

Alley Company Dividend Portfolio
2018 Q4 Letter

January 18, 2019

Warren Buffett has described short-term stock price fluctuations as driven by “Mr. Market,” an imaginary fellow with incurable emotional problems that cause him to frequently and sometimes wildly change his perception of the value of a business depending on what is going on around him at a given point in time.

True to form for Mr. Market, in 2018 he had some significant mood swings. Early in the year he was ebullient as a new tax reform bill had just passed and the global economy was enjoying a period of synchronized growth. At the end of the year, however, his mood turned gloomy as he fixated on the uncertainty of a trade war, the appropriateness of Federal Reserve (Fed) policy, and a polarizing political climate.

Opportunities for investors are created when near-term volatility causes prices to detach from long-term fundamental value. While heightened volatility in markets may well continue in 2019, long-term investors should look to benefit from Mr. Market’s mood swings.

Despite the macro-oriented clouds overhanging the market, the U.S. economy continues to show evidence of being on solid footing (robust employment market and well-anchored inflation) and corporate profits are currently expected to reach another record in 2019. After the recent pullback, the S&P 500 is now trading at approximately 15x forward earnings, or an earnings yield of 6.4 percent, while the 10-year U.S. Treasury yield is 2.70 percent, an attractive valuation relationship for stocks.

Dividends on a per-share basis for the S&P 500 increased +9.8 percent during 2018. This robust growth was aided by corporate tax reform to some degree, but strong underlying business fundamentals also played a large role. Dividend increases are a signal from corporations about their future business prospects.

Quarterly Performance Update

The Alley Company Dividend Portfolio outperformed the Russell 1000 Value Index in the fourth quarter. For the full year 2018, the portfolio had a strong year of relative performance as well. For the past 3 and 5 year periods, the portfolio has generally experienced an up-capture ratio of approximately 1.00 and a down-capture ratio of approximately 0.80, a favorable reward/risk dynamic.

Top contributors and largest detractors from an individual holdings perspective in the quarter were:

| <u>Top Contributors</u> | <u>Top Detractors</u> |
|--|--|
| Starbucks (SBUX) Procter & Gamble (PG) Merck (MRK) | Apple (AAPL) Broadridge Financial (BR) Lockheed Martin (LMT) |

Top and bottom sectors in the marketplace during the quarter were:

| <u>Top Performing Sectors</u> | <u>Bottom Performing Sectors</u> |
|--|--|
| Utilities (-) Real Estate (-/+) Consumer Staples (+) | Energy (-) Technology (+) Consumer Discretionary (+) |

(+) indicates that the portfolio is overweight this sector and (-) indicates that the portfolio is underweight this sector.

Dividend announcements among Alley Company Dividend Portfolio holdings during the quarter were:

| <u>Company</u> | <u>Dividend Change</u> |
|-------------------------------|-------------------------------|
| Abbott Labs (ABT) | +14% |
| Crown Castle (CCI) | +7% |
| Merck (MRK) | +15% |
| RPM International (RPM) | +9% |
| Six Flags Entertainment (SIX) | +5% |

There were no new holdings added to the portfolio in the quarter, nor were any current holdings eliminated in their entirety. The portfolio continues to hold thirty-four (34) positions and we would expect the portfolio to stay in a fairly narrow range around the current number of holdings for the foreseeable future. In the quarter, position sizes in Accenture (ACN), Broadridge Financial Solutions (BR), Microsoft (MSFT), and Union Pacific (UNP) were trimmed in favor of increased weightings in Crown Castle (CCI), Kimberly Clark (KMB), Merck (MRK), and Six Flags Entertainment (SIX). Portfolio turnover in 2018 was 13 percent.

Alley Company Dividend Portfolio

The investment philosophy of the Alley Company Dividend Portfolio focuses on striking the balance between attractive absolute dividend yield and strong dividend growth underpinned by solid company fundamentals of our portfolio holdings. We employ a bottom-up, research-driven process focused on fundamental analysis of our portfolio holdings.

Alley Company, LLC

Alley Company is a boutique investment management firm that is dedicated to operating a discernible and disciplined investment philosophy and generating superior risk-adjusted investment returns. Alley Company was founded in 1998 and in 2006 established the Alley Company Dividend Portfolio to capitalize on investment opportunities in quality companies with strong dividend-paying cultures.

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