Berkshire
DIVIDEND STRATEGY

Berkshire Asset Management
46 Public Square, Suite 700
Wilkes-Barre, PA 18701
570.825.2600

Dividend Growth Commentary
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It’s Still a Wonderful Life

The recent banking crisis at Silicon Valley Bank and other institutions brings to mind a quote from *George Bailey in the movie "It's a Wonderful Life":*

"You're thinking of this place all wrong. As if I had the money back in a safe. The money's not here. Your money's in Joe's house... right next to yours. And in the Kennedy house, and Mrs. Macklin's house, and a hundred others."

As we enter the second quarter of 2023, there is much to discuss regarding the current state of banking and its impact on the market. The quote highlights the nature of the banking system itself. People's money is not physically held in the bank, but rather spread out across various assets and investments. The recent banking crisis started with troubles at Silicon Valley Bank, but the panic spread industry-wide, sending stock and bond markets into a tailspin.

While the panic at Bailey Building and Loan was caused by thievery from the dastardly Mr. Potter, today's modern-day version is not so modern. When banks take in deposits, they can make loans or buy bonds. The loans are usually secured by collateral and the borrower makes regular annuity-like payments. The bank can then add on ancillary services like wealth management, trust services and other service fees. There’s an old banker adage that sums up the business: “Borrow at 3 lend at 6 and tee-off at 2! Banking can and should be a simple business with good economics – if ran correctly.

But, during the pandemic, interest rates dropped to record lows. Instead of making loans or investing in very short bonds, some banks like Silicon Valley chose to borrow at short-term rates (i.e., take in deposits) and invest in longer-term mainly U.S. treasuries or mortgages, hoping to earn an attractive spread – a process known as "riding the yield curve." It’s a practice as old as banking itself.

However, when the Federal Reserve started to raise interest rates to fight off inflation, the value of these bonds declined and the cost of the deposits rose. While most of these bonds were insured by direct obligations of the U.S., their prices were down in value. The paper losses were large enough that investors got spooked, creating a run at Silicon Valley and others. There was not enough liquidity or equity to cover the shortfall. There wasn’t enough money wasn’t in the safe as George Bailey correctly pointed out.

Many investors began asking, "Is this 2008 all over again?" We believe the nature of this problem is dramatically different and manageable.

In 2008, the entire banking system was invested in a sea of toxic loans – loans that were not going to be repaid, and the collateral backing them was worth far less than the loan amount. Banks had far less capital to absorb the losses than today. Today's problem is more about near term liquidity than solvency. The bonds on the bank balance sheets are still paying, and the losses have more to do with bank accounting convention rather than permanent losses. Much can be fixed through policy measures such as increasing swap lines, new credit facilities, backstops, and mergers. The market reaction to the crisis is fixing core problems--bond yields falling and credit conditions tightening, which is helping inflation which is good for

the bonds in question. Unlike 2008, the financial system has much more capital to absorb losses. We believe, the system is far more sound today.

We believe problems system-wide are more emotional than fundamental, and if investors could calm down, many of the problems may go away.

Performance of Stock and Bond Markets:

While we normally talk about the stock market, the craziness in the bond market is worth discussing. The bond market has been experiencing significant fluctuations in yields, with the yield curve remaining inverted, which can indicate a potential recession. This level of volatility has been unprecedented lately and has been driven by a combination of factors, including concerns about rising inflation, uncertainty about the Federal Reserve's monetary policy, and geopolitical tensions.

Despite all the volatility, equity markets rallied late in the quarter, and investors experienced strong performance from major U.S. stock market indices such as the S&P 500 and the Nasdaq. Our Dividend Growth Strategy (“Strategy”) tracks more closely over time to the value side. It's worth noting that the S&P 500's gains have been highly concentrated in just a few stocks, potentially masking how the average stock is performing. As of the end of the first quarter of 2023, just five stocks – Apple, Microsoft, Amazon, Facebook, and Alphabet (Google) – accounted for over 25% of the S&P 500's total market capitalization and a whopping 40% of the Nasdaq's.

These stocks have been the driving force behind the S&P's gains, with each of them posting double-digit gains recently. However, the average stock in the S&P 500 has not performed nearly as well. In fact, as of the end of March 2023, over 40% of the stocks in the S&P 500 were actually in negative territory for the year.

Final Tally:

- Nasdaq Composite: +17.05%
- S&P 500: +7.46%
- Russell Large Value: 0.99%
- Barclays Intermediate Bond Index: 2.33%

Name	Total Return Q1 2023	Total Contribution to Index Return
SPDR S&P 500 ETF TRUST (SPY US)	7.46%	
APPLE INC	27.11%	1.61%
MICROSOFT CORP	20.52%	1.12%
NVIDIA CORP	90.10%	1.01%
TESLA INC	68.42%	0.68%
META PLATFORMS-A	76.12%	0.64%
AMAZON.COM INC	22.96%	0.54%
ALPHABET INC-A	17.57%	0.29%
ALPHABET INC-C	17.21%	0.26%
SALESFORCE INC	50.68%	0.21%
ADVANCED MICRO DEVICES INC	51.32%	0.17%
BROADCOM INC	15.57%	0.11%

Add it up. If you did not own these names but owned the other 490, your return was essentially 0%, not 7.46%. That's a narrow group of stocks and doesn't do a good job at describing what's happening to the average stock that would reside in a typical portfolio. Few if any of those pay a meaningful dividend, not to mention many of their valuations appear stretched.

Dividend Drought?

Companies that have the ability to raise their dividends are a major theme in our strategy today. Many companies are being overly conservative with their dividend policy due to uncertainty about the future. However, we believe that this is a short-term issue and that companies will gradually increase their dividends as the market stabilizes.

Concluding Remarks

Despite all the turmoil, we would like to remind investors that historically the U.S. stock market has been incredibly resilient, and staying the course or adding additional assets to the market may be beneficial in the long run. Panic selling is rarely a good idea, and we believe that the current situation will subside with time. Over time the effects of compounding stock prices and dividends can be dramatic, but it takes time and the ability to endure volatility like we've had lately. And yes, this even goes for banks that put all of us through the occasional scare from time to time. So, yes it's STILL a wonderful life.

Thank you for your continued trust and support, and we look forward to updating you in the next quarter.

Contact Berkshire:
Gerard Mihalick, CFA, Portfolio Manager
gmihalick@berkshiream.com or (570) 825-2600

Jason Reilly, CFP®, Partner, Distribution
jason@berkshiream.com or (570) 825-2600

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