ThomasPartners
INVESTMENT MANAGEMENT®

Quarterly Observations

October 1, 2017

Big Trends

Sage advice...

Geoff Yang and his firm Redpoint Ventures stand among the most successful venture investors of the last two decades (funded Netflix, among others). When asked recently to reveal the keys to making good investments, he said, "You have to get *in front of* big trends."

It's an interesting comment. He could have said, as so many do, "buy cheap" or "buy the rumor and sell the news." He could have channeled Buffett, advising investors to buy "when others are selling" and vice versa. He could have advised to buy stocks "hiding under unturned stones."

But such approaches are mostly short-term in nature and generally seek to prey only on the volatility of the markets or on the emotional volatility of the market's players. They are very hard to successfully execute in actual practice, as well.

Getting in front of big trends, however, does not require unique market-timing skills; nor does it prey on the presumed valuation mistakes of the markets or of other investors. Getting in front of big trends allows investors to *profit from the obvious*; to profit without having to "game" the system or to be smarter than all the other "gamers."

Our big trend...

Early in its history, ThomasPartners identified one very big and very obvious trend: *aging demographics*. Specifically, in the U.S., the massively-large Baby Boom generation would start to retire in 2009 or so and would continue to retire for another two decades. As a consequence, the sheer number of citizens over 65 would steadily increase.

But, increasing numbers of senior citizens does not tell the whole story. The so-called X-generation that followed the Boomers is much smaller in absolute numbers[2]; so, those over 65 would soon become an increasingly larger portion of the population, as well.

Given these statistics, it seemed obvious to us then and still obvious today that the characteristic spending, saving, and investment preferences of those over 65 would exert profound changes in the U.S. economy and in the U.S. investment markets...for decades to come.

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As of April 1, 2018, ThomasPartners Inc. was merged into, and became a division of, Charles Schwab Investment Advisory, Inc.

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Did you know?

For many U.S. investors holding securities with broad international equity exposure, the first half of 2017 has generally brought better total returns than their domestic counterparts. While better returns are always welcome, investors should be mindful that currency movements can contribute to, or subtract from, international investing returns.

An example of how currency movement affects the performance of an investment in an investor's home currency can be gleaned from analyzing the MSCI EAFE Index. For US dollar investors, the MSCI EAFE Index is up 20.47% YTD through September of 2017; however, when the benefits of a weakening dollar are removed, the returns fall to 13.77% and the outperformance versus the S&P 500 during the same period is completely eliminated.[1]

ThomasPartners does invest in international stocks; however, we recognize for those investors seeking a predictable and growing income stream, currency movement becomes a risk factor that can just as likely be a headwind as a tailwind to meeting one's investment objectives. Therefore, these risks must be considered when constructing a portfolio that aims to provide monthly income and income growth, with competitive total returns over time.

Economic growth impacts...

Almost daily, a new article or new research study predicting the impact of the aging Boomers appears in the general press and in the business media outlets, as well.

Most of the conclusions are fairly obvious: older people spend less than they did when younger. Their kids are long gone from the house, educations have been paid for, housing needs are smaller, they drive less, etc.

Since personal consumption represents close to 70% of nominal GDP, one economic consequence of a growing over-65 population in absolute and relative terms should, therefore, be chronically-low rates of nominal GDP growth. Slow growth in the labor force as Boomers retire should also inhibit economic growth.

Among the generally favorable economic consequences of aging demographics is that lesser demand growth (for labor, in particular) can more easily be satisfied by existing or slow-growing levels of supply; hence, low inflation and low interest rates should accompany slow GDP growth.

Such a favorable demand/supply balance reduces one of the principal causes of recessions; that is, economic overheating. If aging demographics reduces the risk of recession, it could also inspire higher investment valuation metrics for stocks, bonds, and real estate.

If all this seems familiar, it should. While the aging Boomers have moved near and into retirement since 2009, GDP growth (nominal and real) has, as expected, been slow and inflation and interest rates have, as expected, been historically low too.

Also as expected, over that period, there has not even been a hint of a recession. Consequently, we believe, stocks, bonds, and real estate have consistently all enjoyed high valuation metrics and good total returns...as would have been expected by observing the impacts of aging demographics.

Investor impacts...

The very favorable environment for stock market valuations—caused, in part, by the aging demographics trend—might normally have inspired investors to jump into the stock market with both feet, much as they did when valuations were similarly high in the 1980s–1990s.

But, in general, that has not happened. Average allocations to stocks in individuals' portfolios are not currently elevated and cash reserves are generally higher. This trend toward caution could also be a consequence of aging demographics. The Boomer generation was in its mid-30s to mid-50s—when risk-taking is more likely—during the last stock market boom. Now they are in their 60s, an age that generally inspires more caution, not less.

In addition, as investors age—particularly as they approach or are in retirement—they tend to place a higher value on dependable sources of investment return (to fund retirement spending); especially on dividends and interest. We think Boomer investors who might have invested more of their funds in high-growth, non-dividend-paying stocks in the 1980s and 1990s are now investing more of their funds in bonds and/or in dividend-paying stocks.

The obvious proliferation of dividend-oriented mutual funds and ETFs over the last 8+ years speaks to the trend of investors seeking more dividends, not less.

Market impacts...

Growth in the demand for dividends can be met in several ways. More companies can begin paying dividends and, of the companies that already pay dividends, dividend payout ratios can be increased. With slower general economic growth rates, companies should have more idle cash available for dividend payouts, as well.

But what if the absolute number of shares of dividend-paying stocks available to be purchased in the general markets were to decrease? Investors with limited alternative sources of income in the private markets would be forced to pay up for the public company shares that pay dividends.

This circumstance—increasing demand facing declining supply—is not an idle fear. According to Jason Zweig of the Wall Street Journal, "There were 7,355 U.S. stocks in November 1997, according to the Center for Research in Security Prices at the University of Chicago's Booth School of Business. Nowadays, there are fewer than 3,600."[3]

That's a near-50% decrease caused by share buybacks, mergers, and acquisitions. It's a trend that shows no sign of reversal. It's a trend, however, that bodes well for investors currently owning dividend-paying stocks.

If excess demand over supply of dividend-paying stocks causes the share prices of dividend-paying stocks to perform well, those investors holding dividend-paying shares today should enjoy good capital appreciation in the future without loss of their current dividend income streams.

Investors still waiting for the full impact of aging demographics or those saying they'll wait to buy dividend-payers until they actually retire, however, run the risk of watching the demographic wave pass them by, hoping to catch up later, but finding the share prices of dividend-payers much higher than they are today.

Our approach...

The implications and impacts of aging demographics have had and will have profound influence on ThomasPartners strategies, stock selection, and portfolio structures.

An expectation of slow and steady general economic growth (caused, in part, by aging demographics) inspires us to choose primarily among the common stocks of larger, well-established companies with well-diversified sources of revenues and earnings. Such "quality" characteristics are defining objectives for us; consistent cash flow generation and growth are the principal measurement standards.

The growing demand for steady sources of investment income caused by aging demographics should benefit the share prices of dividend-paying and dividend-growing stocks for years to come; especially if the supply of them shrinks. As such, we choose individual stocks only from the universe of stocks with the capacity and propensity to pay and grow their dividends.

But, the growing demand for steady investment income among retiring investors cannot be fully satisfied by merely owning dividend-paying stocks or by owning only dividend-oriented mutual funds and ETFs.

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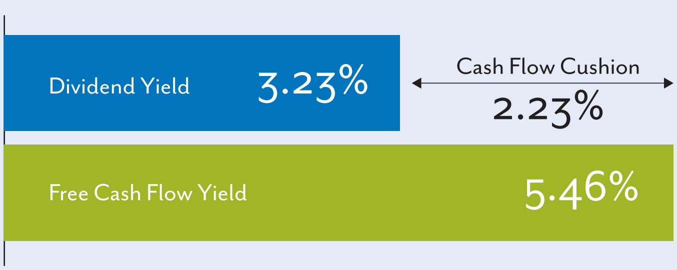
Research Insights

Measuring a Company's Capacity & Propensity to Pay and Grow It's Dividend

ThomasPartners' equity research process aligns with our three fundamental objectives of income, income growth, and total returns over time. These objectives are consistent with the needs of the growing retirement population.

Central to achieving these objectives is our assessment of a company's *capacity* to fund its current dividend payment and grow that dividend in the future. We utilize a combination of quantitative and qualitative analyses to make this determination with a key output being a proprietary estimate of a company's forward free cash flow yield (cash from operations less capital expenditures divided by its market capitalization). Free cash flow yield is a metric that, when combined with other analyses, demonstrates a company's cash-generating capacity to fund its dividend. Some industries (financials, for example) don't lend themselves to this type of analysis and thus, alternative metrics may be used to determine dividend capacity. As of this writing, the average stock in our coverage list generates an estimated free cash flow yield of 5.46% compared to an average dividend yield of 3.23%.* The difference between these two numbers, 2.23%, represents the cash flow cushion that covers the current dividend payout and provides the capital to potentially increase dividends per share in the future.



The amount of cushion we require for any given company depends on a number of factors. The cyclicality and competitive intensity of the industry in which it operates, the overall quality of a business, the condition of its balance sheet, growth rates, and volatility of cash flows all contribute to the discussion.

We also analyze a company's *propensity* to pay dividends. This is admittedly a "softer" exercise but we utilize a variety of sources to ascertain how important a dividend track record is to the company's senior management team and board of directors. Long histories of annual dividend increases like current portfolio holdings, Procter & Gamble (63 consecutive years) and Genuine Parts (60 years), send an important signal as to how ingrained that dividend history is to the corporate culture. We also examine company filings and communications to determine how companies are allocating their capital. If they aspire to dramatically expand capital expenditures (plant and equipment), make large scale acquisitions, or de-lever an overleveraged balance sheet, we may not see that cash flow returned to us in the form of dividend increases.

When combining both of these analytical exercises, we are confident that our portfolios can maintain its current dividend payout, consistent with our first objective of monthly income, and continue to grow its aggregate income in the future, supporting our second objective of income growth. Given the low level of interest rates in both the U.S. and abroad, equities are being asked to play a greater role in generating income for those who are retired or are looking to live off of their asset base. Constructing a portfolio of dividend-growing stocks will help satisfy this need as long as aggregate portfolio income can be maintained and grown over time.

*Proprietary estimates are from ThomasPartners' Research as of 9/25/17.
Source for underlying data: Bloomberg & FactSet.

To meet aging investors' needs for steady and growing *streams* of dividend income, portfolios have to be structured and managed to that objective. This is an important distinction of ThomasPartners approach; we build and manage client portfolios to enjoy consistent and steadily-growing dividend income streams from their portfolios.

Thank you…

Thank you for your support and your confidence in ThomasPartners. It inspires our continuing commitment to executing portfolio strategies that we believe best meet the circumstances and challenges of the present and the future while maintaining a consistent dedication to meeting the specific present and future investment needs of our clients.

Dividend Increases

10 U. S.-based companies in the ThomasPartners portfolio increased their cash dividends payments in the third quarter of 2017.

Declared increases:

Company	Ticker	Increase Declaration Date	Annual Dividend	Percent Increase
Lockheed Martin Corp	LMT	9/28/2017	$8.00	**9.89%**
Texas Instruments Inc.	TXN	9/21/2017	$ 2.48	**24.00%**
Microsoft Corp	MSFT	9/19/2017	$ 1.68	**7.69%**
JP Morgan Chase & Co.	JPM	9/19/2017	$ 2.24	**12.00%**
Philip Morris International	PM	9/13/2017	$ 4.28	**2.88%**
Verizon Communications Inc.	VZ	9/7/2017	$ 2.36	**2.16%**
Wells Fargo & Co.	WFC	7/25/2017	$ 1.56	**2.63%**
BB&T Corp	BBT	7/25/2017	$ 1.32	**10.00%**
PPG Industries Inc.	PPG	7/20/2017	$ 1.80	**12.50%**
Occidental Petroleum Corp	OXY	7/13/2017	$ 3.08	**1.32%**

Important Disclosures:

[1] MSCI EAFE Index and MSCI EAFE Local Index performance data sourced from Bloomberg. MSCI EAFE Index is a dollar denominated index that covers developed countries in Europe, Australasia, Israel, and the Far East. MSCI EAFE Local Index measures the returns of the MSCI EAFE Index without currency effects.

[2] Fry, Richard. "Millennials overtake Baby Boomers as America's largest generation." Pew Research Center, 25 Apr. 2016, www.pewresearch.org/fact-tank/2016/04/25/millennials-overtake-baby-boomers/. Accessed 2 Oct. 2017.

[3] Zweig, Jason. "Stock Picking Is Dying Because There Are No More Stocks to Pick." The Wall Street Journal, Dow Jones & Company, 23 June 2017, www.wsj.com/articles/stock-picking-is-dying-because-there-are-no-more-stocks-to-pick-1498240513.

Past performance is no guarantee of future results; the value of investments and the income derived from them can go down as well as up. Future returns and the achievement of stated goals are not guaranteed, and a loss of principal may occur. All expressions of opinion are subject to change without notice in reaction to shifting market conditions. Our investment strategy seeks to provide dividend income every month, dividend income growth every year and competitive total returns over time. The information provided herein is for general information purposes only and should not be considered an individualized recommendation or solicitation to purchase or sell certain securities or personalized investment advice. Indexes are unmanaged and cannot be invested in directly. Data contained herein from third-party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed.

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