

Alley Company Dividend Portfolio 2020 Q2 Letter

July 15, 2020

As we have learned over the past several months, the challenges presented by a global pandemic are numerous. Along with hundreds of thousands of tragic health outcomes, COVID-19 has also disrupted nearly all aspects of everyday life. The ability to congregate, travel, work, attend school, etc. have all been impacted and our previous “normals” are unlikely to be obtainable until widespread vaccination or natural herd immunity occurs.

Moments of significant disruption and crisis, however, also create opportunities for advancement. If there is a silver lining to this pandemic, it is that individuals and businesses are adapting and developing creative solutions that will likely have a lasting impact well into the future.

In a matter of just a few months, some prominent trends and data points have emerged:

- Zoom, WebEx, and other providers of online collaboration tools have become an efficient alternative to conducting in-person meetings.
- Telemedicine has become an increasingly viable option in which to effectively engage with your doctor and the health care system.
- Google Classroom active users have doubled to more than 100 million, enabling students and teachers to productively engage in remote learning.
- The use of digital wallets and contactless card payments are accelerating, providing safe and effective forms of electronic payment.
- And not surprisingly, internet traffic has increased between 50 and 70 percent in developed nations over the past several months.

Net, the speed at which the world is embracing technology and digital solutions of late is noteworthy. An article by McKinsey Consulting commented, “we have vaulted five years forward in consumer and business digital adoption in a matter of around eight weeks.”¹ Indeed, necessity is the mother of invention, and this is especially true during a pandemic.

As with past technological change, the implications of such events are distinctly positive for economic productivity. Research from Booz & Company indicates that an increase in digitization of ten percent within an economy results in a 0.50 to 0.62 percent gain in per capita gross domestic product (GDP). Importantly, a ten percent increase in digitization also reduces a country’s unemployment rate by 0.84 percent.² And while these statistics are encouraging, perhaps the largest benefit is in improved living

standards. For example, twenty years ago, we just started using hand-held devices primarily for phone calls. Today we use our smartphones to order retail goods, send and receive digital payments, read the news, take pictures, stream media content, and this only covers a portion of the functionality of modern smartphones.

Technological advancement, though, does not happen without collateral damage. Those who are on the wrong side of the digital divide will be more apt to struggle. The past several months have been especially challenging for companies that lack the financial wherewithal or management acumen to make the necessary investments to reach their customers in this digital age. Case in point is that e-commerce spending is actually expected to *grow* by 18 percent in 2020, while traditional brick-and-mortar retail will *decrease* by 14 percent.³ There is no doubt that this shift has been exacerbated by COVID-19, nonetheless it underscores the notion that a business that is embracing digital change is well positioned for the future while those that are not could struggle with financial performance.

Businesses across the economic landscape are tapping the power of digital and stand ready to reap future rewards for their shareholders as a result. Whether it be the quick service restaurant that is moving their clientele towards mobile ordering, or the industrial company whose products are tethered to the internet for real-time analysis, or the medical device company whose implanted devices can now be monitored remotely, the opportunities are numerous. Going digital can mean lower long-term costs, increased brand loyalty, and in some instances, accelerating revenues. At Alley Company, our mission is to understand these trends and seek out quality companies with strong balance sheets and market power that are benefiting and growing stronger as a result. We expect these companies to be able to maintain and grow dividends to shareholders into the future.

Quarterly Performance Update

After strong relative performance in the first quarter of 2020 during a significant down market, the Alley Company Dividend Portfolio was also able to outperform in the second quarter during a snap-back up market. As a result, on a year-to-date basis, the Alley Company Dividend Portfolio has delivered substantial outperformance relative to the Russell 1000 Value Index benchmark.

From an individual holdings perspective, top contributors to and detractors from performance in the portfolio during the second quarter were:

<u>Top Contributors</u>	<u>Top Detractors</u>
Apple (AAPL)	Wells Fargo & Co. (WFC)
Phillips 66 (PSX)	Philip Morris Intl. (PM)
Discover Financial Services (DFS)	NextEra Energy (NEE)

Top and bottom performing sectors in the marketplace during the quarter are displayed in the table below. The performance of the portfolio relative to the Russell 1000 Value Index benefited in the quarter from our sector exposures in Technology (overweight) as well as Financials (underweight). Decisions to adjust weightings in the portfolio are driven by a bottom-up fundamental research process.

Top Performing Sectors	Bottom Performing Sectors
Consumer Discretionary (-) Technology (+) Energy (-)	Utilities (-) Consumer Staples (+) Financials (-)

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

During the second quarter, three new holdings were added to the portfolio: Ameriprise Financial (AMP), Honeywell International (HON), and Snap-On Inc. (SNA).

AMP operates three businesses within financial services, including wealth management, asset management, and insurance. The majority of the company's revenues are driven by wealth management where the Company has developed a successful brand. We believe management has been thoughtful in their return of capital (dividends and buybacks) to shareholders and we expect a similar approach in the future.

In addition to leadership positions within building products and safety technologies, HON has developed an exceptional aerospace franchise serving both commercial and government customers. With a very strong balance sheet, we believe HON is well positioned to manage its business through the economic cycle and has the ability to be opportunistic should attractive bolt-on acquisitions become available.

SNA's tools for the aerospace, automotive, and industrial sectors have a remarkable reputation with technicians that has led to significant brand loyalty in the marketplace. Management has methodically grown the business through the years and the Company has an enviable track record of paying an annual dividend to shareholders since 1939 without interruption or reduction.

During the quarter, the portfolio's holdings in 3M Company (MMM) and Wells Fargo & Co. (WFC) were eliminated. Position sizes in Abbott Laboratories (ABT), Accenture (ACN), Lockheed Martin (LMT), and Microsoft Corp. (MSFT) were trimmed, while Discover Financial Services (DFS) was increased.

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

Company	Dividend Change
Apple (AAPL)	+6%
Medtronic (MDT)	+7%
Pepsico (PEP)	+7%
Procter & Gamble (PG)	+6%
Ameriprise Financial (AMP)	+7%

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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¹ McKinsey Consulting, "The Covid-19 recovery will be digital: A plan for the first 90 days", 05/14/2020.

² Booz & Company, "Digitization and Prosperity", 8/28/2012.

³ E-marketer, "US Ecommerce 2020: Coronavirus Boosts Ecommerce Forecast and Will Accelerate Channel-Shift", 06/08/2020.