Predictability and Consistency

April 2018 Client Letter

Recently, I spoke to a long-time client who has been with Richard C. Young & Co., Ltd. since August 1995. When we have telephone conversations to review his portfolio, there is often no need for me to schedule the appointment on my calendar. That's because for the past 12 years we've spoken on a Friday at 10:30 a.m. Naples, Florida, time and 7:30 a.m. Orange County, California, time.

While our phone appointments are both predictable and consistent, the markets have been anything but. During our last conversation, we discussed how 2018 is becoming a much different year than 2017. Last year, markets were consistent in that they were mostly up. But certainly not predictable, in that many investors expected volatility that never materialized. By example, in 2017 the Dow Jones Industrial Average didn't experience a correction of even 3% for the entire year. Additionally, from 2017 to 2018, stocks lasted 404 days without a decline of even 5%.

Last year was an unusually

calm environment and one we don't expect will be repeated. While it's nearly impossible to predict how the market will move, here is how it has historically behaved.

- At least five 2% daily dips per year
- About three 5% corrections each year
- One 10% or greater correction per year
- One 30% drawdown (decline from peak to trough) every five years

For the remainder of this year, we expect an environment more like early 2018 than 2017. Excess liquidity is draining out of the global financial system (albeit slowly) and the economic expansion and bull market are aging. It has been almost a decade since the last 30% drawdown in the stock market, and that may increase the probability of a more challenging period ahead.

Long-Term Investment Success

Our long-time client became aware of Richard C. Young & Co., Ltd. after having been a subscriber to my dad’s investment newsletter, The Intelligence Report (IR). IR was consistent with its investment strategy and forms the basis of how we invest for our clients.

Diversification and patience built on a foundation of value and compound interest is a phrase we use often and one you will see at the bottom of the first page of this letter. Compound interest is, if nothing else, predictable. If your portfolio is compounding, your portfolio continues to accumulate additional shares of the companies you own. The longer time you allow shares to compound, the greater your chance of investment success.

When our client joined our firm he would have received the August 1995 issue of The Intelligence Report. I looked back at that issue to see what type of strategy was being recommended at the time and found, to no surprise, it was similar to what we advise today. Here is an excerpt from page 3:

A Three-Point Guide To Long-Term Investment Profits

When you invest in or for retirement, I like you to think in terms of a three-point total return concept:

1. Look to current yield to fund day-to-day living expenses. It is a fact that over the long term, dividend yield accounts for approximately one-half of total return. Your minimum portfolio yield should be a yield at least 20% higher than the Dow or S&P 500.

2. After current yield, look next for annual dividend increases to help you neutralize the *negative effect inflation has on purchasing power. If you are retired on a fixed income, your income will buy you increasingly fewer groceries at Winn Dixie as time passes. Your high-yielding stocks should give you average dividend growth of 3%–4%, which will pretty much cancel the negative effect of inflation.*

3. Look for a long-term annual increase in the price of your portfolio stocks that matches the dividend growth of the shares included in your portfolio. If you plan on an average 3%–4% appreciation component for your high-yielding portfolio, you should be

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on target.

A History of Consistency

Another benefit of dividend payments is their predictability. While the direction of the stock market is unknown, we can usually predict dividend payments. Most often, blue-chip-type companies strive to maintain their dividend policy. Not doing so can be seen as a sign of weakness or concern. Hence, when we invest in blue-chip dividend-payers, we can take comfort knowing we are investing in a security where there is an element of predictability and consistency.

Kiplinger recently opined

on the merits of a dividend-based investment strategy. Here are some of the highlights:

Companies with a long track record of consistent dividend payments are attractive, but dividend growth matters, too. Steady dividend hikes not only make a stock more alluring to new income investors but also reward existing investors with increasingly higher yields on shares purchased at lower prices in the past.

Dividend stocks that raise their payouts have appeal in an aging bull market, when the pace of shareholder-friendly stock buybacks and mergers can slow, according to Heidi Richardson, an investment strategist for BlackRock.

Dividend growers, she adds, also can offer an edge when interest rates are going up: "Stocks with a history of consistently growing their dividends have historically tended to perform well and exhibit less volatility in a rising rate environment." The Fed raised rates as expected on March 21, and Kiplinger thinks investors should brace for two more potential rate hikes later in 2018.

108 Years of Dividends

State Street is an example of a dividend-payer with a history of dividend increases. State Street is up for the year and has paid a dividend since 1910. From its founding 225 years ago, State Street has grown from a small maritime bank into a global financial institution now responsible for 10% of the world's assets. State Street serves more than 100 markets and is the world's third-largest asset manager, holding $2.7 trillion in assets under management at the end of 2017. State Street also provides custody services to other financial firms, and at the end of 2017 held $33.1 trillion in assets under custody. The business's fee revenue alone exceeded $2.3 billion in 2017. State Street is also the world's third-largest player in the ETF industry.

Harris Corp. is another long-time dividend-payer that has performed well year-to-date. Harris traces its roots back to 1890 when brothers Alfred and Charles Harris invented an automatic printing press feeder to speed up the traditionally manual process of paper feeding. By 1895 the two had incorporated and set up shop in Niles, Ohio. By the 1940s, Harris had become a leader in the printing press business by focusing on technological advancements. During WWII, Harris got the first opportunity to become the military supplier it is today by helping to develop an innovative sighting system that improved bombing accuracy. In 1949 Harris made one of its most important acquisitions, buying Farnsworth Radio and TV Corporation. Entering the radio industry would change the company forever. Today Harris is a leader in providing communications systems to the military personnel and first responders of the United States and many other countries. Harris also creates systems for electronic warfare, avionics, satellites, undersea systems, and much more. Harris has paid a dividend since 1941 and increased its dividend for 15 consecutive years.

Patience with Walgreens and General Mills

While I would like to think all of our stock selections demonstrate short-term positive performance, this is simply not how things always work.

Walgreens has had share price struggles, but it is one of two dominant pharmacies in the U.S. The retail pharmacy stocks have struggled from a perceived threat from Amazon, but we think Walgreens and CVS are more entrenched than others assume. We are also not paying much to own Walgreens. The stock trades at 11X 2018 estimated earnings. The shares offer a dividend yield of 2.46%, have increased dividends for 42 consecutive years, and we expect another 7% increase in the dividend this year. Over the last twelve months, Walgreens has returned over $12 billion to shareholders in the form of dividends, buybacks, and debt paydown. That is equivalent to almost 20% of the company’s current market value. That $12 billion is not a sustainable number, as Walgreens drew down cash to execute a portion of the capital return program, but it does send a signal of management’s confidence in the business. Notwithstanding the 20% capital return, investors have managed to find a reason to send Walgreens shares down both year-to-date and during the last year.

Unfortunately, Walgreens performance isn’t an isolated incident, but part of a larger trend among consumer staples stocks. Staples stocks are suffering from what one might call the market's Wimpy Syndrome. Everybody remembers Wimpy from the Popeye cartoons. Wimpy was obsessed with hamburgers. He would regularly try to con others into buying him hamburgers today in return for payment in the future. His most famous line was "I'll gladly pay you Tuesday for a hamburger today."

In today's environment, many investors seem to be falling for the Wimpy con. They are gladly offering the Wimpys of the corporate world (think Netflix, Tesla, etc.) capital today in hopes of getting paid back in the future.

The companies that pay investors today in the form of dividends and big streams of free cash flow are being shunned by investors.

Take General Mills, for example. General Mills has its share of challenges, but over the last 12 months the company generated almost $2.3 billion in free cash-flow. The market value of the company is $26.6 billion for a free-cash-flow yield of more than 8.5%. The dividend yield is 4.4% at today's price. General Mills has been around since 1866 and owns some of the world's most valuable brands. Contrast that to Tesla. Tesla pays no dividend and burned over $3.4 billion in cash last year. Tesla operates in a fiercely competitive industry with established competitors. Tesla has a market capitalization of $47 billion, or about 1.8X greater than General Mills'.

As the Walgreens and General Mills examples show, sentiment toward the staples sector is poor, and the proliferation of factor-based investing and exchange-traded funds hasn't helped the issue.

We can't forecast how long staples stocks will remain out of favor, but as Ben Graham famously said, "In the short run the market is like a voting machine, but in the long run it is more like a weighing machine." Over the long run, count on a recovery.

Is the Yield Curve Forecasting Recession?

Some economists, including members of the Federal Reserve, are sounding alarm bells over the flattening yield curve. Typically measured as the difference between the 10-year Treasury yield and the 3-month T-bill rate, the yield curve has historically been a good predictor of recession. When the yield curve inverts, that's when long-term rates drop below short-term rates, recession often follows within the next 6–12 months. Today, the gap between long-term and short-term interest rates has narrowed significantly, and some pundits are worried the curve may invert if the Federal Reserve continues increasing short-term interest rates.

We would view an inverted yield curve as a concern, but the current cycle has some artificial elements that may weaken the signal's significance. What's artificial about the flattening yield curve? The Federal Reserve is putting upward pressure on short-term interest rates by raising the Federal Funds rate and allowing maturing treasuries to roll off its balance sheet. The U.S. Treasury is contributing to the upward pressure by issuing more short-term debt. Meanwhile, the Fed continues to own a significant portion of long-

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term Treasury bonds. The Fed is effectively engaged in yield curve management, where they are putting upward pressure on short-term interest rates and maintaining downward pressure on long-term rates.

So while an inverted yield curve should still be respected, central bank distortions of the yield curve make the signal of an inversion less reliable.

Have a good month. As always, please call us at (888) 456-5444 if your financial situation has changed or if you have questions about your investment portfolio.

Warm regards,

Matthew A. Young
President and Chief Executive Officer

P.S. Mark Mobius, the 81-year-old investment guru, believes the U.S. stock market is set for a 30% correction that would essentially wipe out the gains of the last two years according to MarketWatch, as reported on April 21, 2018.
"The market looks to me to be waiting for a trigger that will cause it to tumble. You can't predict what that event might be—perhaps a natural disaster or war with North Korea."

MarketWatch continues: "Mobius, who predicted the start of the bull market in 2009, has concerns that any fall would be amplified by the increasing use of exchange-traded funds, which account for nearly one-half of all trading in U.S. stocks. His fear is ETFs would trigger further drops once markets fall."

P.P.S. Our favored PNC Financial Services one-ups State Street on dividend history, having paid since 1865. PNC is one of the largest banks in America, based on deposits and branches, and one of the country's leading providers of credit to middle-market companies. PNC has a 19-state retail banking business, with asset management and corporate and institutional banking operations that serve all 50 states. PNC also has strategic offices in Canada, China, Germany, and the United Kingdom. But small businesses are only part of the PNC story. The bank's customers also include more than two-thirds of the Fortune 500. PNC also owns a minority stake in BlackRock, the world's largest publicly traded asset management firm.

P.P.P.S. IBM reported quarterly results recently that weren't to Wall Street's liking. The company beat earnings estimates, but Wall Street didn't care. As is often the case in the tech sector, Wall Street is more focused on financial metrics that don't translate into shareholder value.

Revenue growth is where the brokerage community tends to focus, but it is free cash-flow, dividends, and share buybacks that create actual shareholder value. Over the last 12 months, IBM generated $14 billion in free cash flow, paid dividends of $5.6 billion, and repurchased $3.6 billion in stock. Today, IBM is trading at less than 10X last year's free cash flow and offering a shareholder yield (dividends plus buybacks) of 6.7%. The dividend is well covered and has been increased annually for 21 consecutive years and, we estimate, by another 5% this year.

IBM has some work to do to transition from a company with legacy businesses into a firm with greater shares in faster-growing segments of tech, but the company is well on its way. The transition won't be smooth as evidenced by Wall Street's reaction to the latest quarterly results, but IBM is a firm with a long and storied history of making successful transitions as markets evolve. Don't forget this company was founded in 1911 to make tabulating machines—decades before mainframes were invented.

We own IBM in many portfolios in modest size. We see potential for resurgence in the shares should the company successfully transition to faster growth with a valuation and yield that are not demanding in the event the company stumbles.