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Well, hello and welcome to another edition of the Dividend Cafe. It is wonderful to be with you to be able to talk about dividends in the Dividend Cafe. I'm committed to writing about dividend growth, investing a minim of once a quarter in the Dividend Cafe, but I don't even know why I made that commitment because I'm pretty sure I do that anyways and very candidly, I'm writing about dividend growth weekly in ways that you may not always see, but a more explicit kind of reaffirmation of certain components of dividend growth on a, at least a quarterly basis is something I've kind of committed to. And I think it makes a lot of sense. The particular inspiration today is a desire to talk about a couple objections that may come up every now and then that allow us to hopefully provide you a little bit of education information about some sort of basic accounting terminology and just a real important conceptual framework for what equity investors are doing and talking about and how public companies work, some basic components of corporate finance that lead to this discussion around dividend growth.

And so, what I'm going to do is start off by reminding everybody that dividend growth is not about a company that has profits versus a company that doesn't. It is about a company with profits that is paying it out to you or a portion, I should say, a portion of the dividends out to you in the form of a dividend. Now you could say, well, no, there's other companies that don't make profit.

Well, that's true too. And that is a little outside of what our general theme is in public market investment. Venture capital is not only usually pre earnings. Companies, but often pre revenue companies, in the small cap space, not the way we like to invest in it, but certainly like even in the index and even for publicly traded companies, there are a significant portion, if you ask me far too many, that don't have positive earnings.

There can always be things that happen to even big public companies that represent a shock to earnings. Most of the time when you hear that, not always, most of the time it's that a company was expected to make a big amount and they made less, or they had a one time charge to something, or they had grown profits year over year.

10 percent one year and then the next year they only grew profits 3%. So not only were they still profitable, but they even grew profits year over year. They just grew them at a lower rate than the year before. So all of that's different. Like we're, we're basically in a debate when it comes to dividend growth and we take a very counter cultural view of this about what to do with the profits.

And, and so when I talk about companies that, oh, there's this returning cash flow, I sometimes am equivocating because there's two context for discussing cash flow. One is the cash flow, the company's generating, and the other is the cash flow you as an investor are, or should be, or hopefully, or might be, or we want you to be receiving and a company's use of cash flow.

Then invites the optionality of a dividend payment, but a company could have positive free cashflow. It could have earnings, profits that it doesn't pay in dividends. And rather than focus today on companies, instead of repaying you some of those profits after tax profits, obviously to you as dividends, that should companies consider stock buybacks.

Should companies consider debt reduction? Should companies consider M&A? I'm going to talk instead about this idea that should companies just consider holding the cash and reinvesting it in other business ideas they have? And that has become this argent generally from very self interested actors, namely the C suite themselves, that, hey, why should we return the cash to you?

We're going to do better with it than you are. So I want to start with where this argent is a hundred percent right. That the dividend does not create a profit. If a company has 10 of value and they then go make a profit of one that gets put into the coffers of the company. You now have a company worth 11 and if you as an investor have a company worth 10 and it pays you out a cash dividend of one, you as an investor now have a value of 11, 10 plus one in both environments will still equal 11.

All we're talking about is whether the company is better off retaining that one. or distributing that one, returning, paying a dividend or retaining, holding reinvesting. Now, listen, I'm being simplistic here because as a general rule of thb, we have very, very few companies. We do have some, by the way, for good reason, but we have very few companies that have a 100 percent dividend payout policy.

Most of our companies do use some portion of their free cash flow. To buy back stock, to do comp, avoid stock dilution that, share issuance from executive compensation and employee stock options represents, they have capital expenditure needs and so they have to reinvest into the business.

Sometimes they just wanna hold a bit more cash to build the equity value, the balance sheet of the company. So there could be reasons as to what use of cash looks like, but we're not really debating between 42 percent and 56 percent right now. , and it's rare that you're talking about a hundred percent.

We're debating about 0 percent versus something else, some dividend that let's say averages about 50%. Of a payout from the company earnings versus zero. And the argent for doing zero, in this context today is, well, gosh, the company, you know, does so much with the money. Why not just reinvest this?

Again, now forces an equivocation, but not one I'm going to do an equivocation that you need to understand the difference on. First of all, it is not true that 10 plus one and 10 plus one, both equal 11 in the same practical sense to an investor, a company worth 10 that then has a dollar of profits, it is now on a spreadsheet worth 11 versus the 10 and distributing you one.

There is for a major difference off the top, which is for a lot of investors, let's call it roughly half. They need the one because they have to live. They have foundations have giving requirements and downments have giving requirements. Pensions have payments to make to retirees. Investors themselves have cashflow needs, whether it be groceries and vacations and grandkids and college tuition.

And so forth and so on but then the argent is, okay, but you have 11 the other way too. And you can just sell shares and, and, and stock public stock markets give you the ability, the divisibility, the liquidity. So you can sell shares and get the one. And what is the problem with that? Obviously your stock does not stay at 10.

Sentiment goes up and down. And someone who has a recurring cashflow need that is not getting it in recurring dividend payment when it's being paid to you in the form of this profit distribution, they're not, it's, they're not lowering the value of the company. Cause it's coming from profits of the company.

And it is periodic. Let's say it's monthly or quarterly in line with the spending need of the investor. Then the, value being distributed. is never at risk of being withdrawn in a negative context. It can only be a positive context, but somebody withdrawing and selling shares can't do so with any consistency or periodic benefit.

And you go, well, wait, yeah, yeah. But I want to, reinvest in the value of the business because they're, they're doing such great things and look how the shares are going up. This is the equivocation. I'm all for that. That's exactly what I do in my dividends is reinvest them in the acculation. I take fruit that comes from a tree and buy more trees.

With the, fruit from the tree and it's akin to, I've used this example, I think for 15 years now of, someone getting rent checks from apartment buildings and then buying more apartment buildings with the rent checks. It's miniature compounding, but why someone can't just live off of selling the shares systematically is that we started with an analogy of a business value and a profit, but the, but the share prices you're selling don't function in line with the profits. They go up and down second by second. The profits didn't change of a particular business in the last 20 minutes since I started recording, but the share prices do. And what is one of the biggest drivers of day to day movements in the stock market that we're now talking about attaching to a checking account function for investors?

Sentiment. Sentiment goes up and down all the time. Dividends only go up. So 10 plus 1 and 10 plus 1 are not the same in this case. In one case, you subject yourself to the possibility of needing 1, but having to have 11 be 8 or 9 when you get it, and then you've negatively compounded. You've permanently eroded your base.

The other example. The value of the 10 goes up and down, but you don't compound it because you don't sell it because you hold it and you immunize yourself from the silly volatility around it. Meanwhile, you're receiving the one. So this is not the same thing. The investor mechanics are entirely different.

But I would point out there's also a huge difference between the type of company that can pay a dividend quarterly. And a company that can't, some might have good profits, but they're highly lpy, highly cyclical, sometimes speculative. So there is a benefit to investors when a company can periodically pay dividends in, in that kind of systematic and consistent and growing fashion, you are getting an insight into the company.

So two companies are going to make a billion dollars of profit. One of them is just regularly like clockwork distributing 250 million a quarter. And one of them is not, there's a very good chance it's not the same thing. Now the other company not distributing might be wildly more profitable. A few of the most profitable companies ever, not dividend payers, but I'm talking about the general financial and economic rules here that there is a benefit across a diversified portfolio of the category or quality of companies that can do it. And, and no matter what company you're talking about, the investor needs become a big issue. And then I would point out finally, in this category of why the two things are not equal. That the math of investor returns becomes entirely different around such volatility when about half of your return is coming from something that never goes down versus about 90 percent of your return coming from something that

Almost every year goes down 10 to 15 percent and at multiple times throughout history goes down 50%.

And that regularly has averaged 20 percent drawdowns every 4 or 5 years. It's been a little less than that lately, but that's still the average for 60, 70 years. And, and on a very consistent basis, averages a 10 to 15 percent drawdown. 2000, 2002 seems like a long time ago. It was in some of the earlier years of my professional money management career, but you had a three year period of negative returns in the S&P 500, 1974-75, which was the first two years I was here on planet earth.

You had negative years, even apart from, I think it's something like, nine times since that you had one year, a negative return, two to three year period of drawing down to get your, to sell your profits when the share prices are lower, but the companies were profitable and you're selling a piece to get what you need for your living expenses.

Or whatever the investment cashflow need is that erodes value quickly and violently. If we don't have long bear markets, it still does it in the middle of a good year. Because in a good year, the market is average 10. It's actually 14 percent average drawdown, including in the years in which markets are positive.

So this smoothing of profits that dividends represent matter in every practical and mathematical sense imaginable. But then finally it is the underlying issue of, okay, well, apart from investor mechanics, let's just get to that investor who doesn't need the cashflow. And again, those of us who are acculating, net worth and don't, do not require fruit from the tree of our investment portfolio.

First of all, if you just believe in what the underlying company is doing, the profit engine that is creating the dividends can be automatically reinvested in do with the automatic reinvestment of the dividends that not only can be done, it is what's done. It's what almost always should be done. And so that mechanical option of reinvestment that then makes a benefit.

It's a curse to withdraw in downside volatility. It's a benefit to reinvest in downside volatility. So dividend reinvestment is already available, but the equivocation I spoke about a moment ago. Is that we're not talking about reinvesting in the shares of the company. Hey, reinvest in our company. We're, we're going to do great.

Look how high our returns have been. You can do that. Now we're talking about within the company, what they do with the profits of the company. They're not buying their own shares. Always historically share buybacks when they are doing it are either just simply offsetting dilution from. employee compensation, or there's a gazillion examples of being done at rather elevated amount, periods in the stock price.

But it, the idea is what we can reinvest in a new business ventures. If the underlying business they do that generates the profits, think of an oil and gas company or real estate company or industrial company or utility company that has high capex need, they need. Some of the profits are generating to continue feeding the capital expenditures that drive the tree generation, which, which creates the fruit production.

I'm all for it. The reinvestment of some dividends into CapEx as a means of sustaining a growing business makes sense, but above the CapEx needs, because no company needs a hundred percent of their profits to invest in capital expenditures to then try to do something else. That is only going to be profitable to the extent that all profits are turned around and put back into CapEx, rinse and repeat.

That's a Ponzi scheme. At some point there has to be a real free cash flow. And talking about new ventures. So there's the profitable activity of the company that is generating the profits from which the dividends can either be paid or not paid. Versus saying, well, we want to not pay some of those profits or any of the profits to you because we want to now go into this other business line.

The business line that was making the first batch of profits is already on the table. Now you can say, well, there's new products. Great. Okay. You guys are pretty good at conser marketing. Go make some more conser products, certain technological things. Did we forfeit the law of marginal utility?

When we came up with this idea that all of these C suites have infinite amounts of reinvestment opportunity from their own profit making activities that are equally return oriented as the original activity, If there is no diminishing return to the next idea, the next idea, then why were they doing that idea to begin with?

So if a company is really profitable selling peanut butter and then they say, well, now we want to go into this other deal. It's even better peanut butter. Why didn't they do the other deal before peanut butter? I just made that up right now. I don't even know where, why peanut butter was, for example, but I think you get the idea.

A lot of companies can generate a lot of ideas and continue making more and more money off of it. Okay, so I'm all for it. I'm talking about a company already at scale, already at business maturation. There's a diminishing return because that's called the law of marginal utility. At some point, it starts diminishing.

And the testimony of history is clear that it's not just that there's less good ideas on your 450th idea than there was on your first and second idea. It's also empirically companies end up doing db things over time that they, in their pursuit of the next big thing to sustain their power, their access to bonus pool, their access to the capital base of the company that is now built up from the retained earnings they did not pay out to shareholders, that they end up misallocating capital.

And sometimes they don't, sometimes they can get things right. But the core competency of the company, we're not questioning. That's what generated the profits from which we're now having a discussion about what to do with the profit. The dividends come from the profits. The profits come from the company itself, and we're talking about what is needed to feel new profit making ideas.

And what I'm suggesting is that that number is finite. Those ideas are finite. They might be high and heavy, in which case you want a lot of money being able to go back into the company. But the notion that 100 percent should and 100 percent always should is arrogance and it's ignorance and it destroys value over time. I think that at the end of the day, investors do not want companies to retain all the earnings they generate. Because profits are often needed for some purpose other than reinvestment. , investors often need cash flow and when that isn't needed, investors have the ability to reinvest in shares of the underlying company and acculate over time.

And companies don't want, investors don't want companies to hold all, profits forever. Because they want to mitigate the risk. They want to monetize their investment and they want to learn from the lessons of history that companies through time end up misallocating capital. There is a discipline that comes from rewarding your shareholders for the risks they're taking.

Something has to be done with capital. The question is what. And perpetually having the company reallocate is either playing the fire to eventually you get to a point where they do something very ill advised. , or you, you, you, and out of that, you create a really bad incentive structure, in my opinion, for the management of company assets.

But it ignores the practicality and logistics of investor needs. You can't eat retained earnings. You can eat distributed profits and where you don't need to eat from your portfolio. You can reinvest. But the discipline that comes from this alignment between shareholders and management is why I believe the notion of companies retaining a hundred percent of earnings perpetually is perverse and that the right structure for corporate finance is healthy and hefty dividend repayments. Two shareholders who took risk in acquiring the equity of the company. Little corporate finance, little practicality, little reaffirmation of the dividend growth philosophy here at the Bahnsen Group. If you have any questions, reach out. We'd love to unpack these things more. And in the meantime, Have a wonderful weekend. I think you know where we are here in this time of year that now we are going into March Madness and that is not a description about the stock market necessarily but rather the greatest sporting event on our calendar. , so good luck and have fun putting your brackets together for all you college basketball fans or just good Americans. we'll enjoy March Madness and I'll be back with you next week in the Dividend Cafe.