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Well, hello and welcome to the Dividend Cafe, and I am very happy to not be writing about the Fed today. I want to give you the same caveat, those of you listening to the podcast and watching the video, that when I say, "Oh, the Fed stuff's overdone, and I feel very strongly that the Fed has an outsized role in our perception of the economy", that I'm referring to, the fact that I do not believe they should have the role that they have, The fact that monetary policy is as significant as it is and that I criticize such is not a issue, rather with what is, but rather what I think ought to be. In other words, I got to keep talking about the Fed and I have to keep talking about the role of monetary policy in the economy and what it means for investors because the Fed does have that role. My critique is the fact that I do not think they should, that all things being equal, I'd prefer a landscape in which undeterred and unfettered human action, both with risk and with reward, both with victory and with pain played out in a business cycle and played out in what we would refer to as an economy, a market economy. And so I want to just put that out there that I'm taking a week off from talking about the Fed. But no, I don't get to stop talking about the Fed. And it is true that I'm reasonably obsessed with monetary economics, but I wish that monetary economics were more tangential to our understanding of investment opportunity and not so fundamental. Now, the fact that a lot of people get things wrong in the way they assess it, or at least I perceive or believe that there's a lot of inaccuracy in how people understand monetary policy and monetary economics, that's a whole separate deal and I'm going to keep writing and speaking and trying to clarify what that means for investors. And I don't think that's a few months or few quarters or a few years. I think it's a few decades, and I've said that for a while, but maybe now I should start this week's Dividend Cafe.

I'm excited to just take a week off from the Fed because I think every now and then there are things that ought to be talked about unrelated to

monetary economics, but I am pretty much talking about my other hobby horse. The other thing that I've obsessed over now, if monetary economics has been a sort of intellectual curiosity for over 20 years, dividend growth investing has certainly been an intellectual endeavor, but also a professional pursuit for 15 years. Now, it was in 2007 that I became fully converted after a very, very long and exhaustive process of study and analysis.

So I put three charts in dividendcafe.com this week and I'll explain it to you right now. One is what the Fed Funds Rate has been throughout my investing career. That is now over 20 years. You go back into the mid and late '90s and you had a Fed Funds Rate higher than is now but then you had it kind of drop substantially, then it kind of came up a little. And then we went to financial crisis and it went to zero for most of the time of the last 14 years. And now in the last eight months, it's obviously come back higher. It's been the subject of discussion. When you get past the Fed Funds Rate and look out at the 10 year bond yield, which is a more reasonable comparison in terms of an investment metric, the Fed Funds Rate may speak more to cash rates, but the 10 year speaks more to bond market returns and a more holistic asset class. And candidly we have gone a whole decade until just literally weeks ago, a whole decade without seeing a 4% yield on the 10 year. And so you're talking about a pretty lengthy period of time now, it was mostly over four, for periods before the financial crisis.

But the reason I bring this up is even with the Ten Year in that first decade of my investing life between let's say the four and six range and then of this lengthy period afterwards, dividend yields were a lot higher in the first decade as well. I have, when you're comparing to cash rates in the bond market always been able to start the conversation with a dividend growth portfolio is starting with a higher yield, a higher income distribution to investors, and then also has this and this. And right now

the 10 year at, let's call it 4.0% or 4.1%, and a dividend growth portfolio of about 4.0/4.1% at initial investment are at the same starting yield.

Now, I also have a chart at dividendcafe.com about the S&P 500 where you had a period in the first half of the '90s that the yield may have been above 3%. You went into through the tech boom where it kind of dropped back down near two below two even. And then the only other time period that it got above three was when the S&P dropped 50%+ during the financial crisis. And then as markets recovered, dividends were way down, valuations started going higher. The S&P has stayed right around a 2% yield basically for 14 years. And more specifically for the last several years of that with a yield in between 1.3 and 1.8%. So you go, Okay, well yeah, but now the market's down 20%, so that pushes yields higher. No, the S&P yield's still at 1.9. So that shows you how high the S&P was at its 22, 23 times multiple, that the current yield of the market index was down to 1.3. So even with this price depreciation you're only back to a 1.9 yield on the S&P.

So we're not going to spend much of our time focusing on comparing the starting yield of dividend growth or a dividend growth type portfolio to the S&P because there's still a very significant delta about a little bit more than double, but it's the bond yield thing that I think is very important. And one could argue, and this is kind of what I want to discuss, that somebody could put a million dollars into a 10 year treasury right now and they're going to get 4.1%. So they're going to get $41,000 per year, and at the end of the 10 years, they're going to get their million dollars back guaranteed by the United States Federal Government. And so 10 years worth of $41,000 of payments is going to be $410,000. So is it worth it for someone to avoid the volatility of the stock market, have a guarantee, a principle return, and get $410,000? And what I want to walk you through is what the math looks like.

For most of the time until financial crisis, dividend growth for my study of it suggests far more than a hundred years, but my intense study of 20th century investing in more sophisticated and modernized equity markets still indicates that it was the better way to go. But that was not because it had a starting yield higher than the bond market. That became an added feature in the period of financial repression where the Fed had rates down to the zero bound. And a part of Japanification is these lower expectations for long-term growth, putting downward pressure on bond yields, and I believe making shorter duration equities that have current cash flows and current known balance sheet characteristics that make it more investible, more attractive. But you say, "Okay, well maybe things have changed a bit because now that current yields come back higher." And I want to point out that if one, and I'm going to use the exact numbers I use in Dividend Cafe, if you get your 4.1% on a million dollars in a dividend growth portfolio, then that's right. You have 410,000 in year one, just like the bonds would've given you. But if we assume something in the range of about a 6% growth of dividend year over year, now that's at the low end of the range that we would be targeting is dividend growth portfolio managers. But I don't want to assume that what we've done in the past will be done. Again, I'm willing to lower the expectation but I'm being as conservative as I can be. Okay? And in my mind, the math here is going to tell us a few very important things because the compounding of it in year one, you know, get your 41,000. Now technically that's not even accurate because there would be dividend growth in year one as well but we'll pretend there. And then going into year two, the 6% kicks in and now it's 43,460, and then it's 46,000 and then it's 48,760 and 52, 55, 58. I'm rounding up rounding up or down to give an even number. The bottom line is taking that 41,000 of dividend growth in the first year and then just having that go up 6% a year, regardless of what the stocks do, regardless of up and down movements and volatility, that 41,000 in the final year becomes 69,000.

Okay? So from 41 to 69, you're talking about a 68% increase in the amount of income in the final year that the dividend growth portfolio generates versus the bond portfolio. But when you look at the income premium over the whole time, then you're talking about $540,000 over a 10 year period versus 410,000. Okay? So that's a 32% premium, 130,000 more divided by 410, that's a 32% premium. That's a lot. But see, that doesn't really even tell the story. I don't need to speculate what the dividend stock portfolio might be up after 10 years. All I know is that if an underlying asset has seen its cash flow distribution grow 6% a year for 10 years, then I believe it's going to be higher. Even if I don't believe that the earnings growth and the multiple expansion and other things that can play into it would've necessarily pushed prices higher that just by nature of the underlying distribution growth, think of it like real estate. Can real estate kick off more rental income year over year over year and not be higher in value? It's absurd. So even if I assume only 6%, the same 6% growth from dividend and don't factor in other earnings growth, other stock buybacks, other return to capital to shareholders other multiple expansion, any other kind of bells and whistles, you're still talking about if you use 6%, excuse me, 4%, 4%, then a one and a half million dollar value, and if you assume 6%, you're talking about 1.8 million. So then you factor in, you have $500,000 $800,000 more money and then you factor in that 130,000 of income premium. Okay, now you're talking about a 75% difference. I'm meeting in the middle of that 500 to 800, I'm saying 600 and something thousand plus the income premium. You're more or less talking about with me being as kind of absurd as I can be with estimates being conservative, something in the range of 75% difference between income and price appreciation. The price appreciation of the 10 year bond is known, it is zero. Now the price depreciation of the bond is also known. That's also zero. So the question is, the known return of principle at no dollar greater than the invested capital and what you assume would be much less volatility along the

way, bonds can have volatility this year is a pretty great case in point, but I'm the first to admit this is a historical year. Bonds generally don't have their yield go from 1.8 to 4.1 in one year. So I'm not going to count this year's volatility against the expected volatility profile of the asset class, but there would still be up and down movements on the way, but I'm happy to concede they wouldn't be the same as what could happen even in a well managed, well diversified basket of dividend stocks. But my point being is one, willing to pay $750,000 over 10 years on a million dollar opportunity cost. I find that a little expensive. It is the growth of income and it is for those who care about terminal value, the growth of price appreciation that goes there with the underlying growth of income that makes the starting yield much less significant. They call bonds fixed income because they're just giving you a description. It's fixed. We call it dividend growth because we're giving it a description. It's dividends that are growing. The price one pays for mass volatility is a significant return premium. The price one pays to get that extra return is the acceptance of that greater volatility. And then the premium they receive what we call the risk premium is that enhanced return, the growth of income, the growth of value. Now there's also other things I'd throw in there like tax consideration are people may or may not like it, but bonds are taxed or ordinary income on a Federal level, dividends are taxed at basically less than half of that. So there's significant tax advantages as well, but maybe in retirement accounts you don't have to think about that so forth. I'd throw it out there as kind of, again, a sort of gravy caveat.

I would also point out too that knowing you're getting your million dollars back in 10 years, you are accepting a guaranteed loss of purchasing power. Even one who obsesses over Japanification as I do, who has written time and time again about expectations of a return to disinflation as a result of suppressed growth expectations over years and

decades to come because of the excessive indebtedness that I don't think any of us believe is going away anytime soon. Even I believe you're looking at one to 3% annual inflation. Now, a lot of people listening would say, "No, we think David's wrong. We think it'll be even higher than that." I don't think it's going to stay in the seven to 8% range it is now, and I don't think you do either, but you can use a really bearish indicator of inflation or something that is closer to what we've been dealing with for the last 20 years. But even then, the inflation we've had for the last 20 years until these last year and a half of this last year and a half you would lose about 25% of your purchasing power at the end of 10 years. That million dollars would be discounted down to about 750, 700, $80,000 of inflation adjusted value. So you, and that, unlike with dividend growth, that has the potential for price appreciation that we're saying will accept it, just sort of playing out how it does. The difference on the bond side is it's locked in. You're it. You're not getting more than the par value, which is in nominal terms, not real terms. So the point I want to make is that on a relative basis, I very much like the fact that bonds offer better portfolio diversification, better hedging instrumentation better income for that portion of one's portfolio that they need to diversify and mitigate risk with that there's a tolerance of volatility all investors have and that one can more meet the blended bandwidth of volatility that they're comfortable with by using some degree of boring bonds inside of an equity portfolio.

However, the idea that there now is a competition between the growth objective and the income objective and the growth of income objective of dividend equity allocation with instruments like boring bonds that offer a starting yield that's comparable, misses the mathematical point. It misses the economic point of what dividend growth is there to do. Relative to the S&P 500, it's not even a conversation. There's still more than double of the dividend yield. Now, of course, someone could say, I

don't care about the income, I care about the stock prices going up faster, and I have, that's an entirely different Dividend Cafe. It's an entirely different chapter in my book. And not to mention the fact that lately we've been focusing on kind of the attribution that is embedded in those expectations. But when you get down to evaluating yield on an apples to apples basis I think right now we're in a golden opportunity to reinforce how the growth of dividend over time becomes incredibly important part of either the withdrawal of capital's needs or the accumulator of capital who is a future withdrawal, their needs.

That would be my reinforcement lesson of the day. And I think a lot of people want to know why we feel so confident in our ability to manage equities that are continuing to grow their dividend. This of course, is what we do what we devote ourselves to and on a portfolio basis believe very strongly in doing on behalf of our clients.

Management of Fortune 500 companies of publicly held companies, this part is not very unpredictable or surprising. They mostly don't want to get fired. It's a big common theme I found CEOs and CFOs, I'll tell you a very quick way to get fired. If you're ever in the C-suite of a public company, it's to have a dividend and then to cut it. Now, there might be cases or CFOs or CEOs have been spared when a dividend cut has happened, but I'm not aware of very many and I've followed this a long time. I mean, for the most part, it could happen a day later or a month in advance, or it could happen six months later, but it pretty much usually happens. So one of the great ways to avoid having to cut your dividend, which leads to a high degree of vulnerability for your job is to not pay a dividend that you can't afford to pay. And when management sets dividends, they have to be thinking about what they can afford to pay in the future. Ideally, we want companies that can afford to grow the dividend and grow it helpfully not two pennies at a time, but more substantial dividend growth over time.

That is largely found in companies of a high free cash flow yield. PE ratios can matter. You don't see a lot of 30 times earnings companies growing their dividend a lot. So high PEs generally are correlated to low dividend growers and lower PEs can be correlated to good dividend growers, but low PEs can also be correlated to dividend cutters if something is broken in the company. Free cash flow yield though has been a much more reliable indicator. That's actually the chart of the week in the written Dividend Cafe. And so we have to kind of operate off of what we know about management, that they have a view to the future and a knowledge of what they see within their own company, their order book, the competitive landscape, the delivery of their goods and services, their new products, new innovations, and they're setting a dividend around those realities. And they can be wrong. They can often be too conservative, which allows surprise upside dividend increases later. We love outperformance, but when the dividend becomes a better sort of "inside" look air quotes on purpose than anything else that I've seen far better than what analysts might be able to provide. And when we do that work we believe that we can start with a portfolio that has that dividend yield far higher than S&P and has been far higher than bond yields for most of the last 20 plus years. Right now it's starting off at a equal point and then that dividend growth on top that fixed income bonds can't provide, and that movement higher in value that is not tied to a par value, a return of principle, a maturity redemption amount that the bond market is. These things become very compelling. Then you factor in taxes, you factor in inflation, and pretty soon you're just decorating your home library with my book saying, "Wow, this dividend growth stuff really makes sense."

I'm just kidding about that last part. But I believe in this very strongly and I hope that you'll give very strong consideration to the environment we're in right now because back to my Fed stuff a lot of things have

been distorted and this undistortion of some of those things is quite useful to help clarify the importance of free cash flow generation, dividend growth in a viable, repeatable, sustainable, attractive, investment portfolio. Thank you for listening to Dividend Cafe. Thank you for watching those watching on video. Reach out with any questions any time we help. We hope that you will share this podcast. Rate us favorably, subscribe, and we look forward to answering any questions you have. Thanks again.

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