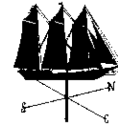
DAVID WENDELL ASSOCIATES, INC.
INVESTMENT COUNSEL



P.O. Box 21980
325 Corporate Drive
Portsmouth, N.H. 03802
(603) 427-0200
www.davidwendell.com

Fourth Quarter, 2017

An Underappreciated Virtue: Growth Stock Dividends

*"Do you know the only thing that gives me pleasure?
It's to see my dividends coming in."*

- John D. Rockefeller

While our team does have a great deal of experience, none of us ever met John D. Rockefeller. And while his business practices were considered "hard-nosed" and have been the subject of debate for a very long time, we believe it is uncontroversial to state that Mr. Rockefeller knew a lot about making money.

After becoming the wealthiest American in history, John D. Rockefeller died in 1937. As our style of growth stock investing began in the 1940s, he never benefited from it. Nevertheless, our investment strategy has created meaningful wealth for many individuals and families over the years. While there are few guarantees in life or the stock market, the ability of growth stocks to produce significant capital appreciation over long periods of time is well known to many successful investors.

Less well known is the ability of growth stocks to both generate and grow dividends, a characteristic we think Mr. Rockefeller would have appreciated. When prospective clients review our list of equity holdings, they often assume that dividend income is not an important part of our investment strategy as the yields are typically low -- often 1% or less. But these low yields can be deceptive because as the prices of successful growth stocks tend to rise over time, so do their dividends. Thus, if the share price has risen, the yield may still appear low even though the dividend has increased at faster than average rates.

This misconception is as old as the growth stock investment strategy itself. In 1968, William "Ledge" Mitchell, our firm's Chairman, entered the investment profession and began following the work of David L. Babson. Of particular interest were his Staff Letters comparing the dividends produced by growth and income stocks. Ledge joined Mr. Babson's firm in 1979 and soon realized the necessity of highlighting dividend growth as a key component of growth stock investing because of their deceptively low current yields. As the challenge still exists today, we feel it is important to continue this decades-long discussion.

The information provided herein represents the opinions of David Wendell Associates and is not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

Similar to Mr. Babson's analyses, we created a representative list of ten growth stocks to compare to a dividend-producing alternative. Since we have remained growth stock investors throughout our firm's history, we decided to use our top-ten client holdings at year-end 2017 for this purpose. They are shown below:

1. Automatic Data Processing
2. Mastercard
3. Stryker
4. Apple
5. Ecolab
6. TJX Companies
7. Johnson & Johnson
8. Nike 'B'
9. Colgate-Palmolive
10. McDonald's

While Mr. Babson compared his list of growth stocks to a group of income stocks, we thought it would be more current and realistic to compare our list to an exchange-traded fund -- an "ETF". These passive investment vehicles have become increasingly popular among investors in recent years. In fact, some on Wall Street think ETFs (many of which simply mirror the overall market) are better than an active approach of identifying and selecting high-quality companies with strong fundamental characteristics.

For our analysis, we chose the iShares Core S&P 500 ETF (ticker symbol "IVV"). It is one of the largest passive investment vehicles tracking the Standard & Poor's 500 and was founded in 2000, so it has, for an ETF, a relatively long track record. Also, it is managed by BlackRock which is one of the world's largest investment firms. In addition, we chose to use the payment date when calculating annual dividends. While this method creates some volatility in dividend growth rates[1], companies often select these dates for a purpose. This methodology reveals how much dividend income investors received in a specific year and a company's sensitivity to issues such as changes in tax laws and policies.

It should be noted that this is not a performance analysis. Over the past ten years, our top-ten client holdings have changed and our clients may not have owned all ten companies through the entire period. However, comparing our current top-ten holdings to an ETF is a good way to analyze the ability of growth stocks to generate meaningful dividend income.

We started with a theoretical $10,000 invested in each of the ten individual stocks and a theoretical $100,000 invested in the ETF, rounding up or down as needed. We wanted to see what the differences in dividend income would be for a $100,000 portfolio invested in growth stocks versus a $100,000 portfolio invested in an ETF.

We chose the ten calendar years between 2006 and 2016 as they include a financial crisis, a recession of historic proportions, and the subsequent slow growth economic recovery. Using this period provides a good understanding of corporate dividend policies in rising and falling markets. The results of the analysis are shown on the following page.

As can be seen, dividends for our group of ten stocks grew at a much greater rate than that of the ETF. While in the very first year dividend income generated by our growth

---

[1] For example, IVV, Nike 'B' and Ecolab shifted payment dates at times during the period creating the illusion of dividend decreases.

stocks was 29% less than the ETF's, our stocks quickly caught up. Just three years later -- in 2009 as the Great Recession took hold -- our growth stock dividends took the lead and were 38% greater than the ETF's even though Apple did not pay a dividend at the time.

Dividend Income: DWA's Top-Ten Holdings vs. iShares Core S&P 500 ETF

	Estimated Dividend Income (based on payment date)										
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Automatic Data Proc.	$159	$198	$249	$284	$292	$310	$340	$374	$413	$421	$456
Mastercard	$20	$119	$132	$132	$132	$132	$231	$462	$968	$1,408	$1,672
Stryker	$25	$50	$74	$113	$135	$162	$191	$239	$275	$311	$342
Apple	$0	$0	$0	$0	$0	$0	$716	$1,593	$1,744	$1,918	$2,107
Ecolab	$112	$129	$146	$157	$174	$196	$288	$193	$308	$370	$392
TJX Companies	$116	$146	$181	$202	$245	$310	$378	$473	$576	$692	$851
Johnson & Johnson	$240	$267	$296	$318	$348	$371	$396	$427	$455	$487	$520
Nike 'B'	$143	$170	$212	$230	$320	$214	$428	$290	$442	$662	$442
Colgate-Palmolive	$225	$252	$281	$310	$365	$409	$439	$479	$511	$540	$558
McDonald's	$300	$450	$488	$615	$678	$759	$861	$936	$984	$1,032	$1,083
Total Top 10	$1,339	$1,781	$2,058	$2,360	$2,689	$2,862	$4,268	$5,466	$6,676	$7,841	$8,423
% Change		33%	16%	15%	14%	6%	49%	28%	22%	17%	7%
iShares Core S&P 500 ETF	$1,875	$1,576	$2,733	$1,706	$1,767	$2,057	$2,370	$2,643	$2,988	$3,517	$3,724
% Change		-16%	73%	-38%	4%	16%	15%	12%	13%	18%	6%

Data provided by FactSet and the companies and fund listed

In 2012, when Apple started paying a dividend, the group of growth stock dividends became 80% greater than the ETF's dividends. And by the end of the entire period, dividends for our group were more than double those of the iShares Core S&P 500 ETF. In absolute terms, the annual income generated by our top-ten stocks increased from $1,339 to $8,423 in just ten years. In contrast, the annual income from the ETF grew from $1,875 to $3,724 over the same period.

These impressive results are primarily due to the difference between owning a group of high-quality companies versus a market-replicating ETF. These growth stocks have business and financial characteristics that are far superior to those of an average company. And of course, the stocks in the ETF are, on average, simply average.

Comparing the compounded annual growth rates for three-, five- and ten-year periods highlights this difference even further:

Compounded Annual Growth Rates of Dividend Income
For Periods Ending December 31, 2016

	3 Years	5 Years	10 Years
DWA's Top-Ten Holdings	16%	24%	20%
iShares Core S&P 500 ETF	12%	13%	7%

Particularly revealing was the performance of the group of companies during the Great Recession. Our top-ten stocks actually increased their dividends in 2009 while those of the ETF declined dramatically. As a group, the ten growth stocks raised its dividend each year before, during and after the worst recession since the Great Depression.

Similarly, the steady increases of our growth stock dividends compares very favorably to the significant volatility of the ETF's record. From the end of 2008 to the end of 2010, every Board of Directors and management team in the world was under great pressure. Many were forced to slash their dividends and a number of companies failed.

This reality is reflected in the ETF's dividend which declined 35% between 2008 and 2010. In 2009, it declined a hefty 38%. In contrast, our group of growth stocks grew their dividends steadily during this period with solid double-digit gains each year and resulted in a total increase of 31%.

Individuals and families, as well as some institutions, should take note of this analysis, particularly if they are planning to invest for the long term. Growth stock investing works best over decades -- not days -- during which time investors can reap the benefits of owning high-quality companies that steadily increase their revenues, earnings, and dividends per share at above-average rates.

To be sure, not all growth stocks pay a dividend. Frequently, the companies retain their earnings to plow back into their operations to fund future growth. But as the company grows, the Board of Directors may decide that it is time to pay a dividend.

For example, Mastercard paid only a small dividend when it first started trading in 2006. Apple reintroduced its dividend in 2012 after a 17-year hiatus. But by 2016, both companies paid dividends that were in fact meaningful, as shown above in our analysis. A high-quality company purchased for its growth potential may in fact, down the road, become a valuable dividend generating investment as well.

After revisiting this decades-long discussion of growth stocks and dividends, we conclude -- as did Mr. Babson -- that our investment strategy produces impressive dividend income over the long term. When compared to a modern and popular investment alternative, such as an ETF, our group of growth stocks generated superior income over a ten-year period. They also demonstrated important defensive characteristics by increasing their dividends during the worst economic collapse since the Great Depression -- a period during which the ETF's dividend income declined significantly.

We are devoted to our investment strategy because we believe it works well for many reasons, not the least of which is its ability to generate dividend income -- an attribute we believe Mr. Rockefeller would have found appealing.

Neil G. Bleicken