

Alley Company Dividend Portfolio 2021 Q3 Letter

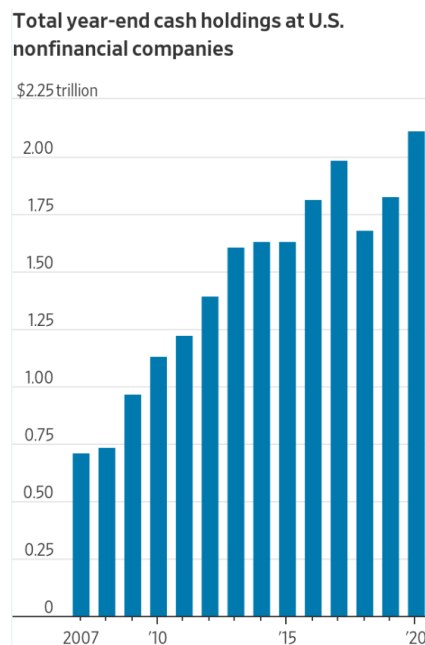
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“Over time, the skill with which a company’s managers allocate capital has an *enormous impact* on the enterprise’s value.”

-Warren Buffett

The best businesses in the world often times have a cash problem. The “problem” rests not in having too little cash, but rather too much! For investors, what the management team does with this excess cash can play an important role in enhancing long-term value creation for shareholders.

Presently, Corporate America is sitting on a record high cash pile of over \$2 trillion¹. Management teams have the opportunity to skillfully allocate this capital via **Acquisitions**, **Buybacks**, **Cap-ex** (i.e., capital expenditures), and **Dividends** – the so-called **A, B, C, Ds** of building value. In this quarter’s letter, we cite individual examples of how successful A, B, C, D activity has rewarded shareholders and how today’s environment of ultra-low interest rates impacts the process.



Source: Moody’s Investors Service

Acquisitions

If a business transaction is well thought out and the price paid is reasonable, significant value can be created for shareholders. Beyond the obvious benefits of accretion to per-share earnings, acquisitions can deliver the strategic benefits of fortifying a company's competitive position and/or diversifying into new markets.

BlackRock's (BLK) purchase of Barclays Global Investors in 2009 for \$15.2 billion is an acquisition success story. The crown jewel of Barclays Global Investors was their nascent iShares ETF business. At that time, iShares ETFs had \$300 billion in assets under management (AUM). Fast forward to the present day and iShares now has over \$3 trillion in AUM and has been a major source of profit growth for BlackRock.

Buybacks

Utilizing excess cash to repurchase or "buyback" company stock can be a significant tool for increasing shareholder value over time. Financial markets can be fickle and investors can temporarily sour on a company's perceived future prospects pushing down the share price to attractive valuation levels. Astute management teams that understand the value of their company can take advantage of these temporary price dislocations by repurchasing shares and lowering shares outstanding. Importantly, the reduction in shares outstanding increases the ownership stake in the company for remaining shareholders.

During the past decade, Apple's (AAPL) management team repurchased over \$300 billion of Company shares at an average price of \$32.75 and reduced shares outstanding by 34 percent. With AAPL currently trading at approximately \$140 a share, this use of excess cash has added considerable value for long-term investors.

Cap-Ex

Capital Expenditures are the necessary cash investments made back into a company to allow it to maintain its competitive position. Management teams can choose to invest the bare minimum back into the business or they can think strategically and invest larger sums to help grow future revenue and profits.

Union Pacific (UNP), which operates railways in the Western half of the U.S., has embraced investing more cash back into the business and its competitive position has been enhanced as a result. Between 2011 and 2020, UNP management spent \$38.5 billion on cap-ex which represented an increase of 60 percent over the previous decade. During this same period, the Company's operating margins improved by 1,500 basis points and earnings advanced by 11 percent annually.

Dividends

Dividends provide shareholders with a tangible/cash return on their invested capital. Once started, dividends are not technically an obligation for a company, but they are mostly viewed as sacrosanct by shareholders and management alike and neither party wants to see them reduced. Quality companies that have durable and growing cash flow can reward shareholders with an attractive dividend that increases over time if the business continues to be operated successfully.

Home Depot's (HD) dividend program for shareholders is a prime example. HD has grown revenue and earnings consistently for many decades as they, along with Lowe's (LOW), have consolidated the home improvement retailing industry. HD started paying a dividend to shareholders thirty-four years ago and has consistently increased it ever since. In 2020, the Company paid out \$6.45 billion in dividends and the trailing five year annual dividend growth rate has been 22 percent, representing a significant enhancement to shareholder return.

The Low Interest-Rate Environment

For corporate borrowers with pristine credit ratings, the cost of capital in today's environment is extremely attractive. Berkshire Hathaway, for example, sold five year, Japanese Yen-denominated bonds in April of this year at an interest rate of 0.17 percent! While most corporate issuers are borrowing at higher levels than this, it underscores that the current interest rate environment can provide additional firepower and flexibility for management teams to find ways to add value for their shareholders.

Our investment philosophy focuses on identifying quality companies that have the "problem" of what to do with excess cash generated by the business. We are mindful that poor decisions on the capital allocation front can damage shareholder value. As a result, we seek out companies that have demonstrated track records of successfully allocating capital and we look forward to future skillful A, B, C, D activity that can enhance shareholder value over time.

Quarterly Performance Update

During the third quarter of 2021, the Alley Company Dividend Portfolio outperformed the Russell 1000 Value Index by a modest amount.

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

<u>Top Contributors</u>	<u>Top Detractors</u>
Accenture (ACN)	Phillips 66 (PSX)
NextEra Energy (NEE)	RPM International (RPM)
Ameriprise Financial (AMP)	Crown Castle (CCI)

Top and bottom performing sectors in the marketplace during the quarter are displayed in the table below.

<u>Top Performing Sectors</u>	<u>Bottom Performing Sectors</u>
Financials (+)	Industrials (+)
Utilities (-)	Materials (-)
Communications (-)	Energy (+)

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

During the third quarter, Discover Financial Services (DFS) was trimmed back in favor of adding to Philip Morris International (PM).

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

<u>Company</u>	<u>Dividend Change</u>
Accenture (ACN)	+10%
Altria (MO)	+5%
Discover Financial (DFS)	+14%
Duke Energy (DUK)	+2%
Honeywell (HON)	+5%
Illinois Tool Works (ITW)	+7%
JPMorgan Chase (JPM)	+11%
Lockheed Martin (LMT)	+8%
Microsoft (MSFT)	+11%
Philip Morris International (PM)	+4%
RPM International (RPM)	+5%
Starbucks (SBUX)	+9%
US Bancorp (USB)	+10%
Verizon (VZ)	+2%

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.

The Alley Company Quarterly discusses general developments, financial events in the news and investment principles. It is provided for information purposes only. It does not provide investment advice and is not an offer to sell a security or a solicitation of an offer, or a recommendation, to buy a security. The statements and opinions contained herein are solely those of Alley Company LLC and are based upon sources and data believed to be accurate and reliable. The Russell 1000 Value Index measures the performance of large- and mid-capitalization value sectors of the U.S. equity market. Additional information regarding Alley Company, LLC can be found by accessing the SEC's website at adviserinfo.sec.gov.

¹ Per Moody's Investors Service, US based non-financial companies' cash holdings totaled \$2.15 trillion at year-end 2020, up 32% from 2019.