DIVIDEND CAFE | PODCAST TRANSCRIPTION

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Well, hello and welcome to another Dividend Cafe. I am at the tail end of what has been incredibly productive and informative and stimulating week. And we're recording from our New York office studio in the middle of the market day on Friday. And I don't know, I think I've been in the office three times all week and for very brief periods. I mean how many meetings we've had outside of the office has been absolute whirlwind. Very, very long days and very high quantity of meetings and really some meetings with money managers with hedge funds. There was a one day, there was a symposium of different economists and more global macro type guys. But either way, the amount of information we brought in has been really substantial and I think that some of the takeaways are going to be really, really valuable.

So I need to consolidate that, organize it. Our investment committee had a initial kind of autopsy type meeting last night, but then we've had a couple more meetings here today. And so we're going to wrap a bow, tie a bow around what we're trying to take away from this. And then we'll create a client deliverable of just key takeaways and summaries and thoughts and probably be back at you, maybe even Dividend Cafe talking more about it. So today, rather than kind of go to some of the key takeaways and lessons from the week, I do want to just have a brief conversation about our view right now in terms of this tension between short and intermediate view of the markets. Because I would say the vast majority of the time we have a view that is 'short term agnostic' meaning I have no idea and don't care what the market's going to do in the next three weeks, three months, one year, whatever.

And intermediate term that is more often than not more bullish but is meant to be by design more nuanced. And this is one of these rare times where we have a view in the short term and intermediate that is quite similar if you're talking about the broad stock market risk assets at large. And I'm more convinced than ever mathematically and intellectually that were in for a period of a range bound type market. And so I think in the distinction between the short term view and intermediate, it's always still agnostic in the short term, but I'm very open to kind of continued bearish feelings in the short term. Although even then my bearishness is not sincere. It believing that you very well could go lower is different than saying I know we absolutely will. I just believe that right now we're in a period of markets sort of solidifying around certain uncertainties and it's very difficult to solidify solid right certainty out of uncertainty.

And the uncertainties have to do in the short term with what the stimuli will be that the Fed reacts to, how the Fed will react to that stimuli and how markets will respond and when to what the Fed does in response to what the stimuli may be. So you have layer upon layer of variable and there's uncertainty there and it enhances market volatility. And I think there's an upside risk. And what that term means is the risk of things going higher when you're not in them. And that upside risk centers around the idea that 'yes, you may have recession' and 'yes, you may have more Fed tightening'. And we've already seen it's gone a hundred basis points in terminal Fed Funds Rate more than I thought it would. And maybe it goes more than that. I don't know yet.

Markets have priced that in. And the upside risk is do you before employment conditions, economic conditions, potential recessionary concerns get better?

Do you see the markets start to price in the inevitability of some normalization and some recovery? And that would not be an outlier, that would be the norm. It happens more often than not. So there's an upside risk there. Those waiting for bad news to become good news absolutely miss a substantial amount of market based recovery. But then there's a downside risk of does the stimuli get worse? Does the Fed's response get more surprisingly challenging? Will the Fed break something more severe? And then the third is perhaps some of those things are not as priced in or market response to an unexpected market response to an unexpected Fed activity, to unexpected stimuli. If those things pile on one another, perhaps you get more downside. So in the short term that you have this idea of, look, you can have more days weeks is what we've been seeing lately.

The market's down a thousand and the next week it's up a thousand and there's a bit of volatility. And I'm of the view that bond yields are probably going to tell us when that kind of stops. They will not tell us when we go higher, but they will tell us when we stop going lower and that a new top in the Ten Year has not been put in. Or if it has, we don't know it yet. But once you get to that point at which you say, Okay, bond yields are done going higher, the dollar may be done going higher, and you can get some sort of reversal in yields in the US dollar, I think that it makes it easier to start to call a bottom. And we're not there yet. So there's an uncertainty in the short term environment and to me it's a great time to have cash that you can deploy.

And it's not just to stocks, it's one thing I'm talking about from this week is there's just a multitude for asset allocators who are opportunistic like I am, that you're just licking your chops right now at the ability to diversify a portfolio and create and represent different risk levels across an allocation at some of the levels that we're currently seeing for long-term investors. I think it's very appetizing. However on the equity side, the stock market side, I think that there's a great opportunity to enter into certain positions that are down to favor defensiveness and high quality. And actually you're getting paid quite nicely without having to reach for speculation and for junk and for low quality and for deterioration of earnings certainty and things like that. And it's what we call kind of short term versus long term equity, short duration versus long duration. And it's really quite synonymous with value versus growth in the short term.

We want dividends, we want dividend growth, we want to be agnostic about what stock prices do. We want less cyclicality. So we like the defensives with healthcare and consumer staples and energy and utilities and some of these things, some of which are doing very well, even in this distressed environment, some of which are not done as well. But that's the nature of a diversified portfolio. When I say the intermediate now has a similar outlook, what I mean is the reality of a flattish range bound, not a straight bear market down, not a straight bull market up expectation four, five, seven, maybe eight, nine, ten years. That's not a normal call. You have secular bear markets, you have secular bull markets. But when you come out of those, you generally get prolonged period of range band of choppiness. And there's periods where all of a sudden things feel a little better.

There's catalyst, there's macro economics that could be some Fed tight or excuse me loosening accommodation. And then you give some of that back as you go up and down. But the primary source of a market environment like that is when you can't get multiple expansion to drive equity market returns and to get secular bull market where you hey, because maybe, hopefully in Lord willing, the economy's doing well. So you have revenue growth and companies are efficient, so you get margin expansion. And then, so therefore revenue growth plus margin expansion is called profit growth just by because of math, it's a tautology. You get profit growth and that has to drive stocks. And we've talked about that a lot. But a bull market is when, yeah, of course there's got to be profit growth combined with a multiple expansion, a higher valuation over a sustained period of time.

And one of the things I do in Dividend Cafe today is I break out for you the actual math of what has taken place over the last 10 years. You know, do have stocks that were up, let's call it 300%, and you have profit growth that was 120% and sales growth that was up 50%. And you go, how do you get stocks up 300% off revenues up 50%. Well, because the profits were up more than 50%. So how does that happen? Margins expanded. So growing revenues with growing margins equals even more growth around the profits. That's good enough. But 75% expansion in the multiple, the valuation, that's the real story of the 2012 to 2021 stock market. We're leaving the bear market that we've entered into in 2022 out of it. So when I look to the next 10 years and I look at what caused our attribution of return over the last 10, do I think we're getting that same thing?

Are we going to get 75% expansion in the multiple? Well, remember we were at 12 times 13 times earnings coming out of GFC. We're at 17 and a half times right now, maybe 17, and we might even still be a little higher in that trailing 12, but on a forward basis, if you do end up somewhere between 210 and 220 of S&P earnings next year, and there's some that think it could be worse, it really can't be much better, but maybe it hits that level and you look at where the S&P is now, you're already at 17 to 17 and a half times. So are we going to get 25 times multiple in the S&P and the same level of earnings growth, which would require the same level of sales growth at the equal level margin expansion?

I mean, I don't think I'm out of bound to say that all three of those things are utterly preposterous. Like you'd have to be an imbecile to predict all three of those things. I don't believe there's an intellectual defense for arguing for one of those three things, not one of them. I don't think revenue growth can equal what it was out of the last trough with this level of economic growth. I don't think margins can expand. I think if there were any of those three, I'm willing to bet the most money on it would be that margins may contract. But if you are as bullish as can be, you say they kind of stay where they are. So you have equal level of margins. And that's best case on sales growth that is very, very likely to be more muted. And then a lack of that multiple expansion.

That to me is what an index investor very likely and not at all with some weird bearishness or perma pessimism, those people that do that stuff are such scoundrels and charlatans very likely don't even mean it themselves, but certainly don't know what they're talking about. That's not what I'm doing. I'm not one of these guys that permanently believes, oh, nothing is as good as it seems. And all of this is as blob of sham and is all going to go to hell in a hand basket. That's not who I am. Everyone who knows me knows that. But I do think as a sum of parts, we can dissect where equity tends to come from and throw in some expectations in the future and not come away thinking it's going to be a golden period for index investors and that you could have some ups and downs, a couple thousand up and a couple thousand downs, some range, maybe that range is 5,000 points up or down.

That's not a significant return. And maybe the range ends up being a little bigger. I'd be fine with that too. But that's still on a bullish side is arguing for 3% to 6% returns, not 8% to 10%, let alone the 16 that we got in the post-crisis decade. So this is of course and I always say like, Oh yeah, I'm talking my book here, but the reason why I don't need to footnote this or qualify it much is the fact that I'm talking my book is you people get the cause and effect wrong. Do I think dividend growth is a wonderful solution to a marketing environment like this? You're right, I do. But I am not saying that because it's my book, it's my book because I'm saying it because I believe it that. So there's a total mixture of chicken or egg here. The fact of the matter is that I believe a well diversified portfolio that is focused on free cash flow growth, that because of the likely enhanced volatility and uncertainty needs to lean into more defensive areas of the market, lower beta.

And that effectively what you do in a period where you're not going to get great multiple expansion is you shorten the duration of equities. What's that mean? Known earnings and revenues versus speculated earnings and revenues. And so where multiple expansion helps is where people have the highest long duration expectation of perhaps a company being the next Google or the next Apple or the next Microsoft. But those companies that first of all, very few become the next Google, Apple, Microsoft by definition. But also there's stock prices in the meantime get hammered because there's a long duration of expectation on when their earnings growth and sales growth will materialize. But there are these companies that are more boring, that have a more known reality to their current, they're more mature in their business cycle and they have a known 'knowns' in their financial particulars. And I think those are the kind of value oriented stocks that we think will do better.

And when you add that dimension of a dividend growth around, it makes an awful lot of sense. It insulates investors, particularly withdraws of capital who need to know they're going to have a source of liquidity and income. And then from a total return standpoint, when you add in the right diversifiers, as I talked about last week with what the bond market's now done, you theoretically add some diversifying elements. Maybe they're more growthy around small cap or emerging markets, both of which have secular catalysts that could very well provide them juicier growth returns than an S&P type index would. And then on the income side, there is a way to get paid now in certain aspects of credit markets and in alternatives and in private credit and in the loan market and in parts of the bond market. And you don't have to reach down the risk or credit spectrum to do so that you can kind of capture right now equal or superior yield at a far lower credit risk standpoint than you could have a year ago.

That's a good thing for asset allocators. It's a good thing for diversified investors, it's a good thing for those seeking to be opportunistic and yet maintain some kind of common sense around their risk level. So that that's our view right now is it is going to be an incredibly period difficult period for indexers and yet not a difficult period for all investors. There are things that can be done that we think will be very sensible in one zone financial planning, and for those who are trying to properly invest in the moment we find ourselves. But that moment we find ourselves, you can focus all on the short term if you want. What do we do when the Fed meets next week? What do we do when in Q1 we might officially be in recession? And again, like I said, there's three uncertainties around there and I would argue a somewhat symmetrical upside and downside risk around those things.

It's a little less interesting, it's certainly a lot more risky. But in the intermediate term, I think the reality of which I've kind of tried to lay out the paradigm I think we find ourselves in it speaks for an approach that I happen to believe is what we eat, sleep, drink, and breathe here at the Bahnsen Group and are going to continue doing so and make adjustments as needed within the particulars. So that's the Dividend Cafe today. That's what you get. It's a shorter Dividend Cafe than normal. And a lot of that has to do with the quite literally hundreds of pages of research I'm having to digest every night and morning after hours upon hours of these meetings. But when I say have to, I wouldn't have any other way. This is just as good a week as someone in my career can have. I absolutely love these meetings, these engagements, these arguments, these challenges.

Me being persuaded that I'm wrong about something, me persuading somebody else they're wrong about something that kind of 'come now together, you and I moment' with other economic and financial capital market intellects is a lot of fun. But it's very important because those taking a passive approach to this market are not, in my opinion, being true fiduciaries. And if we are anything at the Bahnsen Group, we may be the most boring people on the planet, but we are fiduciaries. Thank you as always for listening to and watching the Dividend Cafe. I was supposed to say at the beginning and I forgot. Please subscribe. Please rate us, Please help us to help you say all these things with the most utmost appreciation for your support of what we do in your faith in us as clients of the Bahnsen Group. Thank you again for watching the Dividend Cafe.

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