

26 May 2021

Dear fellow investor

## 21-months of strongly rising dividends

To date we have reached several important milestones:

- 70 consecutive correctly predicted dividend increases.<sup>1</sup>
- Average dividend increase of 13.88%.<sup>2</sup>
- 66 investor families joined the fund.<sup>3</sup>
- 6 quarterly distributions paid, including two increases. Most recent distribution increase of 11.1%.<sup>4</sup>
- Core underlying USD return of 44.58% net, or a compounded annual return of 24.09% net.<sup>5</sup>
- AUD return of 27.04% net, or a compounded annual return of 15.04% net.<sup>6</sup>
- 61 years of continuous empirical validation of the underlying MIT dividend growth model.
- 29 weeks of real-time dividend progress reporting, enabling participants to experience the power and feel of a dividend prediction machine in action.

## Performance summary:

| Dividend performance                        |        |
|---|--------|
| Consecutive dividend increases <sup>7</sup> | 70     |
| Average dividend increase                   | 13.88% |

<sup>1</sup> See dividend track record attached at the end of this letter.

<sup>2</sup> Simple average, see dividend track record attached at the end of this letter.

<sup>3</sup> As at 30 April 2021.

<sup>4</sup> For the quarter ended 31 March 2021.

<sup>5</sup> As at 30 April 2021.

<sup>6</sup> As at 30 April 2021.

<sup>7</sup> Correctly predicted in advance by the proprietary DivGro system, from 15 August 2019 onwards.

| Return since inception - cumulative (net) <sup>8</sup> |        |
|--|--------|
| USD  | 44.58% |
| AUD  | 27.04% |

| Return since inception - annualized (net) <sup>9</sup> |        |
|--|--------|
| USD  | 24.09% |
| AUD  | 15.04% |

### The hidden element behind dividend increases

Our system rests on MIT's Nobel Prize winning classic work, that the rate of increase in a company's dividend will ultimately translate into an approximately equal increase in its share price:

$\Delta$  share price  $\cong$  (sustained) rate of dividend increases

Of course, these dividends arise from that part of a company's earnings that it chooses to share with its investors. Hiding behind the MIT formula is the implication that a company can only sustain a rising dividend over time if it is becoming more productive and therefore more valuable over time.

Our research suggests that most market participants that are at all interested in dividends, of which there are relatively few, are only interested in the absolute level of dividends (i.e. dividend yield) and completely disregard (the much more important) *rate of growth* of those dividends. Herein lies our opportunity – if indeed dividend increases power share price increases, it makes more sense to rather focus on the *rate of change* in these dividends.

But why and how do dividend increases lift share prices upwards?

First, a dividend increase is a signal that a business is progressing and that the board of directors expects such progress to continue. When one dividend increase evolves into a sequence of increases, more investors become convinced about a company's positive developments and are gradually willing to pay increasingly higher prices each time their expectations of future improvements (and their resulting share of rising income streams) are confirmed.

Second, far more important, and generally missed, is the hidden part of that dividend activity that one does not see.

A magician waves one hand around to get your attention while the other hand does the trick. To be smart, watch the other hand. The waving hand is the current dividend yield: current income that grabs the attention of most market participants. But a DivGro type company, selected from a higher-quality subset of all companies, tends to pay only a small part of its earnings out as dividends and tends to trade at a low current

<sup>8</sup> Net of fees and expenses, inclusive of distributions and accrued rebates, as of 30 April 2021.

<sup>9</sup> Net of fees and expenses, inclusive of distributions and accrued rebates, as of 30 April 2021.

dividend yield. This means that most of the earnings are therefore retained by our companies for reinvestment.

Our companies reinvest most of their earnings back into improving and expanding their already excellent businesses, and earn approximately 20-25% on these reinvestments, sometimes even more, indefinitely. We showed this in action in previous letters detailing how Starbucks<sup>10</sup>, Costco<sup>11</sup> and Domino's<sup>12</sup> earn outstanding returns on their reinvestments. This is the magician's second hand at work – reinvesting most of the earnings not paid out as dividends in remarkably high return initiatives. At such rates, a company will compound its intrinsic value very quickly and enable it to continue funding its fast-rising dividend payments at the same time. The key takeaway here is that the decisive factors enabling long-term dividend growth have relatively little to do with the current dividend rate or opening dividend yield, which garners most of the market's attention. Rather, it is the part that is retained and reinvested, and the return earned on that incremental reinvestment that drives increasing dividends long into the future.

As the sequence of dividend increases extends, market participants become willing to pay higher share prices each time their expectations of future improvements (and their resulting share of rising income streams) are confirmed. Watch the magician's other hand...

**Companies that raise their dividends at consistently high rates are proven winners. Since our companies can reinvest most of their earnings at very high rates – such as 20-25% – for a very long time – they are most likely to stay winners.**

### **Psychology: inverting problems to profits**

While the hidden component of the dividend, or that part not paid out, is our key growth driver, the part that is paid out as a dividend is still mission critical, but in a completely different (and perhaps unexpected) way.

The activity of receiving real cash dividends in a consistent and timely fashion, and seeing these increase regularly is fundamental to creating a tightening bond between the investor and their investment. Evidence is overwhelming that in the absence of such a tightening bond, investors typically fail to reap the benefits of their investments, irrespective of how good these underlying investments may be. This is true in individual stocks, bonds, mutual funds, ETFs, etc.

DivGro is uniquely pioneering an approach which blends a proven underlying investment methodology with a reinforcing and more compatible psychological framework, the purpose of which is designed to close the gap between an investment's underlying performance and what an investor actually receives.

The system shifts investors' focus to dividend behaviour – which is deliberate and linked to real business performance – and away from erratic short-term price movements. This is further reinforced by the *Weekly Dividend Progress* update which seeks to break the so called 'long-term' into an easily digestible sequence

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<sup>10</sup> DivGro letter to investors – October 2020.

<sup>11</sup> DivGro letter to investors – December 2020.

<sup>12</sup> DivGro letter to investors – February 2021.

of short weekly intervals. We know of no other system anywhere which can provide such truly meaningful information on a short-term basis and are therefore not surprised by the overwhelmingly positive feedback to these weekly emails.

### Blockbuster profits: an old dog's new tricks

Common to almost all of our investments is an unusual or hidden insight that helps to explain an outstanding dividend increase record and why this record is likely to extend for a significant time into the future. See previous letters for examples of such insights.

Consider our holding in Zoetis, the world leader in animal health. Zoetis is underfollowed and misunderstood, partly because it appears to have a relatively short history. In fact, Zoetis' heritage stretches back to 1952 in its prior form as Pfizer Animal Health before its spinoff into an independent company.

While spinoffs from excellent companies tend to be fertile hunting ground for promising investments, Zoetis has been especially good for a few key reasons. Firstly, global pet ownership has been rising in developed countries, and has been rising even faster in developing countries with the emergence of a greater middle class which tends to aspire towards pet ownership. Not only is the 'installed base' of pets growing quite rapidly, but the willingness and propensity to spend more on each pet is growing rapidly in tandem. Studies show that even in a downturn people will cut back on their own expenditures before cutting back those of their pets.

As a general observation, we like to see an installed base into which our companies sell seemingly forever, particularly where their products command an industry standard status. This appears to be the case in Zoetis.

Zoetis occupies a dream position being the hugely dominant #1 in pet medication, as indicated by the following 13 blockbusters:<sup>13</sup>



<sup>13</sup> Zoetis corporate overview presentation.

For the dog/cat/horse owners among you, while you are probably not familiar with any of these names, it is a near certainty that your pet's ongoing health depends on some or several of these. Once prescribed, none of the above indications are one-and-done solutions i.e. your pet will need an ongoing repeat dose at least annually, for the rest of its life.

Further cementing Zoetis' incumbency is the fact that most current vets have been trained to prescribe Zoetis' indications as the go-to standard of care for their entire career. Zoetis' peerless sales force is also ensuring that those vets currently in training are being indoctrinated the same way.

The vet decides which medication to prescribe, rather than the pet owner. The vet is principally driven by the wish to provide the best quality care which is commonly understood to be the Zoetis product line as it occupies the #1 position in its key lines. Price is of secondary concern to the prescribing vet who will invariably pass it on to the owner or pet insurer. This means that to attempt to displace Zoetis, a competitor will need to prove to most vets that their new product is overwhelmingly better since price is not a material competitive determinant. This translates into a situation where Zoetis' medications are usually only usurped by Zoetis itself bringing out a new and improved version of their own product (invariably at a higher price). While there is some degree of competition and price sensitivity in Zoetis' livestock category (where the customer is often a large corporate or government) this division is a relatively small and shrinking profit centre.

Notwithstanding, the pivotal hidden secret is actually the following: *1/10<sup>th</sup> of market size at 1/100<sup>th</sup> of the cost.*

Human health markets are vast, but because the odds of successfully taking a drug from preclinical studies to the marketplace are so low (estimated at 1 in 10,000) the resulting reward is so great that it ensures bitter competition.

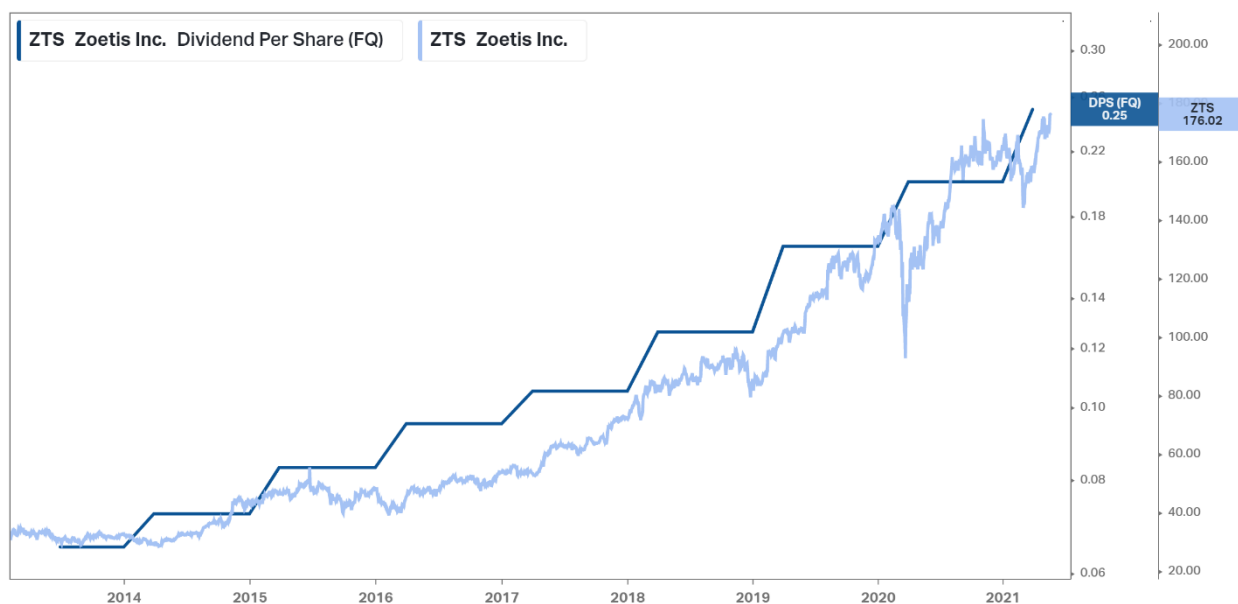
Conversely, since animal health markets are typically only 1/10<sup>th</sup> the size of the human equivalent, on the surface this would suggest that the animal marketplace is considerably less interesting. However, since the cost to bring a drug to market is typically only 1/100<sup>th</sup> of the human equivalent, it immediately becomes clear that the animal medication marketplace can be extremely seductive provided that not too many competitors attack the same space simultaneously.

**Because of this gap: 1/10<sup>th</sup> of the market at 1/100<sup>th</sup> of the cost, an obvious arbitrage opens whereby a human health application is repurposed for animal use. Since there is no end to attempts to discover new and improved human indications, the inference is that this human-to-animal arbitrage opportunity can theoretically continue to be exploited indefinitely.**

For the reasons discussed above, where Zoetis already occupies a stranglehold over a particular application, there is little to no point allocating money, time and effort trying to displace it in its key niches. It would be much more worthwhile for a competitor to try and address an area of the market that Zoetis does not yet occupy. This is reinforced by Zoetis' ability to spend more on research and development than the rest of the industry combined which tends to further extend its leadership. To this end, Zoetis' stated

algorithm is to leverage its best-in-class sales and distribution force with its vastly greater research and development budget to grow faster than the pet health industry, which is already a fast-growing category.

Given its history as Pfizer Animal Health, Zoetis inherited most of its legacy lineup, and by exploiting the cost-to-size repurposing arbitrage, it enjoys enviable profit margins. It is these profit margins coupled with the secular growth in the pet health category that has enabled Zoetis to grow its dividend so fast since becoming independent, and why it can be expected to sustain a high rate of dividend growth long into the future.



The Zoetis graph is a good illustration of the tight bond between dividend increases and corresponding changes in share price as described above. Zoetis' dividend increases have been well translated into roughly equivalent changes in share price. Zoetis has been a key holding since we opened the fund in August 2019, and our dividends from Zoetis are already 52% higher than back then (powered by dividend increases of 21.95% and 25.00%).

Thanks again for your continued support.

Sincerely,

Jonathan & Barney

DivGro Fund dividend increases<sup>14 15</sup>

| Increase Number | Declaration Date | Company Ticker     | Dividend Increase % |
|-----------------|------------------|--------------------|---------------------|
| 1               | 14-Sep-19        | AMT                | 20.25%              |
| 2               | 18-Sep-19        | MSFT               | 10.87%              |
| 3               | 19-Sep-19        | MCD*               | 7.76%               |
| 4               | 19-Sep-19        | TXN                | 16.88%              |
| 5               | 22-Oct-19        | V                  | 20.00%              |
| 6               | 29-Oct-19        | CTAS               | 24.39%              |
| 7               | 30-Oct-19        | SBUX               | 13.89%              |
| 8               | 31-Oct-19        | CDW*               | 28.81%              |
| 9               | 01-Nov-19        | ABBV*              | 10.28%              |
| 10              | 07-Nov-19        | AL*                | 15.38%              |
| 11              | 14-Nov-19        | NKE                | 11.36%              |
| 12              | 15-Nov-19        | ROP                | 10.81%              |
| 13              | 25-Nov-19        | BDX*               | 2.60%               |
| 14              | 03-Dec-19        | MA                 | 21.21%              |
| 15              | 04-Dec-19        | SYK                | 10.58%              |
| 16              | 04-Dec-19        | ECL*               | 2.17%               |
| 17              | 11-Dec-19        | ZTS                | 21.95%              |
| 18              | 12-Dec-19        | AMT                | 20.24%              |
| 19              | 13-Dec-19        | ABT                | 12.50%              |
| 20              | 20-Jan-20        | MTY.TO*            | 12.12%              |
| 21              | 24-Jan-20        | YUM*               | 11.90%              |
| 22              | 29-Jan-20        | MKTX               | 17.65%              |
| 23              | 29-Jan-20        | SPGI               | 17.54%              |
| 24              | 29-Jan-20        | SCHW*              | 5.88%               |
| 25              | 05-Feb-20        | CME*               | 13.33%              |
| 26              | 06-Feb-20        | ICE*               | 9.09%               |
| 27              | 10-Feb-20        | QSR*               | 4.00%               |
| 28              | 20-Feb-20        | DPZ <sup>†</sup>   | 20.00%              |
| 29              | 20-Feb-20        | SBAC               | 25.68%              |
| 30              | 24-Feb-20        | HD                 | 10.29%              |
| 31              | 13-Mar-20        | AMT                | 20.00%              |
| 32              | 01-Apr-20        | WSO                | 10.94%              |
| 33              | 15-Apr-20        | COST               | 7.69%               |
| 34              | 23-Apr-20        | POOL               | 5.45%               |
| 35              | 19-May-20        | AMT                | 19.57%              |
| 36              | 21-May-20        | MDT*               | 7.41%               |
| 37              | 28-Jul-20        | MSCI <sup>††</sup> | 14.71%              |
| 38              | 21-Aug-20        | LOW                | 9.09%               |
| 39              | 10-Sep-20        | AMT                | 20.00%              |
| 40              | 15-Sep-20        | MSFT               | 9.80%               |

<sup>14</sup> \* represents companies no longer in the DivGro Fund portfolio.

<sup>15</sup> † reintroduced as a holding in the DivGro Fund.

|    |           |        |        |
|----|-----------|--------|--------|
| 41 | 17-Sep-20 | TXN    | 13.33% |
| 42 | 30-Sep-20 | SBUX   | 9.76%  |
| 43 | 23-Oct-20 | V      | 6.67%  |
| 44 | 27-Oct-20 | CTAS   | 10.20% |
| 45 | 30-Oct-20 | ABBV*  | 10.17% |
| 46 | 02-Nov-20 | CDW*   | 5.26%  |
| 47 | 09-Nov-20 | AL*    | 6.67%  |
| 48 | 12-Nov-20 | ROP    | 9.76%  |
| 49 | 20-Nov-20 | NKE    | 12.24% |
| 50 | 02-Dec-20 | SYK    | 9.57%  |
| 51 | 03-Dec-20 | ECL*   | 2.13%  |
| 52 | 03-Dec-20 | AMT    | 19.80% |
| 53 | 08-Dec-20 | MA     | 10.00% |
| 54 | 09-Dec-20 | ZTS    | 25.00% |
| 55 | 11-Dec-20 | ABT    | 25.00% |
| 56 | 19-Jan-21 | CTAS   | 6.76%  |
| 57 | 27-Jan-21 | SPGI   | 14.93% |
| 58 | 27-Jan-21 | MKTX   | 10.00% |
| 59 | 01-Feb-21 | YUM*   | 6.38%  |
| 60 | 04-Feb-21 | CME*   | 5.88%  |
| 61 | 09-Feb-21 | MCO*   | 10.71% |
| 62 | 11-Feb-21 | WSO    | 9.86%  |
| 63 | 17-Feb-21 | SHW*   | 23.13% |
| 64 | 22-Feb-21 | SBAC   | 24.73% |
| 65 | 23-Feb-21 | HD     | 10.00% |
| 66 | 24-Feb-21 | DPZ*†  | 20.51% |
| 67 | 04-Mar-21 | AMT    | 14.81% |
| 68 | 14-Apr-21 | COST   | 12.86% |
| 69 | 04-May-21 | POOL   | 37.93% |
| 70 | 21-May-21 | 0700*† | 33.33% |

**Average                    13.88%**



**Important disclaimer**

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