DECEMBER 31, 2023

WHAT IS QUALITY AND WHY YOU WANT IT

Campbell Newman (CN) is a boutique investment management firm best 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 in 2014, we have been asked how it fits under the "quality" umbrella established by our Large Cap Dividend Growth strategy we started in 2003. 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 often do not pay dividends. To us, the answer is 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, except 2020 when stable or increased qualified because of the forced shuttering of the economy. 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 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 lower 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. This screen typically eliminated about 30% of the Russell 2000 Growth's ~1,075 companies because they operate at a loss! More recently, nearly 50% of the benchmark's companies have been unprofitable, and thus removed by the screen.

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."

Let's now turn our attention to some of the positive portfolio statistics generated due to the imbedded quality bias of both investment strategies. Large Cap Dividend Growth and Small Cap Growth are both constructed to participate in up markets and protect during down markets in order to outperform their performance benchmarks over a market cycle at lower levels of risk.

Since inception, Dividend Growth's downside capture ratio is 88.07%. In addition to protecting during selloffs, the strategy participates well in rising markets with an upside capture ratio of 91.57%.[1] Recall that volatility doesn't cut equally both ways. If a price declines by 50%, it must rise 100% just to get back to even. If it goes down by 25%, it only has to appreciate by 33% to get back to even.

In Large Cap Dividend Growth's 20-year history, its S&P 500 benchmark recorded negative returns in 21 quarters. Tellingly, Dividend Growth outperformed, net of fees, in 17 of those, or 81% of the time. Further, in these 21 down quarters, Dividend Growth outperformed by an average of 143 bps on a net of fees basis, with an average return of -6.19% vs. -7.27% for the index.

Our Small Cap Growth strategy also protects during downdrafts with its focus on quality companies. From its inception on January 1, 2014, there have been ten quarters when the Russell 2000 Growth Index had negative returns. Small Cap Growth beat the benchmark, net of fees, in eight of the ten down quarters, or 80% of the time. Importantly, in these down quarters for the Index, Small Cap Growth outperformed by an average of 314 bps on a net of fees basis. Further, the strategy actually had positive returns in two of these quarters.

Another common measure of volatility is Beta, which is frequently paired with Alpha, a measurement of a strategy's excess return. Both Campbell Newman strategies have produced compelling risk/return statistics by these measures, again pointing toward quality:

SINCE INCEPTION[2]	BETA (NET)	ALPHA (NET)
Large Cap Dividend Growth	0.88%	1.57%
Small Cap Growth	0.88%	3.44%

Source: Zephyr

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.

For more information, please visit campbellnewman.com or call John Bonnell at (414) 635-1002.

IMPORTANT DISCLOSURES:

[1]Statistics shown as supplemental information only and compliment the full disclosure presentations, which are available upon request. Statistics shown net of fees.
[2]Inception date for Large Cap Dividend Growth composite is 7/1/03. Inception date for Small Cap Growth composite is 1/1/14. NOTE: All performance periods are as of 12/31/23 and presented net of fees.

Past performance is not indicative of future results. All investments involve risk, including possible loss of principal. There is no guarantee investment objectives will be met. Gross returns are presented before deducting management fees (and custodian fees) and include the reinvestment of all income. Net returns are presented after deducting management fees (and custodian fees) and include the reinvestment of all income. Performance returns are calculated using a time-weighted formula with appropriate adjustments for cash flows, and include all dividends and interest, accrued income, and realized and unrealized gains or losses. Indexes are unmanaged and do not incur fees or expenses. It is not possible to invest directly in an index. All performance metrics are presented net of fees.

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