FRIDAY, AUGUST 11, 2023

Hello and welcome to this week's Dividend Cafe. I am recording from the studio in New York and getting ready to head back to California for a couple of weeks, but this Dividend Cafe I think may be something that many of you have wanted to ask about and talk about and hear about for some time, and that I have been too dense or shortsighted to addressed in this manner. I think it really is paramount for an entity like ours, the Bahnsen Group that believes tooth and nail in the philosophy of dividend growth investing. And I have made the case for well over 20 years for the philosophy of dividend growth investing as this thing that is really beneficial to investors. See, that's who's listening right now or watching right now, who will be reading the Dividend Cafe.com. Those are primarily either investors or future investors, people learning about investing.

And yet today I'm going to be approaching it from the vantage point of the company, not the investor who receives the dividend, but the company who pays the dividend. And there are some reasons why this I think is so important and frankly so interesting. I very much enjoyed writing this Dividend Cafe. Truth be told, I almost always enjoy writing Dividend Cafe. It really is one of the highlights of my week. There are some weeks where I'm a little more rushed than others in doing it. I have a lot of meetings every single week and we run a business and I have for whatever reason decided that as we have grown and so forth as a company, I stay intimately connected to the details of the business, to our clients, to the people that make up our team, our partners, our advisors, our employees. There's a lot of connection that goes on amongst the people that are the Bahnsen Group.

And I'm not really ever separated in any way from all of those things where I can just be off to the side writing Dividend Cafe. And so if it ever seems like one week's Dividend Cafe, I didn't enjoy as much as another. It's just simply that maybe some weeks there was a bit less margin in the way that the week came together than another. But I really do enjoy writing it a lot. And as most of you know, that have been around a while, we've been writing a Friday commentary when I say in this case, I mean me since September of 2008. And so it's something that we have review at the Bahnsen Group as a core offering of what we do. And I can't tell you exactly why I'm saying that. I liked writing this one especially, but I think a lot of people who write a lot know that there's just sometimes when you're done writing where there's a particular fulfillment or realization that came from it.

And this was one of those moments for sure. So let's get into it a little bit. Of course, the purpose of talking about dividend payments from the Vantage Point of companies is to clients and to investors, is very much to further reaffirm the thesis of dividend growth as a particularly beneficial investment strategy. And yet the question I wrote a Dividend Cafe, I think it was four weeks ago now, on the dividend growth mentality and a couple different people, there were two different folks who wrote in with different versions of a question as to why companies pay dividends. We know why we like receiving them, but why does a company pay them? And in a sense, does it go against their interest? I mean, are they giving up money that all things being equal they'd rather hold on to and are they doing it just to be nice?

Are they doing it to say thank you to those investors who have put money into their stock? Are they doing it because they hope it makes the stock price go up and then they want to use the high stock price for other things? What's going on here? What's their real motivation? I think they're really good questions. I do think that there's a potential of a flaw in real question, not certainly a flaw, but the potential of a flaw that is worthy of just clarifying right off the top, which is before we get to the question of why companies pay a dividend, let's back up. Why do companies do what they do? What is the reason for a entity to go out and produce a good or service and to raise capital around doing so? And so I don't answer, it's to pay dividends, I answer.

It's to generate the thing from which dividends come, which is profits. So fundamentally, we're not talking about dividends as something companies do at step one that presupposes they've achieved profits and then dividends become a sub-question as to what companies do with profits. But before there are dividends to pay out that are profits earned and before there are profits earned, there is a company taking a risk and there is a company that is producing goods and or services that meet the needs of humanity. And this is a core economic principle. And of course, most of the time the production of goods or services that meet the needs of requires capital. And so there could be owners who put in equity that use that to help start and generate and run a business. And there can be lenders who loan money to a company to get their money back.

They have some security in the loan. We've talked about credit the last two weeks, and then they're getting a kind of coupon, a rate of interest in exchange for doing that. So there's debt and equity capital. Our capital markets in America are so robust and might add so beautiful that there are various innovations that have come about. There are complexities that can really be quite customized and creatively used to do very productive things for an enterprise. But just back to basics, an enterprise is something that is producing good or service for the aim of achieving profitability. They're creating value so that the cost of production of a good or service that meets someone's need is less than the money that can be received for that good or service. And that differential is called profit. And businesses get very, very complicated. There could be millions of goods and services, there can be all kinds of layers and there's brand value and whatnot.

But we're just keeping it very simple on purpose because really no matter how complex it is, it never ever changes this core principle that there is a differential between the cost of production and the value of what is produced good or service to the end user. And in that delta between value and cost is a profit. We haven't even talked about dividends yet. So fundamentally we remember that that's what the core aim of a business is. Now when we're talking about dividend growth, and most of the time what I'm talking about because it represents, I think right now we're somewhere around 2.6 billion of the four and a half billion that we manage or in dividend growth equities. And there's then close to a billion in alternatives in real estate. And there's a decent amount in small cap growth and emerging markets growth. And then there's fixed income.

We've talked about credit and boring bonds the last couple of weeks that make up kind of the rest as you asset allocate a client to an optimal portfolio in terms of risk and reward for their own financial solution. But yeah, the dividend growth element is dealing with mature public companies. And yet there are, I just want to say this so that people don't get confused. I'm well aware that there's a lot of businesses that are not at the point of profitability. They're trying to get to that point. And so dividend growth sort of takes for granted that it's a later stage company. They're already not only in a point of profitability, but they're in a point of mature profitability, repeat profitability. There's a brand, there's a good or service, there's a market position, a market share buffet famously talks about a moat around the business.

There can often be various things that protect their position. But if you go back to the lemonade stand analogy I've been using for years, there's always growth stage companies that are unprofitable companies. You talk about the venture capital world that might even be pre-revenue companies and people are investing equity to own a piece of a company. It doesn't even have any sales yet because they're developing a technology or whatever. That all has a very important place in our economy and in any market economy and our capital markets, innovations allows for such thing, but it's different than what we're talking about here. And it has an entirely different risk profile as well. It has an entirely different liquidity profile. So you could argue that just by law of numbers, it eliminates a significant amount of eligible investors because of the risk level, illiquidity, things like that.

But then when you take out pre-revenue, let alone pre earnings companies or early growth stage companies, they're all still fundamentally either they're to generate a profit or down the line, setting up the stage for the purpose of profitability. That's what the purpose of a company is to produce goods or services that meet the needs of humanity profitably. We start there. Then you get to the point of mature public companies and you say, okay, they're generating profits now what's this dividend thing all about? And I've spent years and years and years talking to you and all of you have it memorized as to why we think it's so beneficial for investors. But I want to talk about why companies do it. Okay, let's walk through the options here as far as what a company does with profits. So we're taking for granted that the company is up and running, they have something good going on, they do something well, and they have a sustainable profit stream that they generate.

And at that point, good decisions can be made and bad decisions can be made about the enterprise, about what they do to generate more profits, to protect their profits, to grow them, to maintain their reputation, to properly retain good employees. All of the things that go in running a business, many of you run a business and know what I refer to. And then it doesn't really change just because a business gets very complicated or very large. There's just your day-to-day enterprise of what you're doing to compete, to win, to improve. But what we're referring here right now is a particular category of decision-making in the, and that is what to do with their profits. And so let's just, the question is why would they choose to pay a dividend? But let's look at first not why they pay a dividend, but why they would not pay a dividend.

What are some of the things they could do with the retained earnings, cash that has been generated? So in theory, you could say, well, they could just hold onto the money and before we get to what they would do, holding onto the money, just holding onto it for the sake of holding onto it, putting it under the mattress. An investor may receive profits and go put it in their bank account and get a little bit of interest these days on it, but maybe the company just does the same thing. You own a piece of the company, so you still have those profits, you're not getting the dividends, you're just sitting in the company. And so why not just have the company hold onto it versus paying it out to you and it goes to you? Well, you know why we want the money. We want to de-risk the investment.

We want to reinvest it in more shares of this profitable enterprise. We may want to use it for living expenses, but the company could just hold onto it and the value is the same, right? I have $9 of value and a $1 dividend that comes to me, or just $10 of value, 10 and 10 is the same. But here's the issue, why not just hold onto it under the mattress? Because when the company has more cash on hand that is generating less of a return, then it's fundamental enterprise generates when they are earning less than their cost of capital, then they are eroding value. And this is just a fundamental financial reality, a very important almost accounting principle that you erode value when you're using cash, that when you're holding onto cash, that is earning less than the cost of capital. So the return on equity, the basic profitability that the company can generate from the equity in the business equity meaning the assets minus liabilities.

When you measure the production of profits from that equity, you can have a high return on equity with a well-run business and a profitable enterprise and the specifics of what a company does. But you can really deteriorate the return on equity by hoarding cash at an unprofitable level. And the amount you're getting paid on cash is generally going to be a very low discount rate. And most companies are going to have a higher hurdle rate or discount rate or cost of capital, meaning the number at which it makes sense to go do an incremental new investment or new project. And at that point, the value becomes better for the owners to have capital returned versus the company hoarding it, doing nothing. Now, let's move past the mattress option only to simply say, before I do that, we don't need to use a complicated company or a complicated accounting jargon to get there.

Accounting jargon meaning return on equity, cost to capital, return on invested capital. These are accounting principles. Those of us in corporate finance use all the time, but you may say, I'm not following you. Look, if you get a dollar a year in profits from a lemonade stand, or you could make $3 a year out, a hundred dollars investment, you put a hundred bucks in, you're getting a dollar a year in profits, or you get $3 a year just keeping a hundred bucks on the bank account, you're not going to want to go to the lemonade stand investment unless you see that really improving unless you think there's a lot of growth. But if that's kind of what it generates as a business and you can make more than that holding it under the mattress of your bank account, then you're not going to do it.

But if you are generating $10 a year from the a hundred dollars investment with the lemonade stand and only $3 a year in your bank account, then you may very well want to do the lemonade stand. Now even then, there's issues like liquidity and risk. So you still have to measure some things and do cost benefits analysis. That's where asset allocation comes in. That's where financial management comes in, all the stuff that we do all day. But my point is, at least now the math of the lemonade stand is forcing you to make a decision versus that hurdle rate of what you could just get holding onto the mattress. So consequently, any lemonade stand that could generate that, but instead holds onto money at $3 versus the $10, you would say, Hey, you're depriving me of why I invested in the lemonade stand. I can hold onto my own cash.

By you holding onto it, you're hurting that return that I'm trying to get out of the risk-taking enterprise. You follow me? Now, I'm begging the question, and I hope a lot of you are thinking what I'm about to go to next, which is, yeah, but what about the company holding onto it for the purpose of deploying it? They're not just going to hold it in perpetuity under the mattress, but they hold onto it for this next incremental project for more growth, for more expansion. And therein lies the rub. But see, this is the thing. I'm all for it. I don't want companies to give me dividends before they use cash to do things that could reliably generate me more dividends. So I take for granted that there is a use of cashflow towards growth and reinvestment and that there may be some companies that literally can use a hundred percent of free cash flow because they have no investment need.

When they, I'm thinking by the way of a, I'm not going to say the name, but of an investment bank we own where they're just sell site advisory. Their only cost is hiring more people. And whenever they hire people, they're hiring the revenues that are going to produce the growth those bankers bring with them a book of business that generates deal flow. And so by definition, their cost comes with revenue and then the profits generated, they're committed to returning those in the form of dividends. They don't need to hold onto a lot of capital the way a Wall

Street bank would. That has to have a balance sheet, that has to have protective capital, that has brokerage operations, that makes a market and fixed income that needs to go buy other businesses. In other words, there are companies that theoretically have very little need to reinvest in their own business, but it's rare.

What I would say is that the notion that dividend growth needs to supersede reinvest in the business is a false notion. There are dividend payout ratios and those can be lower, and you can have a 37% dividend payout ratio and still have a very high dividend. If you're making a lot of money, even if you're only paying out a lower percentage, you may have a lot of reinvestment that has to happen. Some companies get so mature and have so little incremental new investment to do with their business that they can afford a higher payout ratio. So the nature of the business is very relevant here. But my point is you have to understand the law of marginal utility. There is a point at which the analogy I use in Dividend Cafe here, which I really like a lot, I love using lemonade stands as an example.

If there are 1000 people total, they're going to walk by a corner of where your lemonade stand is set up on any given Saturday, and you're going to make $3 profit per lemonade you sell. And you might try to get them to buy two lemonades, and you might try to get, instead of 400 of those thousand, you may push more sales and more marketing to get up to 800. Or gosh, maybe you want to get 1000 out of 1000 people in foot traffic to stop by. And maybe you want to upsell some other little products. I mean, there's things you can do to drive growth, but soaking wet that might require an additional $10,000. You wouldn't say, Hey, I'm going to put a million dollars in when you know the opportunity set is a thousand people foot traffic. And again, maybe you want to open more corners of lemonade stands, but my point being there is a certain dollar amount in that analogy.

Maybe you could justify, let's put another thousand bucks in and see if we can capture more profits, more sales, more market share. Maybe it's 2000. You debate what the number is, but you know it's not 50,000. There's a diminishing return. This is what we mean by all economics taking place on the margin. And it happens for companies too. There's a point at which the next incremental dollar generates less profitability than the last one. And this is a fact that is universal and has to be wisely discerned by the managers of a business. And so to the extent that they are efficiently optimizing what needs to go into the profitability of a business for growth and expansion and whatnot, then that should be done before dividends are paid out. And frankly, some companies are more CapEx sensitive. They need more investment in capital expenditures. We know healthcare like pharmaceutical companies, biotech have a high r and d expense.

A lot of technology companies might have a decently high r and d expense, but there's only a couple sectors that have a lot of hard infrastructure expense. Industrials, utilities, energy is one of the more capital intensive industries that requires a lot of CapEx reinvestment. And just because I know Dividend Cafe listeners are smart, I do want to complicate things a little bit by pointing out, you don't have to solve for how much to invest in CapEx and subtract that from your cashflow because you also may have knobs to turn and a scale to get to equilibrium using the debt markets. It may be more profitable to retain some earnings, to distribute some earnings and use a lower cost of capital through debt than the cost that is your equity capital to finance some of your expansion, some of your growth. And this is something the great Michael Milken taught me as I was reading him as a much younger guy, that really smart companies, really successful enterprises, not only efficiently, wisely, sometimes brilliantly creatively, innovatively produce goods and services that meet the needs inhumanity, but they manage what's called the capital structure of their business.

And oftentimes with very large and complex and scaled enterprises, this is really where the secret sauce might come, is to where they use their cap stack to involve both equity and debt to most efficiently drive returns. And it's also where, of course, many companies can make very big mistakes being over levered or whatnot. So the point being you do solve for reinvestment in the business. And then at that point, the question is what to do when additional expenditures in business that are efficient, productive, measurable, or not needed. Now, I want to point out the third option. This is so common that we shouldn't skip over it because I think this is fundamentally one of the great arguments for dividend growth is companies could be just holding onto these profits not to keep it under the mattress and not to efficiently use to grow future growth opportunities, capital expenditures of the business, but they could be holding onto it wastefully just setting money on fire.

They could become sloppy and arrogant and wasteful. And I think this happens all the time. And it's funny, I put a link in Dividend Cafe.com to the very, very famous Gordon Gecko's speech from the movie Wall Street in 1987 where Gordon Gecko, the character played by Michael Douglas, he famously says, greed is good in the speech. And that's the portion of the speech I find detestable and became very famous. But prior to that, what he's talking about is just all of a corporate waste and all the money that is being spent on wisely and even apart from just, we all would say flying around on all their private jets and taking huge wild excursions. There's certain examples of corporate waste and excess that are very easily characterized. But there's also a complacency that just comes in the corporate suite that they get less feisty, they get less competitive, they get less savvy because there's so much cash excess that they can afford to be a little lazier.

This is a major problem for corporate America, and it's one of the great arguments for dividend growth that forces companies to be more accountable and more efficient and more shareholder aligned in how they're making decisions. But see, it's not merely about incentives. You could say, okay, but why would management want to do that? If they could have the easy street? Why return money to you when then they have to get rid of, to some degree their laziness and their cushion and their complacency and their sweet gig? Why would they want to do that? Well, you have to remember, they can be fired. They are hired guns by a board of directors. And I'm sort of quickly getting into the point of the answer to the question about why companies pay dividends. The company is you the presupposition in the question that why does management pay us a dividend is that the management is the company, but the owners of the business are the shareholders who then hire a board of directors to boots on the ground, oversee things, and that board of directors hires various corporate executives.

And the other big part of Gordon Gecko's famous speech, which has gotten better since 1987, but is still an issue, was that the average amount of publicly traded corporate America that was owned by the management of businesses was 3% that they didn't have a lot of skin in the game, their own capital. Now, there's been a huge issue to try to solve for that with stock compensation, with stock options, with restricted share units, with stock grants. And I think that's great. I would consider it the third best option. My favorite option is just founders that still run the businesses that own a significant amount of equity, had their own capital in it, and now are still involved in the business today and still receiving dividends today. So you get a lot of alignment when you still have that. But then the second option is that these corporate executives are putting their own capital in.

They're in the aftermarket, not just deferring bonuses, which is new money coming into them that then goes into the stock, but I'm saying using old money, their balance sheet to go buy stock. And you see that a lot of times, some of the CEOs I respect most, there's one in particular. I'm not going to say who I'm thinking of or what company I'm thinking of. I'm literally looking out my window here in the studio on Park Avenue at one that comes to mind that will go out into the market, use their own money to buy shares. I think that stuff is very important, and I think that ties into this theme of alignment. And then yes, third, you do have alignment when there is some form of their own balance sheet that benefits from being a shareholder. Yet at the end of the day, management is hired to run a business generally because they're good executives, they're good and operators, they have a track record, a reputation.

The board of directors has made that decision. But when you talk about a company returning a dividend to shareholders, you are the company and they're giving back your money. And this brings me to the use of the phrase giving back. I generally hate the term giving back in the context of philanthropy and charity. I know what people mean. I am not naive about what the semantics of it are, but you're not giving back. When you give to charity, you're giving, if you were giving back, it would just mean you were returning something you stole. And that's not very charitable. You're giving because you have a heart of generosity. You want to bless a community, a church, a school, a nonprofit you believe in that's giving, that's not giving back. But when a company is returning capital shareholders, the giving you back the capital you invested in it and they're giving you back a return on the capital that was expected when you gave the investment, the fundamental principle here is that it is the company returning your capital to you.

And you could say, well, why would management want to do it? Maybe management. I mean, the very famous book from the eighties, Barb, well, it was I think actually written in the early nineties, but describing the late eighties private equity drama around RJR Nabisco and the Reynolds Nabisco Craft merger that ended up happening. And there was a kind of levered buyout for management that they tried to do, but these guys wanted to hold onto the private jets and the perks and the this and that. And then there other investors wanted to come in and they said, this company's really undervalued. We could put a little leverage on it, take out a ton of expenses, and create a whole lot of value. And look, different people had different theories that could be right a wrong. The book was just sort of the drama of the whole way it unfolded.

I mean, I absolutely adore the book, so that's why I'm using it as an example. But my point is that there are obviously cases where management could desire to hoard assets that don't belong to them for their benefit. But there are not cases where that could be a good thing for shareholders or where it could be sustainable at some point. The owners of a business, boards of directors, if they're being the fiduciaries, they're legally and morally obligated to be, would put an end to it. So why should managers and operators return capital shareholders? One of the great reasons would be because they should be an owner of the business. They should have skin in the game. They should hurt if things go poorly, just like they should benefit if things go well. But another reason is because they don't want to be fired and they can be fired because they work for you.

And this is the really important aspect when you bring basic principles of private property to corporate finance capital markets to the complexity of a large mature business, that's what dividend payments are. So you could hoard cash that depletes the value of a business because the cash is generating less return than it's cost of capital. You can hold cash to put it back in the business. That's a good thing, but then end up holding more cash than is really needed, which is a bad thing. You can waste cash or frivolous spending, and I keep focusing on wasteful spending with too much corporate jets and parties and blah, blah, blah. The most common thing is they go do deals, they become deal junkies. It becomes an ego. It makes them famous, it gives them a lot of profile and a lot of money ends up getting set on fire through bad M&A.

But in terms of why companies should pay out dividends, management ought to have skin in the game, they ought to be part of the ownership base, and they most ought to be held accountable for the returns they're generating for shareholders. And then you look at, once you're generating returns and profits, what are you going to do with the money? Returning it to its rightful owners is a great example net of what is needed to continue running and growing the business. And that is the wonderful process that is capital stewardship in corporate America. It's the wonderful process that is being a investment manager to make those decisions as to where those opportunities lie and where we can invest in them on behalf of our clients. To that end, we work. Thank you very much for listening, watching and reading the Dividend Cafe. I hope you've learned a little bit from this. I hope it makes sense. I welcome any of your follow-up questions and I look forward to coming back to you next week with the Dividend Cafe on Chinanification. Thanks so much for listening to Dividend Cafe.
