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The Power of Dividend Investing

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The easy part in analyzing the current state of affairs is acknowledging the risks. The "trifecta" of concerns I most focus on is not mysterious, it is not opaque, and it is not even new. Each of the categories of concern involve multiple nuances and layers of sub-categories, and each has manifested itself differently in the last several years. More important, the way all of these will play out in the years to come will be different from how they feel and look now. What I want to do in this piece is lay out what that "trifecta" of concern is from my vantage point as an asset allocator and portfolio manager and make the case for dividend growth equity investing as a significant weapon in fighting against these risks and concerns.

The major categories I incorporate into this trifecta are:

- *Excessive government indebtedness*
- *Distortive monetary policy*
- *Geopolitical uncertainties*

All three categories have new dimensions to them. Government debt was $1 trillion when I was in high school 35 years ago; it is $34 trillion now. Public debt-to-GDP was 62% as we entered the financial crisis in 2008; it is 120% now. The balance sheet of the Federal Reserve was $600 billion before the financial crisis; it is $7.5 trillion now. We spent much of the 1960s and 1970s in a Cold War with the Soviet Union (with grave nuclear concerns); we are now looking at Russian adventurism in Ukraine and an uncertain outcome for Israel in its war with Hamas. But you will note—all of these "new" developments have an element of "old" to them, too. Then and now, we had excessive government debt, an interventionist central bank, and a dangerous world geopolitically. The new manifestations of these old categories have created a new paradigm.

Attempts to predict specific outcomes around these three categories have not gone well for the forecasting class. All at once, fiscal and monetary stability have worsened for years and years (with much more to go), yet corporate profits have grown, GDP has grown, and risk assets have produced returns. It can lull someone into complacency if not careful, partially because we have grown used to the can being kicked down the road by policymakers and central bankers, and partially because too many doomsayers have burned people with inaccurate forecasts with wailing and gnashing of teeth. Investors are real people with financial goals, cash flow needs, a timeline, beneficiaries, and particular elements of their own lives and situation that require tailored solutions. A generic belief that "bad things are brewing" does not lead to a specific portfolio that generates specific outcomes. Just as much as Keynes was right that "in the long run we're all dead," David Bahnsen (I made this up) is right that "until then, we're all alive, and have wives and kids." In other words, ignoring the short and intermediate term while we wait for long-term inevitabilities to play out ignores pragmatic reality.

My view is that these three categories of risk, taken together and separately, put a burden on investors that disqualifies much of what has passed for traditional investing over the last couple decades, and redirects investors to a historical practice that ought to serve as a fundamental bedrock for those pursuing investment solutions that meet real-life financial goals. **In the paradigm we find ourselves in, dividend growth equity investing represents a solid, dependable, and historical way to play offense and defense in a contest that requires both.**

This week I will focus on the defensive components of dividend growth investing and how they are situated to protect during periods that require protection. Next week we focus on offense—how dividend growth generates excess returns both for withdrawers and accumulators of capital. What I will not advocate is the silliness or naivete that says, "nothing can go wrong here!" Dividend growth equity is a long equity strategy, and equities go up and down in price. If they produced no downside volatility the risk premium would be so low, it would be a completely unattractive investment proposition! Dividend growth equity is still equity, and therefore subject to the standard price fluctuations that any asset class will have when:

- *It is owned by the highly emotional public*
- *Has a P/E ratio embedded in price that moves around sentiment and comparative economic barometers*
- *Is highly liquid, marketable, and tradeable*

I argue that the reality of price volatility, liquidity, and public temperament in the stock market is an argument for dividend equity, not against. For it is the equity investors who have removed themselves from cash flow considerations who have the most to lose from price volatility. At the heart of this point is, well, math. If one is aiming for a 10% annualized return (to use a purely illustrative hypothetical), and the plan is to get 5% of it in dividend income and 5% in price growth, versus another aiming for 10% but with 1% in dividend income and 9% in price growth, the impact of downside volatility is not equally felt even if the 10% return ends up being averaged over time. A 5% dividend yield does not become -10% at times and +15% at others.

The yield is what it is, and properly managed does not go down at all, *but certainly never goes below 0%*. You never have to pay the dividend to the company; it only pays it to you. But price appreciation, on the other hand, only comes from "up and down" volatility.

A stock portfolio or index that averages 10% per year rarely is actually up +10%. Rather, it may be down -20% in some years but up +30% in others (and plenty of other variances in between). The portion of a return coming from price appreciation is by definition subject to more price volatility than a portion of the return that cannot mathematically go below 0%. Therefore, the volatility of two strategies pursuing 10% where one seeks to get half of the return via dividends, and one is content for just a 1-2% dividend yield are categorically different.

But no matter what you have been taught, risk and volatility are not the same thing. The variance of a return around its mean is emotionally real, and in the context of a real-life withdrawal strategy, mathematically real (more below). But up and down price movements are not the same thing as the permanent erosion of capital. However, if one's portfolio strategy requires a compounding annual growth rate that proves to be far above reality because of valuations or because prices drop and never recover, those are not volatility concerns—they are risk concerns. Real risk. Existential risk. And it is that risk that dividend growth seeks to eliminate.

First of all, valuation concerns... The market's price-to-earnings ratio is high right now—very high. Any number of fiscal, monetary, or geopolitical developments could collapse that P/E substantially. The market has not priced in the very real possibility that:

- *The structural growth rate of the economy has been altered by excessive government spending*
- *The monetary medicine in the next decade will be less efficacious than the last decade*

I do not view either of those contentions as even remotely debatable. The 2010-2020 decade saw significant earnings recovery post-GFC, but also monetary policy facilitating reflation that boosted multiples (and then some).

I believe holding a high multiple will be impossible in the aftermath of what the economy faces. Going from $1 trillion to $20 trillion of debt happened without much structural impediment and with significant monetary facilitation. Getting to $30 trillion fed a lot of mal-investment, created excessive leverage, and further entrenched the economy's dependence on something fundamentally unsustainable—namely a stimulative effect on monetary policy whose stimulative effects can only diminish over time.

Though the analogy is crude and uncomfortable, the high a drug addict gets from the initial stage of their addiction becomes less enjoyable over time. And worse, it requires more and more intake to get less and less of a high. The fiscal and monetary treatments we have used and will, no doubt, continue trying to use are in the "diminishing return" phase. Multiples may hold at a historical level (this would be an optimistic base case), but they are at a big premium to historical levels already, and require significant expansion, still, to achieve that aforementioned historical return.

Dividend growth equities, on the other hand, require less speculation than "growth stocks," feature less frothy valuations, and offer return strategies far more connected to fundamentally knowable and repeatable phenomena than simple valuation growth. Where free cash flow is growing, and a company has a past, present, and future inclination to liberally share that free cash flow at an ever-growing rate with its owners, the impact of valuation volatility is muted. A company trading at 17X earnings is less exposed to a reversion to 16X than a company trading at 22X. And better still, a company paying 4-5% in yield has less price appreciation need to get to an 8-10% return than a company paying 0-2%.

All of this is self-evidently true. Less self-evident is the inherent truth about the maturity of a company that can pay an attractive dividend and grow it from 6-9% per year for year after year and decade after decade. These companies may be past a hockey-stick level of growth that requires very fortunate entry timing and even more fortunate exit timing, but they have achieved a scale, brand, balance sheet, and marketplace position (it can often be called a moat) that makes them successful companies. In other words, the capacity for such a dividend and such repeatable dividend growth is not merely the strength of an investment, but it is evidence of the strength of the company. It both presents and reflects a successful investment proposition at the same time.

What are the characteristics of a company that can grow its cash flow this reliably, and achieve the balance sheet strength, competitive positioning, and operating consistency necessary to be a perpetual dividend grower? Well, for one thing, it had better offer goods and/or services that are consistently needed. In other words, an apparel company making a hot line of clothing for 16-year-old girls is wise to hang tight on dividend payments, knowing that next year 16-year-olds might possibly change their minds (just a hunch). But a consumer staples company that makes toilet paper or diapers or dish soap or soda pop or bottled water (or, maybe, all of the above!) might just have a more defensive business model. In a given part of the cycle, that 16-year-old girls' clothing might print money compared to the consumer staple, but one leads to decades of dividend growth with good and sober management; the other might lead to Chapter 11 once the new school year starts.

There are many examples of companies that traffic in goods and services which are less subject to disruption or changing fads and preferences. Utilities, Health Care, Energy, financial advice, basic technology hardware and infrastructure, Real Estate, and many other sectors in commercial society offer opportunities for market leadership, profit generation, and consistency of results (with ongoing innovation) that lends itself to dependable cash flows.

And that is the story of the defense of a good dividend growth strategy—that it represents the finest exposure to the components of commercial society not prone to being blown over by the winds of cyclicality. Fiscal and monetary and geopolitical risk will still exist, and they will play out how they are going to play out. A remnant of companies will continue to generate profits (capitalism works), and they will continue to share those profits with us.

Another segment of companies will only monetize for investors if they time their entry well, time their exit well, and survive the vulnerabilities of policy error, policy distortion, and other macro events. They are exposed to hope, not strategy, unless that strategy is mere multiple expansion. It is an economic risk but also basic mathematical risk that exceeds logic and prudence.

The environment in which we find ourselves is screaming for reasonable valuation, a buffer of safety, a consistency of operating results, and a management team aligned with shareholders enough to share profits with them. In this environment the path to returns that can be "eaten"—truly received and made efficacious—is in dividend growth.

Let's review the defensive nature of dividend growth investing—defense against irresponsible fiscal policy, distortive monetary policy, and destabilizing geopolitical realities. I approach this from a couple of different perspectives:

• *Mathematical*, as the greater portion of one's return coming from something that cannot be less than 0%, the less volatile the return will be.

• *Structural*, as companies in a position to grow their dividends year after year after year are inherently more stable, reliable, and defensive.

I make the case that what investors are largely defending against in the macro are fiscal, monetary, and geopolitical uncertainties and that conventional means of investing (a 60/40 portfolio, for example, or general use of a S&P 500 index fund) are wholly inadequate for the case at hand. Dividends have gone from being 30-50% of the return of the market (and that is in good decades; they can be over 100% of the return in a bad decade like the 2000-2009 era) to just 10-15% of the expected return now (that is, a 1.2% yield from an asset class with a historical return of 10%). Index investors are asking multiples to expand and earnings to grow more than they ever have, and they are doing so right now from a vantage point of extremely stretched valuations, and a quite robust place of corporate profits.

Understanding the return attribution of index investing is not complicated. The earnings of an entire index go up a lot more than they go down because capitalism works, and because company managers get fired when they don't grow earnings. Earnings can contract in an entire index, and profit contraction is sort of a textbook part of what makes for a recession. That contraction can be violent when the recession is especially severe (i.e., 2008 Global Financial Crisis), but fortunately we do not experience a high frequency of severe recessions. However, indexes get their aggregate price growth from the multiplication of the profits achieved by companies in the index by the "multiple"—that elusive but all-important variable that

represents what *an investor will pay for the future earnings of the company*. A high valuation is expensive for a buyer but is appreciated by the seller and really by a holder as well. The problem is that superlative return results from an index require both earnings growth and multiple expansion.

The total return of the index can be summarized as follows: *Earnings per share growth * Change in multiple + Dividend yield*
Or in formula form: *TR = ((1+EPS) * (1+PE)) + DY*

Earnings per share are, of course, a by-product of sales per share and profit margins. Margins have expanded significantly over the last decade. One has to have a very optimistic view of both margins and margin expansion, and of course revenue growth, to feel that earnings will outperform expectations in the years ahead. And notice I said "earnings," and not "earnings per share." For the index investor the formula is "earnings per share," meaning the share count matters.

SOURCES OF S&P 500 RETURNS: 1900 - 2015

Decades	Dividends	Earnings Growth	P/E Change	Annual Returns
1900s	3.5%	4.7%	0.8%	9.0%
1910s	4.3%	2.0%	-3.4%	2.9%
1920s	5.9%	5.6%	3.3%	14.8%
1930s	4.5%	-5.6%	0.3%	-0.8%
1940s	5.0%	9.9%	-6.3%	8.6%
1950s	6.9%	3.9%	9.3%	20.1%
1960s	3.1%	5.5%	-1.0%	7.6%
1970s	3.5%	9.9%	-7.5%	5.9%
1980s	5.2%	4.4%	7.7%	17.3%
1990s	3.2%	7.4%	7.2%	17.8%
2000s	1.2%	0.8%	-3.2%	-1.2%
2010s	2.2%	9.2%	1.4%	12.9%

*Source: Don't Count on it (through 2009), Updated through 2015, April 14, 2024

Let's review all the inputs that we have now said matter to the index investor for the decade ahead as it pertains to a return expectation and add a little commentary by each.

REVENUE/SALES

It is fine to believe revenues will grow and even potentially grow in line with expectations. But if one believes in the economic logic of revenue growth being correlated to economic growth, and one believes that excessive government indebtedness takes away from future economic growth (something I believe to be tautologically true), then one can be forgiven for not accepting the party line on top-line revenue expectations.

PROFIT MARGINS

Operating margins have gone from below 8% to around 12% today. Profit margins have grown more or less in tandem. It has been a huge source of market returns since the GFC. Are margins able to hold here with unprecedented need for more capital expenditures, research and development, and business investment? Are wages shrinking? Are health benefits shrinking? There is no question there are areas in which efficiencies have enabled margins to reach these levels, and perhaps they can hold. I would not consider that thesis a slam dunk, but it is not out of the question that today's high margin levels hold. But that brings us to the next term...

MARGIN EXPANSION

Even if one optimistically believes that margins hold at these breakneck levels, do we have sufficient reason to believe margins expand still more? Should our investment philosophy depend on believing in such? Will deglobalization expand margins or potentially shrink them? Will onshoring expand margins or potentially shrink them? Does populism indicate higher wage costs or lower wage costs? [Note: I am well aware of the argument that greater technological advancements may represent a push to the pull of this argument, which is why I might be comfortable conceding level margins to where we are now, but additional margin expansion in the face of these headwinds seems highly unlikely to me.

SHARE COUNT

Earnings grow where revenues grow and/or margins grow, but for investors to feel that, it must be mathematically applied to the number of shares the total earnings are being applied to. A high level of buybacks reduces share count and therefore expands earnings per share regardless of underlying earnings growth. Congress in its infinite wisdom has passed a 1% tax on buybacks which reduced corporate earnings per share by 0.40% last year. Buybacks had reached $1 trillion over the 2022 fiscal year but ended 2023 at $795 billion. Downward pressure on buybacks is here, and Congress is just getting warmed up. We must remember that the share count does not go down when companies effect buybacks in one end of the pool but issue new stock for employee compensation in the other end of the pool.

EARNINGS PER SHARE

Effectively, one has multiple inputs that may face downward pressure, but are unlikely to face tailwinds. Factoring in revenue growth, margins, and share count, one need not be apocalyptic about earnings-per-share growth in the years ahead to recognize that the best case scenarios are still not overwhelming. They are moderate if one is an optimist, neutral if one is a realist, and difficult if one is a pessimist.

CHANGE IN MULTIPLE

Now for the whammy! How do we really drive total return for the index, especially if earnings per share are moderate or even sub par? A growing P/E, of course. And this is where I remain mystified at those who would mathematically deconstruct the best case scenarios for the index, and still come away sanguine. Starting with a 22X multiple is no way to bank on multiple expansion for the years ahead. The realities of macro headwinds scream for multiple contraction. The paradigm of any rate environment not like the ZIRP and QE of the last decade indicates at the very least a moderately lower multiple, not an expanding one. The inescapable mathematical conclusion of a 60/40 or straight index portfolio is that multiples will need to expand, and my friends, they won't.

The conclusion I would offer out of analyzing the key parts of an index for the decade ahead, rooted in fiscal recklessness, unintended consequences, monetary excess, downward pressure on the rate of growth, misguided allocation of resources (due to both fiscal and monetary policies), and geopolitical uncertainties, is that the market faces an extended period of "flattish" and choppy returns, *in the best case*. The historical record is clear: Extended and impressive bull markets are followed by multi-year periods of consolidation. They don't always feel like they are "flat" when you are living through them, because the up and down volatility from a starting point to an ending point can be massive. But investors cannot have their financial needs met waking up one day at the same spot they were five or 10 years earlier (and some may say I am being optimistic).

But wait, I skipped something! Remember our formula above?
*Earnings per share growth * Change in multiple + Dividend yield*

*TR = ((1+EPS) * (1+PE)) + DY*

The DIVIDEND YIELD (and implied in this is not merely the

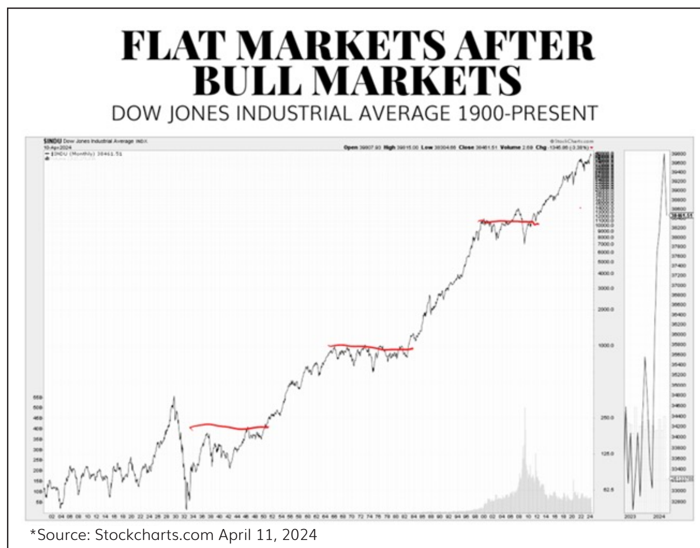
starting yield but the growth of dividends paid year by year as well)... Let's revisit something about index investing versus our chosen path of active, high-conviction, dividend growth investing...

Remember margin expansion? The entire index is a sum of parts of everything, where we know some companies expand margins and some do not. A dividend growth strategy may allow you to focus on where margins are compelling enough that profits are repeatable. How do we know this? They prove it to us... with the dividend payment! Management votes on margin expansion by paying the dividend.

A dividend is money that leaves the company checking account and goes to yours. A change in multiple adds no money to your account. A restatement of goodwill vs. impairment charges adds no money to your account. A reduction of share counts adds no money to your account. No accounting wizardry reduces the cash the company has. A dividend is real money leaving its real account to go to your real account. The analogy I have used for 15 years is individuals with their tax returns. When a person pays real tax dollars to the government, they may very well have made more money than they say, but they sure as hell didn't make less! Real dollars set the baseline for real economic results. A dividend is a communication from management: "This much of our results is real."

But most important, multiple expansion. An index investor has no control over the P/E ratio of the market. The multiple goes up or down around sentiment, psychology, mood, media, macro, interest rates, headlines, and so forth and so on. It is literally the most important ingredient in the investment result for an index investor, yet it is completely controlled by the wind.

The dividend as a matter of investor focus not only has the benefit of being *real* and *spendable* but it is also *a factor one can select in their investment management*. We can select companies with the ability and propensity to grow their dividend; we cannot select or identify an "ability to grow the multiple." The valuation just happens; the dividend is something company management has agency over. Apart from significant manipulation that could become subject to inquiry, corporate management is highly limited in how they can drive multiple expansion. But good companies growing free cash flow have a lot of control (actually, all the control) over dividend rewards to shareholders!



*Source: Stockcharts.com April 11, 2024

It should be no small irony to you that the most uncontrollable and unknowable ingredient in investor return is the one getting all the investor attention these days (either consciously or unconsciously)—multiple expansion. Growing P/E ratios are exciting and those accelerated returns are fun. They also are fleeting, and as it pertains to the market conditions we face in the years ahead, they are not worth taking for granted. Adding to the irony of the moment is that the one ingredient that investors can know and control within their portfolios (within reason, and enhanced by quality research and management), is the dividend. The controllable gets ignored and the uncontrollable gets attention. This is not the formula for playing offense in the years ahead.

Even apart from the cliché adage (which can be extremely true) that the "best offense is a good defense," dividend growth investing is particularly positioned for the years ahead. It puts the mathematical focus in generating a total return off of the vulnerable (multiple expansion) and on to the controllable (cash flows). It redirects portfolio focus to those goods and services in our economy that are needed, that are used, that are not faddish and fleeting, and where the very people running the company have so much confidence in the ongoing prospects that they choose to write a check with real money.

Only unlike in my taxpayer analogy above, this time, the check goes to you. And you will know how to spend it.

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