# DIVIDENDCAFE | PODCAST TRANSCRIPTION

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Due to the publishing time constraints for us to produce our daily missive, podcast, and video, the best we can offer at this time is a machine-generated transcription which contains errors. We will continue to work to improve this service and appreciate your patience with us.

Well, hello and welcome to yet another edition of the Dividend Cafe recording live here in beautiful New York city. It's been a volatile week in markets big drops on a couple of days. Thursday was actually the biggest down day in the Dow in about 14 months. And this volatility has been going on for a while. You know, it's kind of anticlimactic when you say Oh, we're down a thousand points on the week, but then you realize, well, we were up a thousand points last week. And, you know, we're kind of just at the same place that we were a couple of weeks ago. And for that matter, with a big rally in May, but a big drop in April and a big rally in March, we're really just kind of where we were in February at this point.

And so that's what our, ongoing expectation is not merely a kind of flattish market, but a flattish market that along the way has non flat experiences, up, down, up, down. And it kind of can give people whiplash and more important, you know, cause whiplash is solvable, but people getting their faces ripped off in their portfolio is not.

So, you know, being on the wrong side of trying to trade around all this stuff is the only mistake one has to avoid. The fact that things are going to go up and down along the way is not a mistake to avoid. However there's a few kind of investor lessons in some of this I want to talk about.

And very candidly a lot of these things don't apply. to our clients. They don't apply to people who are prone to listening to Dividend Cafe, watching or reading Dividend Cafe because they may already be more sensible investors. But, you know, when I see things, there's a kind of snippet from CNBC.com that we put in Dividend Cafe this week of investor bullishness hit a six week high. ahead of Thursday's slump. There's sort of an irony, but that's a very well regarded sentiment index. The American Association of Individual Investors is AAII sentiment, and it is a reasonably solid contrary indicator.

You know, when that sentiment gets very low, it can tend to be an exciting time for equity investors. And inversely, when it gets very high, it can often lead to something different. Now, not necessarily the next day as might've been the case of this ironic posting this week, but over time, but there's other indicators now, and I just want to go through a few of them.

High yield credit spreads are only about 300 basis points wide. That's reasonably tight. It's not hyper tight, but it's close But what it means is people are not demanding a lot more yield for riskier parts of credit investing The vix as i'm sitting here talking is at 12 and a half. It's been 12. It's been 13 But you know you're talking about very low below average level of pricing of what people pay because of fear to price S and P 500 volatility.

There's something called out of the money puts the money that people will pay to buy protection against things dropping a lot.

And it could be individual stocks. It could be indexes, but the average price level paid for out of the money puts is at the lowest cost and over a year. All of these indicators, you know, by the way, there's another one too, that I want to point out the amount of individual investors buying double and triple levered ETFs has come back up.

It had been only about 500 million back in 2020, and it went all the way up to 6 billion.  And then it dropped back down to a billion and a half as people were getting torched in 2022. But now it's come back up, not quite to 6 billion, but just a hair below it. And again, maybe they're all geniuses and maybe it's all going to work out great.

And maybe it's all very smart trades, but it is definitely retail. Individual investors that are speculating and when you see that kind of fervor coming up in a highly risky product like that when you see you know, a pretty low regard for risk evidenced in risk mitigation prices like credit spreads, vix and puts and so forth.

I just think you're kind of looking at an environment in which the things are frothy at that index level. And I think people have to be more, more careful than following the general crowd. And when I say it doesn't apply to a lot of our clients or Dividend Cafe readers, it's because I don't think that this is a place people come to follow the crowd.

I think it is a place people come for fundamental investment logic and fundamental investment logic is not going to be rooted

in following the crowd and in triple levered ETFs in some of the shinier type things one may do. If I'm looking for value that's out of favor, first of all, I'd like to point out that emerging markets Which are doing just fine, by the way, as an index, they're up 7 percent year to date, our emerging market strategies at 10 percent year to date, but as a relationship.

Between emerging markets pricing and S&P 500 pricing, it's at a 50 year low, a full standard deviation below its normal historical relationship. And the last time it hit this level, it was in 2000. And from the next seven years, you had a tear to the upside of the emerging markets. And of course, you know, U.S. Markets went through a lost a decade. I'm not saying that starts tomorrow. I'm not saying it even plays out the same way. I'm just merely referring to a historical relationship of pricing that's out of whack and presents a value. I'll be it right now.  that is not being reflected by the crowds. And so some could look at that and say that's an argument against it, where we look at it and say that's an argument for it.

Overall, the main issue I want to get to though, has to do with how we think about diversification. That this is a term that when I come in here week after week and say, I see index investing right now is primarily a way to bet on 10 stocks. You're going to buy 500 stocks and you're hoping 10 of them that are all very expensive, get more expensive.

It's very high concentration, about 30 percent of the S&P 500 rooted in a few names and the overall S&P 500 trading at, you

know, a really significant premium to its historical valuation with those key five to 10 names. At an especially high premium devaluation and you hope for a certain level of return in the years ahead that has to come from the valuation staying elevated and perhaps getting even more elevated.

And so I talk week after week, reasonably critical of the strategy. not of the timing around it, but just and by the way, the underlying fundamentals are cooperating. Earnings are growing. The problem is, of course, that's priced in the, if earnings were contracting, if you have a recession, earnings drop, all bets are off.

You're not just going to see the index level fall because of valuations collapsing. You're going to see. Both the P and the E, the multiple and the earnings drop in the P that goes there with, and a priced earnings is, it would be a bloodbath but earnings may not do anything like that. And that would be a reasonably good environment to at least kind of hold the line.

Evaluations weren't excessive, but see my critique of the environment we're in right now and people following the crowd is that following the crowd ends in tears. And the kind of conventional views right now, I think, are excessively valued and therefore present challenges for longer periods of time.

And I'm trying to suggest something that is somewhat counter cultural, and yet diversification is a very cultural idea. It's a very conventional idea, and I am a big advocate of diversification. I

just merely want to point out that when someone says I want 500 stocks with the S&P 500 or I want to buy six index funds or four index funds, that there is a thing called diversification, which is very different than diversification.

And I believe that when you pile on things that are almost 100 percent correlated with one another, you haven't further diversified anything. You've just added on more volume of the same thing you already owned. which is different than achieving a benefit of diversification. So I thought a little investment finance vocabulary today and attaching some of these things to concepts might be useful.

Diversification exists so that you avoid the risk of all eggs in one basket. And let's say we're talking first and foremost about the high level of diversification, which is across asset classes. So It's what we would call asset allocation. And this is where you're diversifying a portfolio by owning different categories of assets.

And that is different than diversification within a given asset class. So let's take the asset class of U.S. equity. For us, we are dividend growth investors. Why do we own, let's call it 30 stocks? Let's Instead of 500 because I don't get any diversification benefit by owning 50, 60, 70, 30 diversifies 50, 60, 70 is more than enough and 500 is absurd and we want to stay within our philosophy of dividend growing companies that we believe in the sustainability of their dividend and all the attractive elements of the underlying business.

So, 30 happens to be the number. It is an acceptable number to get diversification benefit, but not an excessive number where we dilute the value proposition of dividend growth names. Now, what are the things we're diversifying away from? You say, well, the whole market going down. Well, if the whole market goes down, you expect that 500 names will go down.

By definition, the S&P 500 went down because the whole market went down. But if you own 70 or you own 30, you can't diversify away market risk. You can't diversify away systematic risk when you're talking about diversification within an equity portfolio. But there is something called non systematic risk. A CEO getting in a car accident, a scandal you know, some factory or plant that goes down because of a weather issue or unexpected competitor.  dynamic. There are individual things that could come up that you say, okay, this could come up with this company, but it may not be something that impacts the entire market. That's why you have diversification. And so if something goes wrong with one of your companies and you own 25 other ones, the diversification really helps insulate some of that portfolio, the risk of being wrong on a given company, but that doesn't do anything about systematic risk, which is total market risk.

That brings us back to our first category, which was asset allocation. That's where you're trying to diversify systematic risk. You say, okay, well, I have an equity sleeve and there's somewhere to go on the whole market. I have alternatives or I

have fixed income or I have real estate. And so you have different categories.

You know, we happen to be big alternative investors and we believe that we can achieve a diversification across asset classes.  core dividend growth alternatives are some of our heaviest positions. And then we can achieve diversification within those sleeves. In the way that I talked about a mere volume of positions is not diversification and it is a conscious decision to favor quantity over conviction.

And that's where I think diversification comes in. When in the course of pursuing diversification, you allow quantity to trump conviction. One can maintain conviction and achieve diversification.  And they can achieve diversification at a portfolio sleeve level. with let's call it the number of names you own an equity portfolio or a bond portfolio, what have you, and then diversification at a high level in the portfolio with asset allocation across different categories of investing.

And this is the philosophy we would take. And we'd apply that discipline  into our portfolio construction that then favors the things that meet our fundamental requirements that do not get selected based on popularity in an environment where people pick things like mean stocks cause they're playing a game because of the popularity, because of momentum, because of a kind of bet the, those things can go up, they can go down.

It, that, that's not the issue. The issue is that they have forfeited. an investment strategy that has fundamentals that are knowable and is connected to a company outlook. It becomes a pure byproduct of chance. And I think our clients expect more from us than that. And in this environment we're in, I don't think you have a lot of people investing in chance consciously, but I think you have a lot of people investing in dynamics that are far more out of their control than they may expect.

And yet they believe it to be a bit different than it is. When we see risk mitigation, this complacent, and when we see a sentiment become this euphoric we feel quite strongly in the conviction of how we've diversified a portfolio. And that's the underlying message I'd suggest this week.

There's a few other little tidbits in the dividendcafe.com this week a note about natural gas prices that I definitely think the chart of the week reiterating the inevitability of the 10 year bond yield and nominal GDP growth being connected that when they get disconnected for various periods, it's just a matter of time until those those things converge back together.

There's a good explanation of it there. So check out divinitycafe. com if you want to see some of these charts. But if you got your fix already from listening or from watching, then move on with your life. Go enjoy your Memorial Day weekend. We'll leave it there. I, with that said, I do thank you for watching. Thank you for listening. And I certainly thank you for reading the Dividend Cafe. I look forward to being back with you next week for what I

hope will be a well executed, very special edition of Dividend Cafe looking back over the last 50 years. Have a wonderful Memorial Day weekend. Thanks so much.