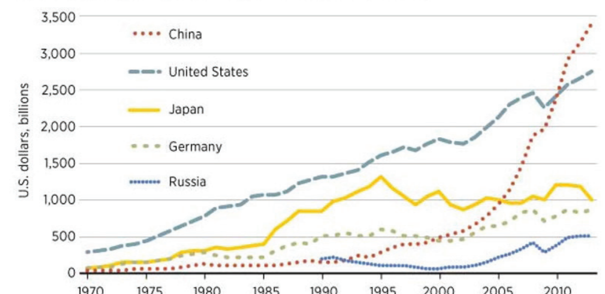
Bahl&Gaynor

1Q 2023 Dividend Growth ESG Update

Sustainability Isn't Just About the Environment

Since the term "ESG" was first coined by the U.N. in the mid-2000's, many investors, corporate citizens, and public servants have seemingly allocated disproportionate emphasis to the "E" – environmental. Sustainability has become synonymous with environmental sustainability. To many stakeholders, ESG had even started to translate to "zero carbon emissions" and "energy efficiency."

Perhaps the Environmental pillar became the most prominent because it was the most tangible of the three pillars? Perhaps the relationship stuck simply because 'Environmental' was the first word in the acronym and there was so much ground to cover within that pillar? Perhaps it was a sign of the times?



Source: United Nations, St. Louis Fed. April 2016.

Notably, the notion of "ESG" came to rise in tandem with the rise of globalization in the manufacturing sector. Corporations and nations alike began to offshore product manufacturing to China in droves **(Exhibit 1)**, which increased global trade potentially at the expense of the environment. Globalization, while perhaps the most important input for global economic growth, meant more cargo ships on the ocean, more freight planes in the sky and more semi-trailer trucks on the freeway. Further, the rise of China's industrial powerhouse status was, at least not initially, accompanied with coal restrictions or environmental protections.

The simultaneous acceleration of globalization, increase in emissions, and colloquialism of "ESG" seemed to result in the translation of "sustainability" to mean "eco-friendly." While we do not deny this is true in part, we do believe "sustainability" means much more than "environmental sustainability" in the context of investments.

Silicon Valley Bank (SVB): An ESG Case Study?

Prior to its recent collapse, Silicon Valley Bank was often viewed as a poster child within its industry from an environmental perspective. The bank was positively recognized for its role in lending to companies at the forefront of innovation, often including renewable energy, as well as sizable commitments to finance sustainability efforts and target to be carbon-neutral by 2025. These factors allowed the company to become known as a favorite of ESG funds with a narrow focus on Environmental criteria.

Many details surrounding its ultimate demise remain unknown; however, it has become increasingly clear that shortcomings in the bank's governance structure, including inadequate risk management and internal controls, contributed to a painful outcome. Similarly, a narrow approach to ESG (e.g. one solely focused on Environmental considerations) may expose investors to risks that a holistic approach may avoid.

Environmental, Social and Governance (ESG) Integration

Rather than a one-size-fits-all approach to defining "sustainability" and "ESG" in the Dividend Growth ESG strategy we subscribe to a process anchored in materiality and informed by the Sustainability Accounting Standards Board (SASB). While the list of material ESG risks for industries often includes "Environmental" in some capacity, that is just one aspect of the ESG analysis. We also believe it is important to integrate ESG alongside other objectives of the strategy: income growth, downside protection and price appreciation.

Since our 1990 founding, we have focused on a variety of indicators to predict investment sustainability, the most important of which, we believe, is the dividend. In our view, a management team that promotes a shareholder-friendly capital allocation policy is a positive sign for the "G" or Governance pillar and enhances the attractiveness of an investment opportunity.

While we vigilantly monitor our portfolio holdings and the ever-changing macroeconomic environment, the Dividend Growth ESG strategy objectives by which we select investments for our clients remain constant.

President Biden's First Veto

On March 20th, President Biden issued the first veto of his presidency to reject legislation that would prevent retirement plans from considering ESG factors in their investment decisions. This action does not force plan managers to consider ESG but continues to allow plan managers to consider ESG factors, or potentially offer ESG focused funds to their employees. While it is unclear whether the President's veto will lead to more ESG uptake by employers given the ongoing market debate about ESG investing, the action allows plan sponsors more flexibility in retirement offerings and investment evaluations.

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Strategy Objectives

1. ESG integration: Significant improvement in ESG rankings relative to benchmark[1]
2. High current and growing income: 2.4% yield; +10.5% growth in trailing-twelve-month income as of 1Q2023
3. Downside protection: Competitive daily downside capture*
4. Price appreciation: Compelling risk-adjusted returns through a full-market cycle

[1] Measured against the S&P 500 index. Please refer to Disclosures for additional information.

Current Quarter Strategy Thoughts Relative to Objectives:

- The Dividend Growth ESG strategy grew trailing-twelve-month income by +10.5%, providing client purchasing power growth in this higher inflationary environment.
- 14 strategy holdings announced dividend hikes; average TTM increase was +9.4%, signaling business stability and financial health of the portfolio.
- Daily downside capture 83.1%† across all S&P 500 down days in the TTM period ended 3/31/2023, a competitive ratio amidst a market backdrop plagued with uncertainty.
- The strategy's dividend growth focused mandate underperformed amid the banking-crisis driven collapse in interest rates. The market is expecting an imminent pause and reversion in Fed tightening, which supports long-duration risk assets especially mega-cap and non-profitable technology stocks.
- Only three of eleven S&P 500 sectors (Information Technology, Communication Services and Consumer Discretionary) had returns at or above the +7.50% benchmark return, a signal of weak market breadth and underlying market health.
- Amazon (AMZN), Apple (AAPL), Google (GOOG/L), Meta (META), NVIDIA (NVDA) and Tesla (TSLA) rebounded by an average +45.6%, contributing 73% of the S&P 500's +7.50% total return and weighing on active managers underexposed to mega-cap.
- Durable growth sectors of Consumer Staples, Utilities and Health Care had negative total returns, confirming investor preference for riskier equity allocations.
- Amidst conflicting market signals, with consensus S&P 500 quarterly EPS estimates trending higher while U.S. GDP growth estimates trend lower, the outlook for risk-aware active managers with a focus on sustainable dividends and stable fundamentals remains positive.

1Q2023 Dividend Increases		
Company	TTM % Increase	Current Yield
Air Products & Chemicals (APD)	8.0%	2.4%
Booz Allen Hamilton (BAH)	9.3%	2.0%
Cisco Systems (CSCO)	2.6%	3.0%
CMS Energy (CMS)	6.0%	3.2%
Eaton (ETN)	6.2%	2.0%
Eversource Energy (ES)	5.9%	3.5%
Home Depot (HD)	10.0%	2.8%
Nextera Energy (NEE)	10.0%	2.4%
Old Dominion (ODFL)	33.3%	0.5%
ProLogis (PLD)	10.1%	2.8%
Sempra (SRE)	3.9%	3.1%
TJX Companies (TJX)	12.7%	1.7%
Waste Management (WM)	7.7%	1.7%
Williams Companies (WMB)	5.3%	6.0%

1Q2023 Dividend Growth ESG Trades Executed	
Initiations	Eliminations
Hartford Financial Services (HIG)	American Tower Corp (AMT)
	BlackRock (BLK)
	Fidelity Information Services (FIS)
	Medtronic (MDT)
Increases	Reductions
AbbVie (ABBV)	Apple (AAPL)
Agilent Technologies (A)	Microsoft (MSFT)
Cintas (CTAS)	Union Pacific (UNP)
Eaton (ETN)	
Motorola Solutions (MSI)	
PepsiCo (PEP)	
UnitedHealth Group (UNH)	
Williams Companies (WMB)	

Source: Bahl & Gaynor and Factset, 2023.

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Positive drivers of current quarter performance

- Ownership of packaged sweet and salty snack food companies while avoiding exposure to the low growth tobacco and cyclical agriculture product and services industries in the Consumer Staples sector.
- Stock selection within the pharmaceutical industry and no exposure to health care services or life science industries in the Health Care sector.
- Under allocation to the Energy sector as a whole and not owning integrated oil & gas companies.

Negative drivers of current quarter performance

- No ownership to low dividend payer NVIDIA (NVDA) while being underweight Apple (AAPL) and Microsoft (MSFT) in the Information Technology sector. These mega-cap tech companies constitute just under 15% of the S&P 500 and resulted in a relative performance headwind of ~2.5%. This was partially offset by exposure to the outperforming semiconductor industry.
- No exposure to non-dividend payers Tesla (TSLA) and Amazon (AMZN) in the Consumer Discretionary sector.
- Exposure to regional and money center banks despite owning institutions that withstood deposit/balance sheet carnage as a result of the Investment Committee's thorough fundamental screening process. Being underweight the Financials sector and having no exposure to life and health insurance companies partially offset headwinds presented by strategy bank holdings.

Largest Portfolio Contributors

1. Broadcom (AVGO) AVGO delivered a strong beat and raise during the quarter, noting continued strength from secular growth drivers across end markets. Longer-term, the company stands to benefit from a robust order backlog, continued growth in networking solutions with a focus on AI infrastructure, and portfolio breadth across strategic infrastructure spending.

2. Old Dominion Freight Line (ODFL) Though less-than-truckload (LTL) volumes continue to decline, the company's ability to flex its business model was evidenced by better-than-expected 4Q2022 efficiency (vis-à-vis Operating Ratio) and earnings. Industry-leading execution combined with steady investments amid lower volumes should support continued earnings and dividend growth. While the company operates as a manufacturer of semiconductor chips and may omit.

3. Qualcomm (QCOM) Weakness in the smartphone market and an expected near-term inventory correction pressured QCOM in 2022. Although this weak demand environment is still present, in 1Q23 investors were able to look through the earnings trough expected mid-year and rewarded the stock for its long-term growth opportunities. During the quarter QCOM released its latest annual ESG report, which documented continued progress in top ESG goals including GHG emission reduction and ongoing oversight of suppliers.

Largest Portfolio Detractors

1. PNC Financial (PNC) Investor concern regarding the banking industry-wide liquidity and capital levels following isolated regional bank failures pressured shares. PNC's balance sheet, asset quality and capital ratios remain strong despite the uncertain economic environment.

2. Truist Financial (TFC) Investor concern regarding the banking industry-wide liquidity and capital levels following isolated regional bank failures pressured shares. TFC's balance sheet, asset quality and capital ratios remain strong despite the uncertain economic environment.

3. Booz Allen Hamilton (BAH) Following robust outperformance and valuation expansion in 2022, BAH underperformed in 1Q2023. Given solid results and increased FY2023 guidance during the quarter, weak relative performance was largely driven by a rotation in investor preference as opposed to fundamental deterioration.

Strategy Characteristics			
Qualified Dividend Income (% of Total)	94.4%	Number of Holdings	50
Median ESG Percentile Rank (Universe / Sub-Industry)[1]	18.3 | 13.6	Weighted/Median Market Capitalization	$163.5 B / $71.2 B
QTD / YTD Turnover	5.0% / 20.1%	A-or better S&P Ranking	41.9%

Source: [1]Sustainalytics. Please refer to Disclosures for additional information on third-party data.

Due to reporting complexities resulting from new SEC marketing guidelines effective 4Q22, Bahl & Gaynor will no longer publish composite performance in its quarterly newsletter. Performance figures may be obtained through your Bahl & Gaynor contact or financial advisor.

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Thanks

Your continued support and interest are much appreciated.

Everyone at Bahl & Gaynor would like to thank you for the opportunity to serve your investment needs.

Important Disclosures

Legal Stuff

*Bahl & Gaynor and FactSet; historical downside (upside) capture is the sum of strategy returns on all S&P 500 down (up) days divided by the sum of index returns on all respective down (up) days. Down (Up) days are defined as any trading day the index posts a negative (positive) total return. Strategy performance is derived from the internal rate of return (IRR) of a single non-fee paying representative/model account.

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