Dear Friends and Clients,

Sure wish we would have moved our stock affection meter to “Love” in late December 2018. I am, however, extremely happy that we have been in the “Really Like” or “Love” mode since well before March of 2009, helping our clients reap the long-term benefits of our county’s longest bull market. There was a fair amount of backing and filling during this period, but the results will spend nicely. Near-term, we have seen the Dow Industrials gain nearly 19% from December 24th through March 28th. We’ll take a move like that any time.

Over the years, we have written letters about the pricing of stocks and bonds, ways to reduce your taxes, saving money, spending money, giving money to your kids and loved ones, and gifting appreciated assets to philanthropies. We’ve also covered how to play 4-point pitch, how to cook a steak and fry fish, and reviewed big city restaurants, warm weather hotels, good books, great movies and even blues pickers. These letters had their highs and lows but all seem to gain a following over time; it was all a lot of fun. Making our current subject, dividends, a laugh riot could be a colossal chore. Let’s see how we do.

How dividends work for the company and the investor…

When an investor buys shares of a publicly held company, they become owners (shareholders) of that company. Every year, the shareholders vote on a board of directors, and the directors, in turn, hire management. Together with management, the board decides how corporate assets and income streams will be allocated. This is done in the best interests of the shareholders, who own those income streams in addition to the company. Dividends are generated from the company’s after-tax income and paid to shareholders as a reward. If they are not paid out, they still belong to the shareholders in the form of bank balances and short-term investments. Consistent dividends are considered a shareholder-friendly corporate attitude and a reflection of financial strength. Once paid, investors include the company in the same universe of other dividend-paying stocks and often gain entry to the dividend growth category. This, in turn, makes these companies “buy” candidates for mutual funds and investment advisors, who use these metrics in their stock selection process. In short, the shares gain a following and their price has a better chance of going up.

Interestingly enough, dividend payments seem to represent cash flows that the individual investor recognizes as “okay to spend.” One of the objectives of this letter will be to change that attitude just a little bit, educating the shareholder about the origins of dividends and the different tax ramifications that occur when stocks generate income through dividend payments versus the shareholder generating income by selling a few shares.

Since dividends can only be paid out of earnings and after all income taxes are paid, they are a way of telling shareholders…look at us, we are doing our job well and can afford to part with some of our cash flow as a thank you. Both shareholders and portfolio managers have a mission and they know that this mission gets more difficult without some cash in their accounts. That cash has to come from somewhere and dividends are an obvious source. Qualified dividends are paid by U.S. corporations and by compliant foreign corporations. They come from after-tax corporate revenues and become taxed again at the taxpayer level. When received by shareholders, dividends are taxed as high as 20% for federal. This double taxation (think 40% total) comes at two different times, when they are generated by the corporation and when they are paid to the shareholders. Some shareholders argue this second event (the taxation of the dividend) should be avoided for as long as possible. We'll let you dwell on this and form your own opinion.

Non-qualified or ordinary dividends are generally "pass through" income and subject to ordinary income tax rates.....think 37% federal plus your state rate. Another option occurs when a corporation characterizes their dividend as a "return of capital," in which case they are not subject to tax. However, this does sponsor many questions… Why is my company returning my capital to me? Are they struggling to generate cash in order to please investors? Do I have to adjust my basis?

Stock dividends are equally mystifying. For years, we've witnessed several companies that have routinely paid dividends in stock instead of cash (think 5.00% of the value of the stock) on an annual basis. This process causes investor holdings to grow, and the stock dividends are rarely spent… Doing so would require the investor to take the kind of action this letter is promoting, sell a portion of their shares periodically. It has been our experience that shareholders like stock dividends but rarely sell them to generate cash. Stock dividends seem to have fallen out of favor with most listed corporations. A high percentage (84%) of the stocks in the S&P 500 pay a dividend of some sort…mostly qualified cash.

Where does the affection for cash dividends come from?

Beginning in 1900, a number of business related board games were earning popularity. "The Landlord's Game" may have been first, followed by several adaptations that included businesses, and then eventually, in 1935, Parker Brothers invented "Monopoly." This game introduced listed securities and cash balances. The popularity of Monopoly was so strong that it remains on shelves around the world to this day. Actually, it created a virtuous cycle that promotes the concepts of Free Parking, Pass Go and Collect $200, Advance to Boardwalk, and Get Out of Jail Free. Generations have grown up believing that these phenomena actually exist. So the question became self-fulfilling… If we own stocks, why shouldn't we get dividend checks in the mail and why shouldn't we be able to spend those dollars on anything we want?

Thinking about where dividends come from and which corporate functions their payment dislocates is hard work. Owning a stock and being able to sell a few shares instead of waiting for the predictable dividend to hit seems to be even more hard work. Individual investors can't be expected to join these tasks gladly. As luck would have it, we need stocks that are both dividend payers and growers. Cash lubricates the gears of a portfolio. Investors (no matter who they are) have fees to pay, expenses, and mission statements. They consume software, hardware, research, web access, video and telecommunication resources. We all need our portfolios to generate a modicum of income, but it would be nice to have it generated by the appropriate source on a schedule of our choice, not the company's choice. It is financially impossible to have too much cash. That being said, it is not in an investor's best interests to siphon cash from assets generating high internal rates of return and then store it in money market funds paying 1-2%.   Let's take a look at some of the criterion that come into play when a corporation pays a dividend, as well as when an investor consumes that cash.

Regular readers of these letters are aware that we believe, if you save something, you will have something.   We also believe money has no value until you spend it. Some would say we speak with "forked tongue." We think it is easier to save when you taste the grapes of your labor from time to time. So if money is going to be spent, shouldn't we recognize this fact during portfolio construction? To do so, the portfolio manager, the investments used, and the client need to be on the same page. When a company pays out a dividend, that event fits their corporate calendar, their cash flow needs, and their tax profile. Do not expect any of the companies that you own to call you on the phone and ask if you would prefer your dividends this year or next. Instead, the investor needs to begin with the end in mind, trusting the historic dividend payment dates and paying attention to the following bullet points.

1) **Amount** - Corporations want to reward and thank their shareholders when they pay a quarterly dividend.   Knowing they are judged by the size of dividends paid, as well as the dividend growth generated, most corporations will think in terms of a shareholder that has been with them for years and knows that dividends paid have a cost of money equal to their company's internal rates of return. American corporations tend to start with a minimal amount and then grow it in linear fashion over time. The European method starts annually at zero and then reflects the financial success of the company over the year. Since common stock dividends are not guaranteed nor cumulative, knowledge of each of these methods affects the other as a year marches on.

2) **Timing** - Most companies use the traditional quarterly system for their payment dates. If the shareholder uses these dividends as income, that probably works fine. However, this sequence assumes the market will always be higher during January, April, July, and October, which may or may not happen. Allowing the shareholder to sell a few shares to augment income based on need seems to make a lot of sense.   This also implies low dividend rates. That rate doesn't have to be zero but might instead be minimal with the growth of stock prices as well as dividend growth being two of the most admired metrics.

3) **Return on Equity (ROE)** - Management constantly needs to ask themselves, "What will we do with these dollars if retained versus what can the shareholder do with them if paid out?" After all, paid or retained, this cash belongs to the shareholders. P&A client portfolios own several companies that generate 15-25% returns on equity (that would be <u>shareholder</u> equity) and, with this knowledge, it is doubtful shareholders want those types of relationships interrupted. ROE is one of the metrics we want to maximize. We understand that investors who want high dividend-paying stocks do not typically care about return on equity, but they should.   It is one of the fundamental measurements of management and business plan. The growth of a revenue stream is akin to the growth of a river. If your water supply in Omaha and St. Louis has diminished, you should be very interested in the Rocky Mountain snow pack.

4) **Investor Net ROE** - The stocks that generate high ROE don't always generate dividends with an "OK to spend" sign attached. They are rarely included in the lists of high dividend-paying companies and sometimes pay dividends with great irregularity. However, a tech stock growing at 20% with a 0% dividend rate and a 6% shareholder liquidation rate (shares sold to generate income) will have an Investor Net ROE rate of 14%. The owners of companies with high ROEs are rarely dissatisfied and generally well fed. Here's an example…

	ROE	Dvd	Investor Liquidation	Investor Income	Investor Net ROE
Tech Stock	20%	0%	6%	6%	14%
Bank Stock	12%	4%	2%	6%	6%
Oil Stock	10%	4%	2%	6%	4%

These numbers are obviously hypothetical. Feel free to adjust them with the metrics of your own holdings, which are available from Yahoo, Schwab, and Google. The takeaway is simple. Investors can have high dividends and low growth, low dividends and high growth, or the best of both worlds, income and growth.

5) **Taxes and planning** - Consistency is one of the hallmarks of a good dividend-paying stock. However, from time to time, it is possible for all of us to make too much or too little during a given quarter or year. The common stock can be a great tax-planning tool. It can generate unrealized gains as well as losses. Either of these can be called upon to even out the disparities that are common for investors. We manage portfolios to diversify risks and to create an arsenal of assets that can generate gains and losses on demand. We don't look for losses, but we harvest them when they occur. A stock trade costs as low as $4.95 through Schwab and our management fee structure starts at 1% and goes down from there… Friction costs are low. Buying an annuity costs between 6% and 10% of the amount you invest, not to mention the typically steep ongoing costs. Owning a hedge fund runs you a 2% management fee plus 20% of the gain they deliver. We like our chances of doing meaningful tax planning with common stocks.

The executive summary might read, "Growth equals dividends." Whether you invest in high dividend-paying stocks or growth stocks that do not pay a dividend, we're just talking about money. Growth spends just the same as dividend income. These are different pockets on the same pair of jeans.

Our most successful portfolios are owned by clients who collaborate with us over time. If the client needs more cash, they notify us. They tell us the amount and then let us pull the weeds and trim the flowers in their portfolio. We do the same thing in our own portfolios. As all of you know, our office is wide open. No cubicles, no individual offices. In this open architecture, questions fly across the room all the time. We rub heads together and compare notes. When clients need liquidity, our answer is always "yes." The securities we purchase for clients are liquid and their portfolios possess the qualities listed above to make raising cash perpetually easy.

The world according to Pitt and Dan

We are pleased to introduce you to Renley Kliewer, a healthy baby girl born to Kristin and Ryan Kliewer on January 24th. Mom is back to work and in the swing of things. Here's to Renley knowing her days from nights and letting Mom and Dad get some sleep. The fun is just beginning.

As you know, we are constantly introducing you to our partners and workmates. I am often accused of trying to retire (not the case), so here are some numbers that will help you quantify family responsibilities around here. We manage roughly $1.6 billion with 12 full-time employees who support 18 children, four of whom are grown up and 14 of whom are still at home. Grandchildren total 10, all directly related to Pitt & Dan. Ten wives and husbands, plus two significant others. Evenly distributed, each of our full-timers is responsible for $133 million… That's a lot of trust. When the flu bug moves through P&A or any of the related grade schools or day care centers, you can count on making a new friend. Since Day One, we have spent a lot of time defining responsibilities, writing down our processes, and cross-training. This has proven to be time well spent, and Dan and I could not be happier about the quality of the team in place at P&A.

At the current time, we employ three former interns, two of which are blood relatives. We have 12 former interns and full-timers working at financial companies across the United States and couldn't be prouder of them. With all of this mind, we thank Kristin and Ryan for generating a new edition of the prototype P&A worker bee. We look forward to trying to hire her 21 years from now, along with all the other progeny created by our co-workers.

Signed on behalf of the entire P&A team (pictured below),

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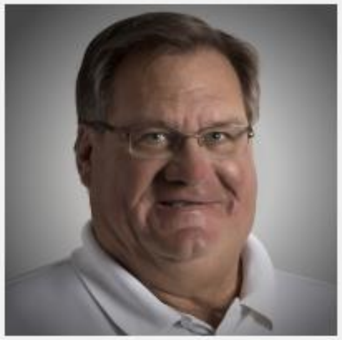

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