CAMPBELL NEWMAN

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REFLECTIONS & PERCEPTIONS

WHAT IS QUALITY AND WHY YOU WANT IT

Campbell Newman Asset Management is a boutique investment management firm known for investing in "quality" large capitalization dividend growth companies. Quality is a rather vague term used by many investment managers to characterize their style of investing as safe or conservative. The term is used liberally throughout investment literature. Some investment managers focus on balance sheet metrics while others focus on income statement metrics to define quality. Both have their merits but, does the term have any tangible influence specific to the investment strategy? In the following paragraphs we will define what quality means to Campbell Newman and how it influences the construction and behavior of clients' investment portfolios.

Additionally, since the launch of our Small Cap Growth strategy a little over three and a half years ago, we have been asked how it fits under the "quality" umbrella established by our Large Cap Dividend Growth strategy. It's a valid question, since smaller companies generally exhibit greater stock price volatility, carry increased liquidity risk, have less access to capital markets and do not even pay dividends. To us, the answer is fairly simple and straightforward though it might be helpful to first review the definition of "quality" embedded in the Large Cap Dividend Growth strategy as expressed in our investment philosophy. We believe that:

"A company's dividend policy is tangible evidence of management's confidence in future earnings growth."

A company's dividend policy is the single most important factor we examine when working to identify our active research universe of investable companies. This is because companies that *pay a meaningful dividend and increase it year after year* are demonstrating with a non-retrievable cash payment to shareholders that they are going to manage the business in a highly disciplined manner in order to grow earnings—and earnings growth drives stock prices.

The Dividend Growth strategy only invests in companies that have raised their dividend in each of the last five years. Five years of annual increases is key because our research found that few companies achieve this high standard but, once they do, regular dividend hikes become institutionalized and an integral part of the company's capital allocation decisions. We believe this discipline creates managements that are better allocators of shareholder capital, increasing the probability the company will produce more consistent and predictable earnings growth – which are essential attributes of a high-quality investment in our view. This differentiates Campbell Newman from other dividend managers that invest in companies that might initiate a dividend or in companies that have erratically raised their dividend over time.

Additionally, our investment process does not define a minimum rate at which a company must raise its dividend, but we do take special note of changes in dividend policy as they can provide insight into a management's outlook and/or the vibrancy

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of a company's end markets. A deceleration in the dividend growth rate can be an early warning signal, just as a larger than usual increase often foreshadows acceleration in earnings growth. As such, we view changes in dividend policy as additional evidence regarding the quality of an investment as they help us assess whether growth is on track with projections.

Dividend growth companies tend to have strong balance sheets, with investment grade credit ratings and low levels of debt, because their operations generate high levels of discretionary cash flow to fund both operations and future growth. Balance sheet strength is an important quality metric as it provides these companies with greater financial flexibility, especially during times of economic stress.

Finally, greater transparency indicates higher quality to us. The payment of a meaningful cash dividend increases confidence in the accuracy of a company's financial statements as it makes it harder to hide financial shenanigans.

Regarding our Small Cap Growth portfolio, "quality" is defined first as proven profitability, as articulated in this strategy's investment philosophy:

"Profitability is tangible evidence of the validity of a company's business model, increasing the probability of sustainable earnings growth and stock price appreciation."

This philosophy and our bottom-up investment process are differentiated by this strict focus on profitability. Our process begins with a screen of all Russell 2000 Growth Index constituents to eliminate the companies that are not profitable on a trailing four-quarter basis from our investable universe. Amazingly, this screen has consistently resulted in the exclusion of roughly 30% of the Russell 2000 Growth's almost 1,150 companies because they operate at a loss!

We believe profitability is a key quality characteristic because:

"The use of traditional research and valuation metrics is more insightful and reliable when applied to profitable companies, compared to the speculation necessary when analyzing unprofitable companies."

These beliefs are reinforced by the results of a study we conducted earlier this year examining how the stocks of profitable small cap growth companies (defined by the companies in the Russell 2000 Growth Index) performed over the last 10 years (2007-2016) relative to the Index, as well as to the Index's unprofitable issues. We found that profitable companies (equally weighted) outperformed the benchmark (market weighted) by almost 150 basis points annually over the 10-year period and trounced the unprofitable companies' (equally weighted) returns by approximately 700 basis points annually.

Let's now turn our attention to some of the positive portfolio statistics generated due to the imbedded quality bias of both our investment strategies. Both the Large Cap Dividend Growth and Small Cap Growth strategies are constructed to participate in up markets and protect in down markets in order to outperform their relative performance benchmarks over a market cycle at lower levels of risk. The evidence shows the portfolios built through our bottom-up stock selection process, which is governed by the quality-based criteria already discussed, has played a central role in lessening the impact of down markets on client portfolios.

Since the inception of the Large Cap Dividend Growth strategy in 2003, its S&P 500 benchmark has recorded negative returns in 14 quarters. Tellingly, the Campbell Newman Dividend Growth portfolio outperformed the S&P 500 in 13 of those 14 quarters, or 93% of the time! [1]

Our Small Cap Growth strategy has also benefited from its focus on quality companies during its relatively shorter performance history. Since inception (12/31/13), there have been three quarters in which the Russell 2000 Growth Index delivered negative returns. The Small Cap Growth portfolio held up better than the benchmark in two of the three down quarters. With such a small sample size, it is worth noting that the Small Cap Growth portfolio lagged the bogey by just 23 basis points in the one period it underperformed in a down quarter. Additionally, in the two other quarters with negative Index returns, it beat the bogey by over 300 basis points in one quarter and almost 500 in the other.[1]

A common measure of volatility is a portfolio's standard deviation of returns. Both Campbell Newman strategies score well in this category. For the 10-year period ending 6/30/17, the standard deviation of the Large Cap Dividend Growth strategy is 13.31% vs. the S&P 500 Index's 15.21%. The Small Cap Growth's standard deviation is 14.38% vs. 15.78% for the Russell 2000 Growth Index since its 12/31/13 inception.[2]

Campbell Newman's bottom-up process of building portfolios of carefully selected high-quality companies has historically dampened the volatility of returns versus the benchmarks for both strategies. Why is this important? It is said that emotions are the worst enemy of investors during periods of heightened volatility because they interfere with rational thought. Protecting on the downside provides investors with greater security in the moment of turmoil while also giving them a larger pool of capital to work with when markets improve.

[1] Past performance is not indicative of future results.

[2] Statistics shown as supplemental information only and compliment the full disclosure presentations, which are available upon request. Past performance is not indicative of future results.