FRIDAY, FEBRUARY 10, 2023

Well, hello and welcome to the Dividend Cafe. I'm actually recording in the Newport Beach Studio, but heading on to Austin, Texas. I have a speaking engagement on the lovely subject of 'woke capitalism' on Friday. And so I'm recording this before I go. And I'm really excited about this topic because I think that the last two Dividend Cafes set up a sort of macro view of how we're thinking about the economy.

Two weeks ago it was short term, it was 2023, it was recession talk, making the argument for why a recession seems very likely and the arguments for why a recession could be avoided or at least be rather non-severe. And playing out what that sort of short term outlook and humble agnosticism we think ought to look like is one thinks about the present economic environment and an investment approach around that. But then last week I wrote about the more longer term macro view. And this is hardly new to people who have been reading and listening and watching Dividend Cafe for some time. It is the great I think, study of my professional life to evaluate the impact into American economic life of the excessive indebtedness we've taken on, and the response to the way in which we treat that the impact that continued fiscal medicine and monetary medicine has and the downward pressure on economic growth that I believe that represents as form of a sort of negative feedback loop where the medicine and the disease all get mixed up together and I refer to this process as Japanification. I think that when you have a short term view that we've talked about with recession, a longer term view regarding Japanification, that it's fitting to then do a refresher. And for those of you that are newer to Dividend Cafe, it's kind of a whole new set of teachings around why Dividend Growth makes sense to us in this environment.

There are some that would suggest an entire risk off approach makes more sense. And the problem with that is, first of all, Japanification is not a thesis of a great depression. It's not a thesis of economic collapse. It's really quite different. You could argue in some ways it's worse because it does exacerbate boom and bust cycles, and those can be more painful for people to get caught on the wrong side of it. But also the fact of the matter is that when you're not in a great depression and Japanification is somewhat elusive, slow, low, no growth, there's always a reason to believe that a certain roaring period is back or there that may not be, and it can entrap people. My belief is that if one thinks we're going to be in Japanification, as I've already I'll quit saying the word, as we've described it, defined it. If we think they're going to be in a screaming bull market, just let the good times roll economic growth risk on if one believes that we're going to be in an up, down, boom bust cycle if one believes we're going to be in a 1970s like stagflation. There are so many different sort of economic scenarios, all of which at one time or another have existed in my lifetime. And all of which I believe Dividend Growth has come out smelling like roses either doing very, very well in terms of the opportunism and offense that it has generated or do at least standing up well defensively relative to other risk on investment approaches.

So my thesis around Dividend Growth is not related to a particular year, a particular economic outlook. However, in the Japanification mode of low, slow, no growth, it exacerbates my skepticism about some of the competing alternatives for risk investors. And the basis for that I've talked about a lot when comparing it to index investing is the idea that in expectation of low, slow and no growth you're going to get downward pressure on bond yields. And that makes investors more starved for income. And Dividend Growth represents a great alternative as a way to get income without tricking yourself into risking up in credit or fixed income. And at the same time I believe that it eliminates the likelihood of perpetual valuation increase that all these great growthy type stocks are going to go through the roof because we're in this environment of growth going up. Now, I want to be real clear. There is a view that says no in low, slow, no growth, you get a premium on those companies that grow. And that could be very true. The problem is that you get that premium of growth until you don't. And those are the very companies that participate in the reality of booms and bust that are so prevalent in a Japanification type economic environment.

We'll put it up at the end of the video, but the chart of the week is going to show you the S&P 500 since I began professionally managing money through 2008 and kind of that first decade or so and again, we're talking about going back well over 20 years now, but seeing this huge move up, huge move down, huge move up, huge move down. All of that happened in 10 years and all of it represented absolutely no positive return for equity investors, which means if one was withdrawing from an equity portfolio along the way, a retiree or whatnot, they were eroding their principle base. And depending on withdrawal level and timing and things could very well have been withdrawing it fatally eroding principle to a point of significant damage to economic goals and longevity. So I would make the argument that the great takeaway in a period of low, slow, no growth and instability in the fiscal sense, dead indebtedness, instability in the monetary sense. I've talked about this a lot. The sort of unpredictability of a monetary regime that we've been in and I expect will be in for quite some time and less focused on this right now. There's more that'll be coming up on some of this, but it's still warrants mentioned geopolitical uncertainty. Now, some people say, you're right, this is coming out of nowhere. All of a sudden China is a foe. All of a sudden Russia's invaded Ukraine. I don't agree with that. I think those are uncertainties that need to be priced and factored in considered, but the specifics can change. I don't think that we were talking about balloons going over the American skies from China previously and it's true Russia did invade Ukraine until February of 2022. But geopolitical uncertainty of some shape and size sometimes involving some of the same countries, sometimes involving different ones. But my point being geopolitical uncertainty has been the norm. It's been the rule, not the exception. And so whether you're looking to the geopolitical side, fiscal, monetary, this macroeconomic thesis we think speaks to a need for quality. And quality can mean a lot of different things. But when we talk about risk asset investing, you are talking with stocks about only one thing, quality of earnings.

If you're not talking about profits, why is one invested in stocks? Well, the answer could be because you believe you're going to buy a stock low and other people are going to love it and it's going to fly higher, and then you're going to sell it to someone else who's a bigger sucker than you are. And they're obviously, people either believe that they're that person who's done it before or they know someone or they hear about her party. And I think you all know it's nonsense. People have a story like that, but then they don't tell you the eight stories that didn't quite work out that well. If a grownup still believes that's sustainable or that is a long term investment solution of sort of day trading and greater fool theorizing their way to portfolio profits, then I wouldn't argue with that. I'd say you do you. But yeah, as far as the long term investing out of the risk levels of equity, you are talking about some form of caption profits and at whatever point you want, all we end up talking about is what to do with those profits. So a company could be choosing to return those profits to you or a big portion thereof. And that's our preference because we want to monetize the investment, make money, and then also de-risk the investment over time, we continue to be financially rewarded and so that any potential interruption to our plan or wrongness in our thesis is less damaging than otherwise would've been because we've already gotten money as we go.

But there is a number of reasons why we believe Dividend Growth investing represents a really significant quality element beyond what so many others are doing. And I would still remind everyone the basic tenets of Dividend Growth investing, the ones that I consider be more evergreen, they still apply in Japanification or in any of these other types of macroeconomic environments. You could find yourself in the ability to accumulate more shares of the compounding assets that are themselves paying off dividends, accumulating via the reinvestment of dividends, therefore making money on downside volatility, not just exacerbating a headache. The compounding within a compounding, right? Any risk asset you own, if it goes up 8% one year and then goes up 8% the next year, the second year you got more than 8% because you got it off of 1.08%, right?

This is Albert Einstein's eighth wonder of the world. That's very much at play with Dividend Growth, but you get further compounding because you're getting that compounding effect on your original investment principle and then on the reinvestment dividends along the way. So the math of it becomes quite a potent force. I wrote a whole chapter about this in my book on Dividend Growth.

But then the withdrawal aspect, it becomes so important to those that want to be sort of out of harm's way and have a consistent cash flow, let's say in a retirement or whatever the period is that they need cash flow for, and yet also have that cash flow growing year over year. And so a withdraw of capital at Dividend Growth doesn't have to face that negative compounding or that deterioration or principle that someone in withdrawing from, let's say the S&P may have over a sustained tough period.

I think it really is worthwhile to remember that the underlying quality of companies that we believe exist Dividend Growth. There can be high quality companies out there that don't necessarily return capital shareholders the way we want. There can be companies that are returning a lot of capital that have a bit more hair on their business model. So I don't speak universally here. I speak generalistically and it's up to us to do our research, to do the specifics, to get the execution right, et cetera. But when I talk about these generalities they're almost unimpeachable that the dividend growers require a free cash flow. They require reasonable leverage ratios. They require the consistency of earnings, and they fundamentally require qualitatively management that believes in returning cash to shareholders. And so all of these things represent these evergreen arguments for Dividend Growth. When you apply it into an environment where multiple expansion is less likely to come because of low, slow and no growth, and you are going to end up because of fiscal and monetary interventions being in the boom and bust cycle, Dividend Growth represents a way to stay out of that. And I can't emphasize enough how much I think that is the environment we'll be in for a long, long time to come. So the application of Dividend Growth is very logically very logically, follows the premises we've talked about there.

Some will talk that will believe the immediate threat to the success of indebtedness to some sort of economic collapse. And I make the argument there could be that could even be better if the economic collapse was enabled us to immediately liquidate debt and start to rebuild a society that that's not usually how these things go. They can be awfully painful and indescribably painful experiences. But I think what I'm suggesting is that it could be an awful outcome that just plays out in a small way over a long period of time. And if people want to debate which one's worse than the other, that's fine. But my point is to try to deal with the reality I think we're in. But I want to make a point about dividend feasibility. The reason that we're afraid of companies with excessive leverage or weak balance sheets is not because we think, oh my gosh, if something goes wrong tomorrow, they could cut the dividend analogous to tomorrow, the economy could implode, they could, that would be bad. But more than likely, a company with a weak balance sheet or excessive leverage, our fear factor is not necessarily that their weakness in leverage or in balance sheet or in cash flow durability leads to a big dividend cut tomorrow. It could lead to the company starting to sell off high quality assets so they don't cut the dividend, but they become a weaker version of themselves. It could be that they don't sell off assets, they don't cut the dividend, but they issue a lot of new equity. They dilute as a way of trying to keep things going. So the cash flows are still there to pay a dividend, but they're diluting the equity value. There's a number of things like that that are more low and slow and yet painful. And those are the reasons why we obsess over balance sheet strength, debt to income, debt to assets, number of factors that speak to us about quantitative quality return on invested capital, return on equity, and so forth.

If you are an index investor or if you're a non-dividend investor and you want to capture profits, you really in a low, slow, no growth environment, you're not going to get 10% profit growth a year, and yet you want 10% return. Now, if we're getting a 5% dividend and 5% appreciation that you can get 10, but if you're getting 1% or 2% dividend, and where do you think you're getting the eight or 9% from? It's got to be multiple expansion unless there's just robust profit growth, which in our macroeconomic thesis becomes less durable and likely is the years and decades go by. So do I think multiple expansion is something to bank on for long term investor? I do not. And that is where you end up getting to this point where you say, Dividend Growth enables me to have risk on, to get cash flow, to get growth and not have to get it from areas that are highly speculative. And that's the real issue that we want to be able in a vulnerable economic time to look to investments that are already proven, already durable, have a moat and not say, okay, there's this new cloud software, crypto something company, plant-based, really great stuff like that and rely on it to get from 28 times earnings to 50 times earnings and grow into some outlanders thing. Obviously, some companies will, but do I think a diversified portfolio across the board can do that? I think it's highly risky. It would be outside the risk profile of many, many private wealth clients.

So Dividend Growth is all at once that great reflection of what we believe about risk investing to begin with, capturing human action, capturing the profit motive in the form of greater cash flows that are being shared with us to both de-risk and reward at the same time, our investment. That's what we do. That's what we're going to keep doing. And I hope you can connect those dots to the macroeconomic thesis I talked about, whether it's 2023, will they or won't they recession this economy? And then beyond that, the outlook we have for growth going forward. If I had a crystal ball right now and it said, we're not telling you anything what to do with investments, we're just letting you know this economy's about to go crazy, it's going to just really take off and you're going to get that 1980s and 1990s real GDP growth for some period of time, then I would still have different growth. But I would also suggest that plenty of other risk approaches would do well. I don't believe that's what we're going into. I think that 31 trillion of debt is going to prove to be a drag on top line economic growth, output productivity, and therefore, we want to be really leaned in to quality. We define quality as Dividend Growth for all the reasons I've just said.

I hope this is helpful. I hope it's clear. I invite your questions. I hope you'll forward it to people and rate us and subscribe and blah, blah, blah. Thank you for listening, watching and reading the Dividend Cafe. Have a wonderful weekend.

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