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Dear Clients and Friends,

September marked the 98th month of the current domestic economic expansion, making it the third longest since 1850. The all-time record--120 months--is within sight: June 2019. As Yogi Berra admonished, "It's tough to make predictions, especially about the future." We have no idea when, or why, the economy will next recede, but we know it eventually will. Whatever the case, there is little question that this expansion has broken a lot of molds.

Re-Writing History?

During the 19th and early 20th century, the United States experienced frequent boom and bust cycles characterized by short and intense expansions and contractions. Policy mistakes turned the hangover from the wildly bullish 1920s into the Great Depression of the 1930s. The changing composition of the domestic economy and ever-improving data measurement techniques helped establish a new pattern of relative stability in the post-WWII era, with longer stretches of prosperity and generally milder recessions. That is, until the global banking crisis triggered the Great Recession of 2008-2009. The policy responses to that debacle of near-zero interest rates and quantitative easing have produced a benign backdrop of low inflation and excess liquidity in the financial system for the economy to grow, corporate profits to rise, jobs to be created and stock prices to rally virtually uninterrupted since bottoming more than eight years ago.

Although impressive in duration, growth of US GDP has remained muted, and by some measures, below potential. Despite this, first half 2017 S&P 500 operating earnings grew at a double digit rate in consecutive quarters for the first time since 2011. Revenue reported by the S&P 500 in the second quarter grew by 5%, continuing a two year trend of faster sales growth. Growth outside the US has accelerated and now exceeds ours in many parts of the world. The companies that comprise the S&P 500 derive more than half their revenues from abroad, so it stands to reason that our larger, global companies are growing more robustly than the domestic economy alone.

We have written often over the last several years cautioning investors to be wary of stretched stock valuations. It is possible, however, that companies within our investable universe will grow into what might seem like presently lofty values. As we approach the end of the year, investors' attention turns to potential earnings in 2018. Consensus projections suggest that

S&P earnings will grow 8-10% next year, slightly slower than 2017 but still robust. This outlook for earnings could prove conservative. Over the last 6-7 months, the US dollar has shrunk markedly in relation to other currencies. A weaker dollar typically causes corporate earnings to accelerate as US produced goods become more competitive abroad, and also tends to spur domestic demand as locally produced goods are more affordable compared to imports. We note that this relatively benign earnings outlook could occur without any meaningful action from Washington to reform the tax code or reduce the regulatory burden.

Unless conditions occur that would undermine company earnings growth (recession, trade wars, hot wars, or some other difficult to predict "black swan"), we believe the current bull market may have further room to roam. We see no reason to stray from our long held belief that ownership of high quality companies remains an investor's best option to preserve and grow wealth. After all, while the S&P 500 may trade at a lofty 21x trailing twelve month earnings, the price of a ten year US Treasury bond ($100) divided by its annual 'earnings' (about $2.00) results in a price/earnings proxy of roughly 50X. Moreover, the purchaser of the bond will never earn more than the $2.00 annual coupon during the life of the investment. In contrast, the average dividend on the S&P 500 is also about 2%, and most companies that pay dividends have a goal of increasing them over time. The percentage of earnings paid to shareholders as dividends has steadily shrunk to historic lows as companies use cash to reinvest in growth, make acquisitions or buy back shares. As a result, many companies have a greater capacity to grow their payouts to shareholders than they've had for the last 90 years.

Do Dividends Matter?

The current 2% annual dividend yield on the S&P 500 has remained about the same for much of the last eight years, even as the index has increased 265%. Companies have grown their dividends at roughly the same pace as stock prices have risen. It has been decades since dividends have been considered an important aspect of owning stocks. At Douglass Winthrop, they are typically low on the priority list of factors we consider when evaluating the quality of a potential new investment. Since 1930, however, dividends have accounted for an average of about 60% of the stock market's total return to investors. In decades that have experienced severe share price contractions (the 1930s and the 2000s), dividends have accounted for 100% of the return from the market. (Share prices were negative during both those decades.)

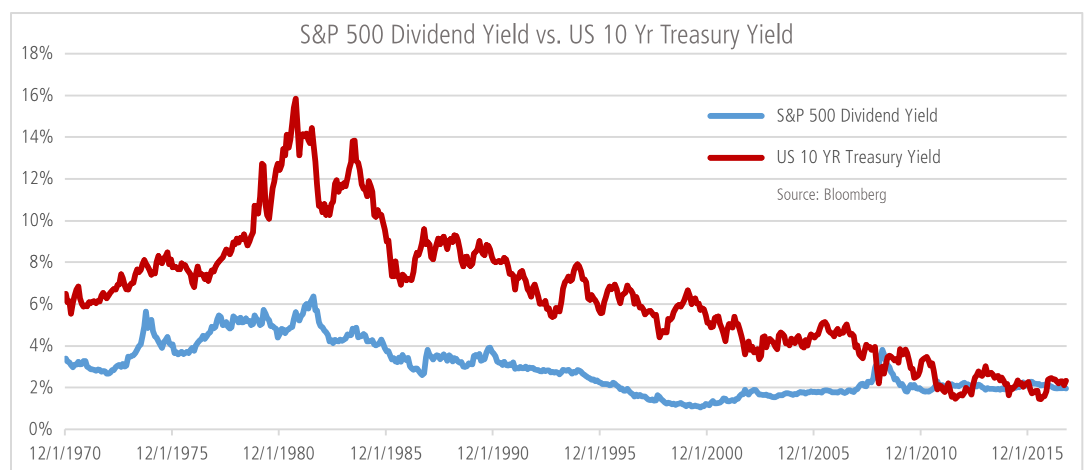
To illustrate the importance of dividends and the advantage they have over the fixed income on bonds, consider two Douglass Winthrop portfolio companies. Amgen initiated a dividend in 2011 of $0.56 per share. That year the stock traded at an average price of about $54 per share, an indicated dividend yield of about 1%. In 2017, Amgen is expected to pay $4.60 per share in dividends, a current yield of about 2.6%. It is impressive enough that Amgen's payout

to shareholders has increased 820% in six years. Now consider that had one bought Amgen in 2011 for $54 per share, the current yield on the original cost per share would be 8.5%, well in excess of the 5.6% average current yield on high yield "junk" bonds, not to mention the relatively paltry yields on safer bonds. We would also note that Amgen pays a modest 36% of its net income in dividends and has a cash hoard of $40 billion, suggesting there is room for growing the dividend.

At first glance, Mastercard does not appear to be a generous dividend payer. We first established a position in Mastercard in early 2011. At the time, Mastercard paid an annual dividend of $0.06 per share for a yield of about 0.02%. Today, Mastercard's yield is still a modest 0.07%, but the current payout of $0.88 is nearly a 1500% increase in the company's dividend over the last six years. Nevertheless, Mastercard pays only 20% of its net income in dividends. We believe investors could be treated to rising dividends for years to come.

This discussion is not meant be a debate over the relative merits of paying dividends. A few companies in Douglass Winthrop portfolios, including Berkshire Hathaway and Alphabet, pay no dividend and show no inclination to do so. Investors in both companies have been richly rewarded through appreciation of the stock price. Berkshire chairman, Warren Buffett, believes taxable dividends are an inefficient way to create shareholder value when compared to earning tax free compounding through share price appreciation.

So why bother talking about dividends? When the average dividend yield on the S&P 500, more or less, equals the yield on 10-year US Treasury bonds, we think investors should take note. Since the 1950s, the S&P 500 has typically yielded significantly less than the 10-year Treasury bond. See chart below:



The fact that the yields on the 10-year US Treasury bond and the S&P 500 are closer than they usually have been in the past six decades could be an indication that equities are still cheap relative to bonds, or it could mean that bonds are expensive, or both. Another cautionary note with respect to bonds, including such safe havens as the 10-year Treasury: with a payout that approximately equates to the rate of inflation, purchasers of these bonds are apparently happy giving their money to the US Treasury with the expectation that in ten years' time they will simply get it back with no real return. If inflation exceeds the yield on these bonds over the next ten years, investors will suffer erosion of their purchasing power. Our view is that bonds are priced for perfection with little margin of safety. For investors with a low tolerance for volatility, however, bonds nevertheless have a useful role to play in a balanced portfolio.

Staying The Course

We do not expect the historically low volatility investors in equities have experienced recently to last. Tense geopolitical conditions, a new level of feckless partisanship in Washington, and the increasing likelihood of central bank tightening in the developed world, could herald a return to more normal levels of volatility. While Yogi Berra is correct that it is tough to make predictions, especially about the future, we are confident that ten years from now, barring extraordinary circumstances, the S&P 500 will be higher than it is today. Furthermore, when the current expansion comes to its inevitable end, creative management teams in excellent companies will be working hard to capitalize on new opportunities, sowing the seeds of the next recovery and expansion. Based on the evidence, we continue to believe that the careful selection and long term ownership of exceptional companies is the best service we can render to our clients.

At Douglass Winthrop, we never take for granted the confidence placed in us by our clients. We attempt to reward that confidence by nurturing a culture of putting clients' interests first, of transparency, of service and counsel to the families, trusts and endowments we are privileged to serve. We thank you for your trust and support. As always, your questions and comments are welcome as are your visits to our offices in New York, Washington and Boston.

Sincerely,

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