

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Wide Moat Linked to Ability to Sustain Dividends Over Time



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SECTOR — GENERAL INVESTING

TWST: Let's start with a snapshot of Fort Washington, your overall business and overall approach to investment and asset management.

Mr. Kummer: Fort Washington is a wholly owned subsidiary of Western & Southern Financial Group, and we've been a registered investment adviser since 1990. We manage roughly \$72 billion in assets as of year end for a diverse set of clients and valued partners through a wide range of investment solutions across the spectrum — private and public, equity and fixed income.

As a firm, we employ a consistent approach to asset management, with tenured and cohesive teams really focused on long-term investment results. Key to our approach is our steadfast focus on managing risk for our clients with a goal of generating top quartile returns.

TWST: You're part of the team that manages the Dividend Equity strategy, the Touchstone Dividend Equity mutual fund (TQCYX), and also the actively managed Touchstone Dividend Select ETF (DVND). What is the underlying philosophy and strategy for those investment vehicles?

Mr. Kummer: The overall objective for these funds is to generate a high level of income and income growth without sacrificing broad market exposure and capital appreciation. To achieve this, we built and designed our investment strategy to focus on elements supported by theory and evidence, and there are really four key ideas included there.

First, we believe dividend-paying stocks outperform over time. Second, we believe companies with high barriers to entry

grow dividends at a higher rate. Third, the highest dividend yielding stocks often have unintentional exposures. And fourth, risk management is the foundation for investment success.

These four ideas — and again, the theory, the rationale is there, the evidence supports it — drive the overall process and portfolio construction of our strategy. We will get a little bit deeper into each of these as we go.

TWST: Yes. So, there are numerous dividend-oriented strategies and funds out there, but exactly what they focus on in terms of the dividend can differ. What specifically is your focus?

Mr. Kummer: This is a great question. We take a balanced approach. When we built this strategy, we found a lot of different risk and return characteristics for the two different approaches, whether just focusing on yield or just focusing on income growth. We believe the optimal approach of balancing the two really reduces investment risk in the portfolio.

As I mentioned, if you focus a little bit too much on yield, you're subject to potentially unintended sector exposures and potentially dividend cuts. But if you focus too much on just dividend growth, you might end up with a portfolio that actually yields less than the overall market, and you might not be getting all the benefits of investing in a dividend fund.

And so, we truly believe by balancing both of those, focusing on above-average yield and above-average growth, we can create a more consistent risk and return profile for investors.

TWST: Is there anything else you would point out in terms of how you might differ from other dividend strategies?

Mr. Kummer: Yes, we think our approach to portfolio construction and risk management differentiates us, and there are three key differentiators here. First, as it comes to risk management, we really seek to avoid the highest-dividend-yielding stocks, while also maintaining sector neutrality to the broad market.

If you look back at the 100 highest-yielding stocks in the S&P 500 in 2020, 30 of them cut their dividend yield. But if you look at the next 100, only eight cut it.

You also have potentially unintended sector exposures. Again, if you look at the highest yielding names in the S&P 500, the top 80, you end up with 40% in real estate, utilities and energy. If you look at the broader market, it's only 10%. Add financials, you have 60% portfolio concentration.

Sector exposures can add undue risk when you're chasing after yield, so we try to maintain sector neutrality compared to the broader market.

The second key differentiator is we drive decision-making down to our sector-focused analysts, who essentially operate as sector portfolio managers. We're really trying to drive and increase accountability and engagement at the analyst level, rather than having portfolio managers having all the decision-making at the end of the day.

And lastly, the third key differentiator is we link dividend capacity with barriers to entry. We believe this is a unique forward-looking assessment of a company's dividend, compared to many strategies that are focused more on trailing metrics such as payout ratios or annual increases. Going back to 2020 again, during the coronavirus pandemic, only seven wide-moat companies cut their dividend, while 33 no-moat companies cut their dividend.

“More specifically, we’re looking for excess returns on capital, a company’s ability to generate returns above and beyond their cost of capital. This excess profit can then be reinvested in the business for future value creation, or distributed to shareholders through the form of reliable growing dividends.”

TWST: What other key elements would you point out in terms of your stock selection, portfolio construction, and ongoing portfolio management?

Mr. Kummer: Security selection, that's key to the strategy. We look for high quality companies with four distinct characteristics. First, sustainable competitive advantages; second, high returns on capital; third, reliable and growing dividends; and fourth, reasonable valuations.

Briefly, the first, sustainable competitive advantage, is really companies with barriers to entry — structural features that help companies sustain excess profits over a long period of time. Examples are supply barriers, demand barriers, economies of scale, and government barriers.

Then we're looking for high returns on capital. More specifically, we're looking for excess returns on capital, a

company's ability to generate returns above and beyond their cost of capital. This excess profit can then be reinvested in the business for future value creation, or distributed to shareholders through the form of reliable growing dividends.

And that gets us to the reliable and growing dividends — that's vital to a successful dividend strategy. We assess not only the historical track record, but their ability to grow and pay dividends in the future.

1-Year Daily Stanley Black & Decker, Inc.



Chart provided by www.BigCharts.com

And then lastly, reasonable valuations. As we all know, equity valuations can be very sensitive to their inputs. Really what we're looking for is trying to avoid extreme valuations. One of my favorite quotes from Warren Buffett really summarizes our approach to valuation. He said, "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

To summarize, we're looking for high quality companies with sustainable competitive advantages and high returns on capital that should pay reliable, growing dividends at reasonable valuations.

TWST: Could you tell us about a few favorite investment ideas? What do you like about them and how do they meet those criteria?

Mr. Kummer: Over the past year we've added two names to the portfolio that have a pretty similar investment theme. These two names are **Stanley Black & Decker** (NYSE:SWK) and **Fortune Brands** (NYSE:FBIN). Stanley Black & Decker, maker of DeWalt, Craftsman, Black+Decker, and **Fortune Brands** with Moen in plumbing and Master Lock in security. The theme behind these two? These are both industrial products companies that have been impacted by the housing

market slowdown and weakening in consumer demand over the last year, but despite these short-term headwinds, long-term prospects for both companies remain favorable.

I touched on the four key elements of our stock selection. Both companies have barriers to entry through the form of customer demand, where they enjoy pricing power due to their products that have high switching costs.

Both companies have long operating histories of generating above-average and consistent excess returns on capital, with both having products that are market share leaders in their respective segments.

“That being said, there are benefits to dividends versus bond coupons, and the fact that dividends grow with inflation while coupons don’t. If you look at our dividend strategy, the income has continued to grow over these past few years, where if you bought a fixed-income bond you’re receiving that same amount of nominal income.”

And when it comes to their dividend, both have generated above-average yields, and both have grown their dividend annually for the past 10 years. In the case of **Stanley Black & Decker**, they’ve increased their dividend annually for 55 years in a row now.

And then valuation, both names were priced with the assumption that this unfavorable near-term environment would last forever, which is highly unlikely. We’ll get past the current economic downturn that we’re experiencing here, and so, when and should earnings normalize over the coming years, both of these names have meaningful upside.

So both names have strong barriers to entry, are market leaders in their respective segments, have high excess returns on capital, above-average yields with strong dividend growth, and favorable valuations. They really fit the mold of what we’re trying to do within the strategy.

TWST: Where did you find your best performers last year, and are you expecting that to be similar this year, or do you find you’re changing focus at all?

Mr. Kummer: Last year was a good year for dividend strategies, and we performed well relative, as well. The overall biggest theme really driving returns was outperformance of dividend-paying names and defensive stocks, and that was very much welcome following several years of underperformance by above-average-yielding stocks. But it was really punctuated by our strong security selection and positioning within the portfolio.

At the sector level, energy and health care were our best performing sectors, whereas real estate and technology were the worst performing. We benefited from this because we were increasing energy and health care toward the end of 2021 and actually reducing tech, so that shift in that positioning going into 2022 was beneficial for our portfolio.

At the security level, a key driver of returns was we were overweight defense companies going into 2022. **Lockheed Martin** (NYSE:LMT) and **Raytheon Technologies** (NYSE:RTX) were two outperformers during 2022. We increased these names toward the end of 2021 and they were top holdings in the portfolio entering 2022. Both names fit our style perfectly: market leaders with barriers to entry in their space, high profitability, and high-quality dividends with favorable valuations. These names outperformed during the year following the Russian invasion of Ukraine and the renewed focus on defense spending.

The overall theme of dividend stocks doing well influenced returns, but then our positioning heading into the year really emphasized that and allowed for even further outperformance due to our sector positioning and security selection.

1-Year Daily Chart of Raytheon Technologies Corp.



Chart provided by www.BigCharts.com

TWST: In the macro landscape and potential impacts on the broader investment market, what are you most paying attention to these days?

Mr. Kummer: The primary question today is, are we going to go into a recession or not? At this point, the economic data is key. We really need inflation to continue to decline so the Fed stops the tightening cycle, which should hopefully lead to an easing in financial conditions. In order to keep inflation trending downward, the labor market probably needs to soften a bit, and that has yet to be seen. So we’ll keep our eye on jobs data.

The positive here is the consumer has been extremely resilient up to this point, but depleted savings and job cuts could

lead to a broader slowdown in the economy and ultimately weigh on company earnings and valuations.

So the economic data, inflation continuing to roll over, jobs weak or softening a little bit — that's what we're watching, because that's what's going to influence what the Fed does, and that'll ultimately influence financial conditions, which, in part, will influence equity returns and earnings within the market.

TWST: Any further thoughts on the Fed's rate increases, especially how that affected the bond market last year and how that has sent some investors looking elsewhere for yield?

Mr. Kummer: I'll address that last part first. In regards to yield, yield is plentiful today. The pain the bond market experienced last year has resulted in the highest fixed-income yields in over a decade. The yield discussion that investors were having a year ago is drastically different today. We don't really see that stretch or that search for yield right now, because there is opportunity for yield across the different asset classes.

That being said, there are benefits to dividends versus bond coupons, and the fact that dividends grow with inflation while coupons don't. If you look at our dividend strategy, the income has continued to grow over these past few years, where if you bought a fixed-income bond you're receiving that same amount of nominal income. So that continues to favor dividend strategies over fixed income.

And then you also get potential for capital appreciation within dividend strategies compared to the bond market. If you take a balanced approach like ours of higher yield, higher dividend growth, with a keen focus on risk management, over the long run it will reward investors.

With regards to the Fed, the Fed should be data dependent going forward. At the time of this interview, the market expects two more 25-basis-point hikes. I think that's aligned with the Fed, and we think that's reasonable. Now, if the inflation data over the next two months comes out above expectations, there could be a case that the Fed might hike another time, but right now I think two more 25 basis point hikes is reasonable, and we're in line with that.

TWST: Do you want to share some final thoughts on your outlook for the rest of the year and on why a focus on dividends is so important?

Mr. Kummer: When it comes to our outlook, it's a tough one, and it's the key conversation happening with all investors today. But our base case is we do think the Fed will be able to maneuver a soft landing and that the U.S. can avoid a severe recession.

Like I said, recent data is encouraging, and there's reason to believe inflation can continue to decelerate throughout the year. And although financial markets, stocks and bonds, will likely remain volatile throughout the year, ultimately we expect positive returns for most asset classes, especially as the economy heads toward a more normalized environment in 2024.

I think because of all this uncertainty in the market, in the economy, dividend strategies will continue to reward investors. You look at 2022 and dividend strategies outperformed by a wide margin. If you're looking at a dividend strategy focused on high-quality companies, it should be less volatile than the overall market, and they should continue to grow and pay out their dividends, which in the face of persistent inflation today, you want income that's going to rise with inflation compared to most other asset classes where it's more nominal yield.

Dividend strategies, after having a tough couple years with value and dividend underperforming, we think with the higher interest rates and the cheap money of low rates behind us, that should favor these higher-quality, more value-oriented dividend names going forward.

TWST: Thank you. (MN)

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