DIVIDENDCAFE | PODCAST TRANSCRIPTION

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Hello and welcome to another Dividend Cafe. I am absolutely thrilled to be bringing you a message that is very similar to last week in terms of the topic. The Dividend Cafe needs to talk about dividend investing. It is what we do at the Bahnsen Group. It is a philosophical discussion. It is an economic discussion, but it really is a personal finance practical ivestment consideration of which we have basically built our investment philosophy.

And so last week I got to write about a common misnomer in dividend investing and understanding that a dividend or excuse me, a profit retained in a profit distributed are not the same thing, that there is a element in which we can mathematically compose it to feel the same, but in every practical and operational consideration to an investor and ultimately long term cultural considerations out of a company operation and company strategy, it is just simply the opposite, not the same. And so we value dividends profits distributed in the form of dividends, not profits retained in other than where they're needed for legitimate business expansion.

This week I want to talk about a little history and I don't think I've done this in Dividend Cafe before where I'm kind of using a particular book that I recently read as sort of my driver. And so I'm going to just start off getting all the You know, risk of plagiarism out of the way, lest I ever interview for the job of president of Harvard, I don't want to end up running into trouble by not fully attributing credit where credit is due, but I'm holding in my hand, a book called the *Ownership Dividend, The Coming Paradigm Shift in the U S Stock Market* by Daniel Peris. I've known Daniel for some time. He's a dividend growth manager at federated been in, in our business a long time. Daniel's an interesting guy because he has a PhD in history where he had a focus on modern Soviet history. And I make the argument in Dividend Cafe this week that I don't believe history is a totally separate subject from portfolio management. I think there is an incredible gift for those who study history in the art and science of managing money. And I believe there is an incredible deficit for those who do not have a grasp of history.

And so what Daniel did in the book that kind of inspired me was walk through some of the history of dividends. I am a permanent believer as a man of faith and the dictum from the book of Ecclesiastes, that there is nothing new under the sun. And I say that quite a bit in the Dividend Cafe, but I was really fascinated to see the how far back some of the bad arguments against dividends have gone and some of the misnomers that seek to strike human nature from an academic calculus of dividend growth investing. And Daniel makes the point that you can say two plus two equals four is the same thing of a big, long algebraic equation that I actually typed out in Dividend Cafe, but I'm not going to sit here and say, The whole thing here on the video and podcast because it'll bore you and confuse you, but you can look at this big, long, confusing algebraic equation that does equal four and understand hopefully intuitively that the way people get there is not the same as that versus two plus two equals four.

And that the check in the mail component of dividends is being paid for risk taken in a way that is tangible, that portion of your monetization comes, de risks the investment to the degree of that receipt of funds, and that attempting to perpetually hold on to unrealized capital gains could end up getting the same place.

Only with inviting a new level of risk at multiple steps along the way in company execution and market sentiment and market timing and investor psychology and counterparty resin and all sorts of macroeconomic things where the risk the de risking. Of that portion of profit receipt is one and done at the point of a dividend receipt.

And so two plus two equals four is not the same as other ways of getting to four when it comes to any real life understanding of getting paid. And I make an anecdotal point that, you know, there's a company that is paying you dividends on the way, and then later on gets into trouble and unrealized gains go away.

But for an investor who is receiving dividends on the way, they at least de risk that portion of the investment. And so you look at companies, there's a gazillion of them, household names that many people right now would think zoom and lift and you know, beyond meat and Peloton are still big, great go growing companies.

They are big brand names and they're well known in in, you know, the current society. They're down 70 to 99 percent depending on the company. And I make the comment that like, okay, well, I guess the investors who held those unrealized gains and lost them would have been better off getting dividends on the way.

And that's true. But of course, those companies had been in a position to pay dividends. It would have meant that they probably would not have ever lost the 79, 9 percent to begin with because they would have had real profits that were really distributed and so forth. But anyways, I digress. There's academic arguments that were used largely over different decades to tax arbitrage, a case against dividends, that there were ways in which different tax treatment dividends, of course, are taxed the same as capital gains long term, they're taxed to better than capital gain short term, and they're taxed significantly lower than ordinary income.

But there have been other periods in which tax regimes were less favorable to dividends, and the data in those periods don't even help draw a conclusion that is anti dividend. But what I want to do and some of this is really quite out of or extracted from Daniel's fine book is proposed to you.

There are three major reasons where we went through a period of time starting in the eighties, escalating in the nineties. And that I believe carried into the two thousands, went through a really bad decade for its own paradigm shift. When we went for a flat decade in the S and P, then of course, in the Fang decade and the Fed QE decade and the zero interest rate decade, it had a, it certainly was a really great decade for growth investing.

But my point is that There was a paradigm shift where cashflow driven investing became less interesting to investors. And that I believe that period is slowly washing away. And very quickly, the three main drivers were number one. I think the secular decline in interest rates when the 10 year bond yield in 1981 peaked at around 13 14 percent and then came down to nine and then seven and then five and then three and then one.

Of course, it's now come back up to four, but this 40 year secular bull market and bonds that was a secular decline in yields gave companies that were competing with the federal government for investors. The ability to not have to pay superlative yield. So you got a significant increase in companies that don't pay dividend and you got a significant decline in the amount of the payout ratio.

But then on top of that, you did have I would argue a a categorical shift when stock buybacks were legalized by the sec in 1982. Sec rule 10 B dash 18. Now stock buybacks reduced the denominator of shares when you calculate earnings per share. They like dividends, do not add to earnings. They are a question of what you do with earnings.

I think they're a perfectly legitimate thing to do. I just simply believe they're inferior to dividends when done right. And that they're most often not even actually being done as a capital return, that they're often a balance sheet arbitrage, where companies are borrowing money, which is making the company less valuable, they have more debt to then reduce share count or add into equity.

Which is making the company in that sense, it evens it out on the balance sheet as far as an accounting mechanism go, but in operational terms, there is now more debt that has to be serviced and thought about, but it created a financialization incentive to borrow money, to reduce shares. And there isn't a single iota of that is operational or strategic or competitive or organic to a company's success. Doesn't mean it was always the wrong thing to do, but it wasn't a focus on driving productive performance of a business. And then I also have made this point over and over. I have a chapter in my own book on the subject.

Stock buybacks have largely been a form of compensation, particularly to the corporate managers. Who are the ones electing stock buybacks? There's an inerrant conflict for the managers who are paid off of earnings per share growth to reduce the level of shares. I would rather see a focus on driving organic earnings, driving productive business growth, but stock buybacks have had their place, but they became in concert with a secular bull market of the eighties and nineties.

A correlated event gave the impression of a causative event in the minds of many investors who became far more willing to say, we'll take stock buybacks. We don't need dividends. We can harvest capital gains as a way of making money. And it seemed to be working just fine until. NASDAQ went down 74 percent in the early 2000s.

But this leads me to the third secular component, which was the rise of Silicon Valley. This has been a dynamically significant thing in our economy and in our culture. There was a high growth digital Revolution and the speculative nature of it is not necessarily being described that way as a pejorative.

There's a casino like atmosphere, but there were big companies making big money and investors experiencing big success and there were big wipeouts. And all in all. It facilitated big booms and big busts, and the blended CAGR, compound annual growth rate, is somewhat unimpressive. But, certain companies did well, very enhanced volatility, but there was a period where company, where investors were willing to bypass their normal need of cash flow investing because of the high growth atmosphere of the NASDAQ.

And I think that culture, got embedded into Silicon Valley. It was sort of a conic classic. It was anti wall street. It was on the other side of the country from New York city. And it was new school versus old school and all this kind of stuff. And I think those are the three issues that really drove a sort of paradigm shift.

And now I look at him and I say, where are we at now? What is the investor culture going to look like going forward? Interest rates are not going to go from 13 to zero again. And maybe they stay in a lower range, but there's not the same secular decline because we're already down in a low single digit integer.

So you don't get 40 years of interest rates, dropping 13 percent when you're at 4%. Stock buybacks are being demonized by many on the right. They're being demonized by a ton on the left. There's taxation issues going at them. They're to try to disincentivize companies using stock buybacks who have become in a lot of ways an unfair boogeyman for various arguments in terms of class warfare.

And then in terms of the investor needs, can harvested or unrealized capital gains continue to feed the till with the gazillions of folks entering a post work stage of life, requiring greater cash flow, and now having the clarity of decades of real results. Showing booms and bust, but not the magical panacea of harvesting capital gains as opposed to receiving cash, investors need cash.

The hipness of Silicon Valley that's created certain booms and bust. I do not believe will drive investor results. Investor appetite, investor behavior for the next 10, 20 years, cash based investing can't wipe out speculation altogether because speculation is a byproduct of human nature. It will still be there.

Some of it will be profitable if people are good at timing their exit. But I say this, I don't care if what I'm referring to becomes popular or not. I happen to think it will be. But for the reasons of outline below, I think a lot of the cultural factors that were at play in an era in which dividend companies paying dividends and the amount of dividends paying out reduced the opportunity set going down.

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I would rather have 80 companies to choose from than 60 to choose from. I made up both those numbers, all things being equal. I like there being a better opportunity set of companies participating in good shareholder management, alignment profit generation that is being returned to shareholders and so forth.

All things being equal, I prefer that, but I also don't mind getting a premium on the value that is created from companies that are doing the right thing relative to a bunch of companies that may not be doing the right, that may not be doing the right thing. What happens. With broad investor sentiment going forward is outside of my control and outside of my concern relative to our demand to do the right thing.

Relative to our insistence upon doing the right thing. Monetizing investor results through dividend growth, which is what we do believe in and then thoroughly convinces the right thing for investors. Do I think there's a good chance of a lot more people are going to see it my way? I do. Maybe they don't, but I hope you all will.

That's what we're here to do in the Dividend Cafe. Thanks for listening. Thank you for watching. Thank you for reading. Please do check out the written dividendcafe.com. Enjoy your weekends. Look forward to being with you yet again, next week in the Dividend Cafe.