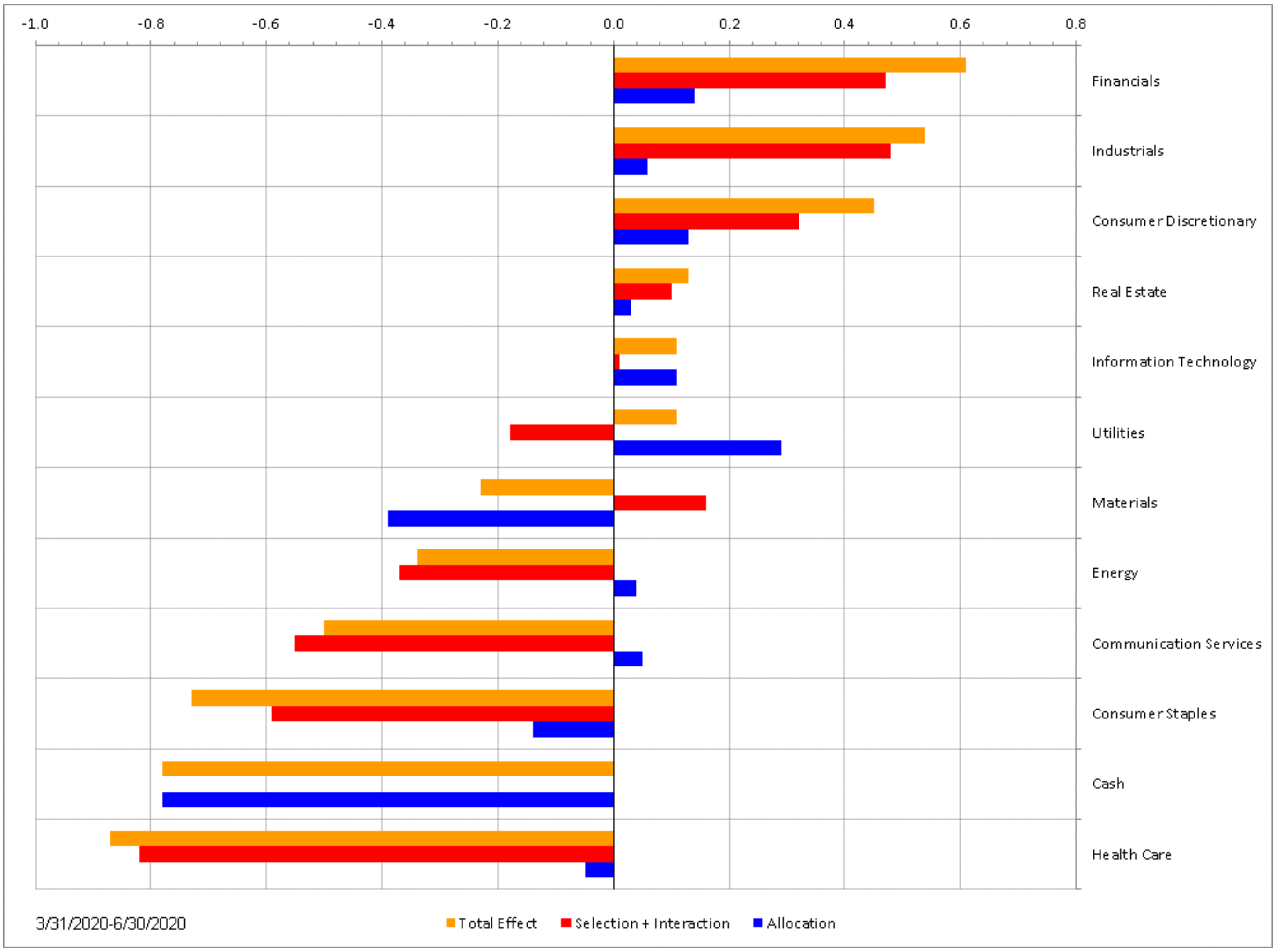
Declining Covid-19 case levels and mortality in developed markets and a broadening economic recovery in May led to a rotation into Value stocks, particularly cyclical Energy, Financials and Industrials which collapsed in the March market sell-off. While a resurgence (second wave) of Covid-19 cases in the US led to a June risk-off environment, the initial economic bounce favoring Value stocks gives an indication that a sustained economic recovery can lead to Value outperformance.

The valuation and dividend yield of the High Dividend strategy are attractive on an absolute and relative basis. At quarter-end:

- **Low P/E Valuation Discipline**: The strategy's P/E was 16.1x 2020 earnings versus 19.7x for the Russell 1000 Value and 22.0x for the S&P 500 (Q2).
- **High Absolute Dividend Yield**: The strategy's dividend yield was 3.8% versus 2.8% for the Russell 1000 Value and 2.0% for the S&P 500 (Q2). As the Covid-19 pandemic moved from crisis to recovery, the strength of our portfolio companies' balance sheet and liquidity position combined with resilient business models and cash generation has supported consistent and growing dividends during this period.
- **Strong Dividend Growth**: In Q2, 5 out of 41 portfolio companies raised their dividends with an average increase of 4.9%. Year-to-date, 20 out of 41 portfolio companies have raised their dividends with an average increase of 5.6%. In the first half of 2020, one current portfolio holding has reduced its dividend. Welltower, a healthcare REIT, reduced its dividend by 30% in May. While the company has experienced low levels of mortality at its facilities, the dividend cut will help the company preserve capital as it prepares for an uncertain re-opening. Year-to-date, 12% of the S&P 500 companies have reduced/eliminated their dividends.

## Portfolio Attribution:

**Attribution Effects – High Dividend Value vs. Russell 1000 Value 3/31/2020 – 6/30/2020**




Source: SCCM/Bloomberg, 6/30/2020.

Our underweight allocation and strong stock selection made ***Financials*** the largest contributor to relative performance for the quarter. The sector underperformed largely due to the uncertain path to recovery for the economy and banks. Truist Financial (+23.5%), Citigroup (+22.7%) and Morgan Stanley (+21.3%) managed to recoup a portion of their 1st quarter declines, although all three banks remain at discounted multiples with attractive yields. Our overweight allocation and strong stock selection within ***Industrials*** contributed to relative performance. The sector benefitted as cyclical stocks within the sector rebounded on optimism for re-openings. Siemens (+40.6%) outperformed as revenue and orders were more resilient than expected and the company is expected to move forward with a value enhancing spin-off of Siemens Energy in the 2nd half of the year. Johnson Controls (+27.6%) announced it will resume its share repurchase program in July, allowing it to continue to deploy cash from the 2019 sale of its Power Solutions business. Raytheon Technologies (+24.5%) outperformed following the completion of its April merger with United Technologies, as its defense business exhibits resilience amidst economic uncertainty. Our overweight allocation and stock selection in ***Consumer Discretionary*** aided performance. Discretionary was the top performing sector for the quarter, as retailers benefitted from consumers stocking up on essential items, a gradual re-opening of nonessential stores, and a surge in e-commerce. Lowe's (+58.0%) handily exceeded consensus revenue and earnings estimates in the 1st quarter as the lockdown spurred home improvement activity. Genuine Parts (+30.3%) saw a sharp increase in online orders in its auto segment while most of its industrial customers resumed operations in May. Our underweight allocation and stock selection within ***Real Estate*** contributed to performance. The sector lagged given uncertainty on re-openings as well as the longer term impact on real estate demand. However, healthcare REITs including Healthpeak (+17.4%) and Welltower (+14.6%) outperformed as occupancy levels at senior housing facilities incrementally improved in May and June from earlier levels. Our overweight allocation and stock selection within ***Information Technology*** benefitted relative performance. Technology stocks continued to benefit from the lockdown, particularly cloud computing applications related to workplace collaboration and online entertainment. Microsoft (+29.4%) continued to outperform as its cloud service, Azure, posted 59% growth year over year.

Our overweight allocation and stock selection within ***Healthcare*** detracted from relative performance. Pharmaceutical stocks underperformed in the quarter partly on concerns surrounding the November elections and potential heightened regulation of drug prices. Pfizer (+1.2%) reported a disappointing clinical trial for its leading drug, Ibrance, for use in treating early-stage breast cancer; however, the drug remains a leader in the treatment of metastatic breast cancer where it continues to experience strong sales growth. Merck (+1.3%) lowered its full-year outlook partly on a decrease in physician-administered drugs, which have been interrupted by Covid-19. Yet the company's leading immuno-oncology drug, Keytruda, saw sales increase 46% year-over-year. Our overweight allocation to ***Consumer Staples*** detracted from relative performance as defensive, lower volatility stocks lagged. Walgreens' (-6.3%) underperformed on commentary that an initial surge in prescription and upfront store sales started to normalize to lower levels in the quarter. Philip Morris International (-2.4%) reported a negative impact on volumes from the worldwide lockdown; however, management noted that its leading reduced risk product, iQOS, continues to see strong volumes and is on track to meet full year targets set at the beginning of 2020. Finally, our stock selection within ***Communication Services*** detracted from relative performance. BCE (+3.7%) has experienced strong resiliency across all of its businesses but underperformed on a rotation into cyclical stocks in the sector. AT&T (+5.5%) is experiencing pressure in its Media and satellite video businesses due to the lockdown and secular consumer shifts. However, the firm launched its new streaming service, HBO Max, in July and its wireless segment should benefit from a more benign pricing environment following the close of the T-Mobile merger with Sprint.

## Portfolio Changes:

The steep sell-off in the quarter created a considerably larger set of opportunities to own high quality companies trading at attractive valuations. We continually evaluate the merits and risks of the positions owned in the portfolio and their ability to weather the current market environment and benefit from an eventual recovery.

***Purchases / Additions***

**Duke Energy (DUK)** was added to the High Dividend Value strategy. Duke is a diversified utility with operations spanning six states in the Southeast and Midwest including the Carolinas, Florida, Ohio, Kentucky and Indiana. The company has a large rate base of regulated assets spanning three segments including Electric Utilities, Gas Utilities and Renewables. Demographic trends remain attractive in the states that Duke serves with population growth and rising incomes necessitating expansion in energy infrastructure at a healthy clip. These trends will fuel a robust capital expansion plan featuring 4-6% growth in the regulated asset base with expected equity returns in excess of 9.5%, at the high-end of the national average. The current plan includes $11B+ in per annum capital spending for the construction of electric, natural gas and renewable generation assets that is expected to at least mid-single digit EPS growth over the next several years. The long-term growth plan is supported by a balanced capital structure with a strong investment-grade credit rating. At purchase, the stock was trading at a forward P/E multiple of 14.8x with a dividend yield of 4.8%. The company has had a long-standing constructive relationship with regulators in the states that it serves and has paid a dividend for 93 years running and has grown its dividend in each of the last 10+ years.

**Morgan Stanley (MS)** was added to the High Dividend Value strategy. Morgan Stanley, a global financial services company, is a top-tier global investment bank, wealth management and asset management firm. Despite the global recession unfolding, we believe the company is managing through the crisis well as asset values have partially recovered and volatility and financing needs should benefit the firm's investment banking business. Morgan Stanley does not have a significant book of commercial and consumer loans, which are likely to see increased losses; its relatively small loan portfolio is comprised of high quality corporates and wealth management loans. In addition, the company has less reliance and expected to be less impacted from low rates and a flat yield curve relative to traditional money-centered banks. The stock trades at an attractive valuation: 8x 2020 EPS, 0.8x book value with a 3.6% dividend yield (33% payout ratio).

The position in Bank of America (BAC) was added to in the quarter.

***Sales / Reductions***

**Wells Fargo (WFC)** was sold from the High Dividend Value strategy. Wells Fargo has been subject to a years-long salesforce investigation which has since extended to many other parts of its organization. While the company has attempted to resolve those issues and revamped its organization to better integrate risk controls and compliance, regulators have yet to sign off on and have maintained onerous asset caps and regulations on the company. In addition, the significant deterioration in the economy and resulting higher loan losses to be realized will be a challenge for the company. Low rates and a flat yield curve will further pressure bank earnings this year.

The positions in ConocoPhillips (COP) and Truist Financial (TFC) were reduced in the quarter.

## Dividend Summary:

In the second quarter of 2020, 5 out of 41 portfolio companies raised their dividend payments with an average increase of +4.9%:

- Chubb (CB) raised its dividend payment by +4.0%
- Johnson and Johnson (JNJ) raised its dividend payment by +6.3%
- Medtronic (MDT) raised its dividend payment by +7.4%
- Travelers (TRV) raised its dividend payment by +3.7%
- Target (TGT) raised its dividend payment by +3.0%

Year-to-date, 20 out of 41 portfolio companies raised their dividends with an average increase of +5.6%.

## Market Outlook:

The equity market rally that began off the March 23rd market lows is one of the strongest in history with the S&P 500 up 36% through the second quarter. While the unfolding Covid-19 pandemic and resulting global economic shut-downs triggered the fastest bear market on record, unprecedented monetary and fiscal stimulus eventually helped to stabilize capital markets. V-shaped improvements in some economic data in addition to record liquidity injections have fueled markets higher. Economic data that have bounced back to prior levels have benefitted from an uplift from rising off of significant lows. Historically, market recoveries have been led by Value (Figure 4); in all of the past fourteen recessions, Value has outperformed the S&P 500 coming out of each downturn (BofA/ML, Covid-19 and the Economy, June 2020). And in this recovery, Energy has been the best performing sector, up 61%, from the March 23rd low through the end of Q2.

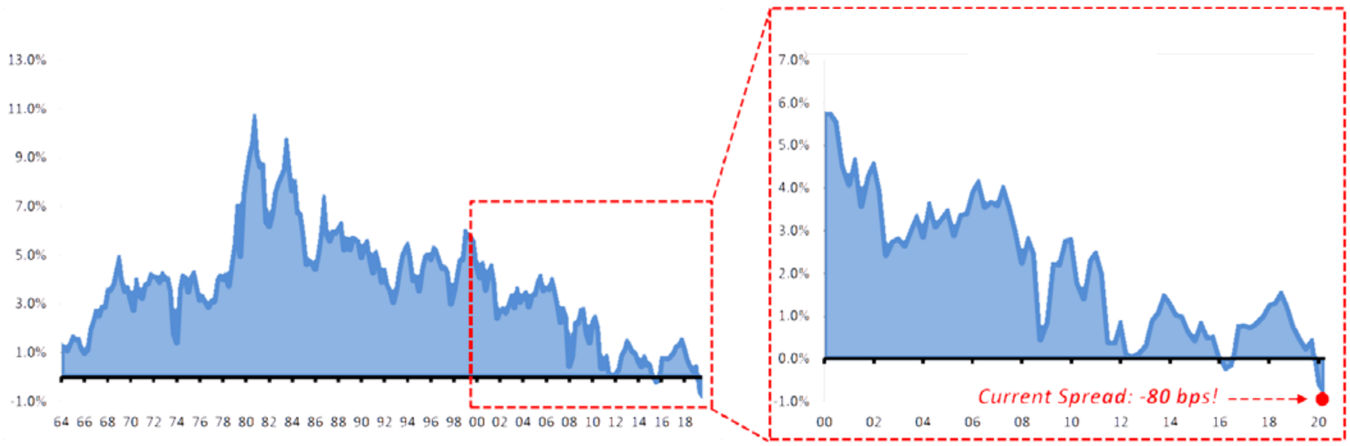
**Figure 4: Relative Performance of Value vs. the S&P 500 After Recessions**

| NBER Peak / Trough dates | | Value vs SPX performance | | | |
|---|---|---|---|---|---|
| Peak | Trough | Start | End (or 12mth) | # Mth | Rel. Perf. vs SPX |
| August 1929 | March 1933 | 05/31/32 | 8/31/1932 | 3 | 78.3% |
| May 1937 | June 1938 | 05/31/40 | 5/31/1941 | >12 | 27.2% |
| February 1945 | October 1945 | 08/31/45 | 11/30/1945 | 3 | 11.1% |
| November 1948 | October 1949 | 03/31/50 | 1/31/1951 | 10 | 29.7% |
| July 1953 | May 1954 | 12/31/53 | 12/31/1954 | >12 | 21.5% |
| August 1957 | April 1958 | 12/31/57 | 12/31/1958 | >12 | 26.1% |
| April 1960 | February 1961 | 06/30/60 | 5/31/1961 | 11 | 9.8% |
| December 1969 | November 1970 | 12/31/69 | 8/31/1970 | 8 | 9.0% |
| November 1973 | March 1975 | 11/30/74 | 11/30/1975 | >12 | 14.7% |
| January 1980 | July 1980 | 11/30/80 | 11/30/1981 | >12 | 28.3% |
| July 1981 | November 1982 | 06/30/83 | 6/30/1984 | >12 | 16.8% |
| July 1990 | March 1991 | 12/31/91 | 6/30/1992 | 6 | 18.1% |
| March 2001 | November 2001 | 10/31/01 | 6/30/2002 | 8 | 10.3% |
| December 2007 | June 2009 | 02/28/09 | 4/30/2010 | 14 | 25.9% |

Source: BofA/ML, Covid-19 and the Economy, 6/30/2020. **Past performance does not guarantee future results.**

The bull case for equities is underpinned by a number of positives. Markets can be driven higher by historically high levels of cash in money market funds (sidelines) and bond flows. While absolute valuations are high – current Price/Earnings, Price/Book, P/E to Growth, EV/Sales, and EV/EBITDA metrics are all above 90th percentile relative to historical levels (Goldman Sachs) – relative valuations are more attractive given the low interest rate environment. The spread between the US 10-year Treasury and the S&P 500 Dividend Yield is the lowest on record and in negative territory.

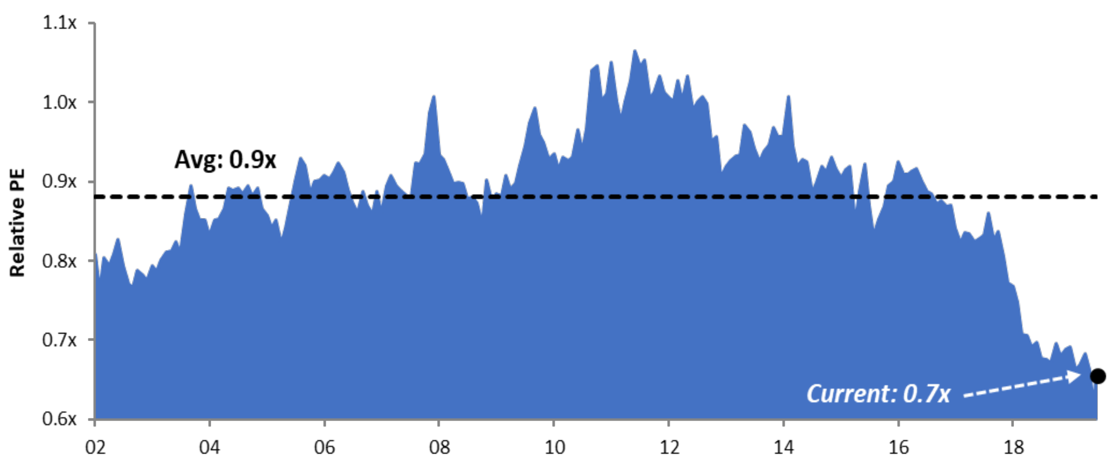
**Figure 5: Spread Between the US 10-Year Treasury Yield and S&P 500 Dividend Yield**




Source: Wolfe Research, Dividend Investing, 6/22/2020.

Within Equities, Low Price/Earnings (Figure 3) and High Dividend Yielding stocks (Figure 6) are trading at deep discounts to the overall market. Figure 6 shows that the valuation of the highest dividend yielding stocks is at their cheapest level in nearly 20 years.

**Figure 6: Highest Dividend Yield Relative P/E to the Market**




Source: Wolfe Research, Dividend Investing, 6/22/2020

While equities can continue to grind higher, risks are now building to the overall market and the most popular stocks in broad indices. World economies face steep uphill battles in their attempt to return to pre-Covid levels as the virus has yet to burn out and there is no certainty around the timeline and effectiveness of vaccines and treatments. The US Presidential Election poses a risk if a Democratic agenda takes hold, likely resulting in higher taxes and increased regulation. In addition, the market has become increasingly concentrated in expensive Technology stocks. Concentration within the S&P 500 with the Top 5 stocks (Microsoft, Apple, Amazon, Google, and Facebook), all technology stocks, is now at near record levels – those stocks now comprise 22% of the index, a level not seen since the 1970's. Meanwhile, these five stocks account for 7% of S&P 500 revenues and 12% of S&P 500 earnings (refer to Figure 7).

**Figure 7: Weight (%) of the Top 5 Stocks in the S&P 500**


Source: Morgan Stanley, 6/30/2020.

Investors often believe current trends will persist – currently, that momentum and Growth could continue to outperform for the foreseeable future. However, history has proven that the largest stocks – either due to sheer size, valuation or other factors – eventually underperform as price to value revert to normalcy.

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.

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