Defining Return Expectations by Employing a TSR Framework

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At Crawford Investment Counsel (Crawford), we continually strive to improve upon our investment research process of underwriting businesses and making judgments about individual stock valuations. Our preference for companies with long histories of dividend consistency leads us to invest in higher-quality businesses, which we believe elevate our likelihood of success in the process. We also seek to further enhance our probability of "getting things right" by using a variety of analytical tools and conventions which dovetail with our underlying philosophy and rigorous fundamental approach. One such protocol that has been developed and honed over the past 4-5 years is our "TSR Framework." This exercise defines and evaluates our internal expectations for a company's Total Shareholder Return (TSR) algorithm. It is an example of a process enhancement that we believe helps us better achieve our investor objectives.

FORMULA FOR TSR. The components of total shareholder return are defined in our overall growth algorithm as: sales, a measure of before-interest expense and taxes profitability, earnings per share, dividend yield, and any expected valuation change. We find that this methodology is well-suited for an investment approach such as ours due to our focus on higher-quality businesses. We believe this produces more consistent earnings, cash flow, and ultimately, dividends. Our insistence on limiting investment to only predictable and consistent companies means we have more visibility on each of the individual components of investment return, and this insight enables a higher confidence interval around our investments. Importantly, this enables us to more rapidly detect companies performing above or below our internal growth expectations and thus empowers portfolio decision-making. In summary, outlining our formal set of expectations around each component of investment return is something we find is well worth scrutinizing and continually tracking. At its essence, this really defines "what we are playing for" in each of our portfolio investments.

One significantly positive byproduct of this investment apparatus is that it enables more effective comparison and evaluation of cross-sector investment opportunities where different members of the analyst team are arriving at conclusions on companies under their coverage. The TSR framework formalizes each component of expected return. While return is not the only measure upon which investment opportunities are evaluated, this exercise helps break down some of the structural impediments that can occur when comparing investment opportunities across different areas of the economy and those that fall under different analyst coverage, helping eliminate investment bias that can exist. We believe that not only does this practice produce significant benefits for purposes of individual company considerations, but when collectively evaluated at the portfolio level, it can help inform decisions on overall levels of expected returns. In other words, it becomes a reality check on how much a group of companies might be able to

provide investors over an intermediate-to-long term investment horizon, and more precisely, how those results might be achieved.

Below, we apply the TSR formula to leading health care company Johnson & Johnson (JNJ), which meets our strict underwriting criteria and is owned across several of our large capitalization stock portfolios. **JNJ's annualized TSR potential over the next few years is estimated at 9%-11%.**

SALES: +3.5%-4.5%. We analyze each of the three divisions to determine a corporate level, sales growth rate.

- **Pharmaceuticals** (55% of total sales, 5%-7% expected growth): The oncology and immunology franchises account for over half of the division, and both are growing at a low-teens rate, whereas other drug areas face losses of exclusivity and competition that restrain overall growth potential.
- **Medical Devices** (30% of total, 1% growth): We see this half of business represented by advanced surgery products and interventional solutions as outgrowing the underlying market and mostly offset by declines within the orthopedic and vision segments.
- **Consumer** (15% of total, 2%-4% growth): This division is propelled by steady demand for several power brands (Zyrtec, Motrin, Aveeno, Listerine) which are expanding at mid-to-high single digits rate, whereas other smaller products grow less rapidly.

EARNINGS BEFORE INTEREST AND TAXES (EBIT): +6%-8%. In a similar fashion to sales, we assess the profit growth potential of each division.

- The **Pharmaceutical** division is the most profitable, with operating margins of ~30%, and over the next several years, forecasted profit growth is similar to that of sales given the ongoing need for a high rate of research and development investment.
- The **Medical Device** division is currently under-earning, in our opinion. Despite having the lowest revenue growth, its EBIT growth should be faster than sales as profitability expands due to a combination of product mix and recovery in procedure volumes depressed during COVID.
- The **Consumer** division is a more stable performer, both in respect to sales and EBIT growth. We anticipate some margin improvement leading to EBIT growth slightly outpacing that of sales.

EARNINGS PER SHARE (EPS): +6.5%-8.5%. Below the operating line growth generated from capital deployment, we conservatively expect modest benefit from share repurchase, consistent with the $5 billion spent annually over the last three years. We do not see the company reducing debt, and it maintains a differentiated AAA-rated balance sheet, which could easily support a higher level of capital deployment.

DIVIDEND YIELD: Johnson & Johnson currently pays a well above-market 2.4% dividend. The company has increased the dividend for 59 consecutive years, and we anticipate 6%-8% growth over time (the last five years, dividend increases have been very consistent at 6%).

VALUATION: We view the current valuation of Johnson & Johnson as neutral to slightly positive. We analyze

valuation using several different approaches and perceive absolute valuation as fair versus history, and we note relative valuation is attractive versus the broader market. We conservatively assume no significant contribution to JNJ's TSR from valuation improvement.

In our quarterly earnings reports, we include a summary graphic:

JNJ TOTAL SHAREHOLDER RETURN POTENTIAL: 9.0%-11.0%

Sales: +3.5%-4.5% – upside from COVID vaccine, Pharma pipeline, and Device volumes
EBIT: +6.0%-8.0% – portfolio re-alignment and operating leverage
EPS: +6.5%-8.5% – constant though modest share repurchase benefit
Dividend: 2.4% – dividend should grow mid- to high-single digits
Valuation: neutral to slight positive bias

While companies often share with investors their "growth algorithm," we are the only firm we are aware of that formally incorporates this into our process, maintains and adjusts company-specific expectations on at least a quarterly basis, and embraces a stock rating system that complements this by focusing on the main components of TSR. Please see our piece on Internal Stock Ratings for further discussion of this topic.

Our goal is to produce attractive total investment returns for our investors, while maintaining a lower risk profile. Risk can manifest in fundamental shortfalls or valuation compression, both of which can be factored into our model. We incorporate this into our modelling and expectations in an effort to identify and own fundamentally strong companies that both demonstrate consistency in their business and are attractively valued. This leads to a "smoother ride": less risk and the ability to help preserve capital in difficult market environments. Our internally developed TSR methodology is one important enhancement to our proprietary process that relies entirely on our produced research and analysis. Our process is unique, leading to differentiated portfolios that are uniquely successful. This requires differentiated thinking and internally developed tools that help us build consensus and promote group discussion and input. In summary, we think this helps lead to more successful outcomes in portfolio management for our clients.

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