What Should You Do During a Stock Market Correction?

October 2018 Client Letter

When stock market volatility escalates, clients may ask what needs to be done with their portfolio. I explain that often minimal, if any, trading is required. Certainly, heading to the exits is not a strategy we favor. We did not overreact to the 2008 financial crisis, nor will we today. A kneejerk reaction to movements in the market is most often the play of the amateur investor or the investor with no thoughtful guidance. Few things can be more stressful than fretting over your hard-earned savings amid a market correction.

Preferably, investment portfolios are crafted to reflect personal financial situations and tolerance for risk. Investing is both about making money and limiting your downside. Younger, working folk can naturally assume more risk. But as you get older, you need to look in the mirror and determine a strategy that is most appropriate.

The Right Strategy for Many Investors Who Are in or Nearing Retirement

For many, that strategy is a high-quality, balanced portfolio with the ability to endure a lifetime. High-quality means investing in businesses that can be expected to persevere through various business and economic cycles. Balanced refers to the inclusion of both stocks and bonds in the portfolio.

Yes, bonds appear boring, and yields have been low, but their counterbalancing characteristics can be critical. We all caught a bit of a break during the 2008 financial crisis. As ugly as it was, stocks rebounded quickly. I caution any investor assuming quick rebounds from a crash are the norm. Remember the dotcom crash? Particularly concerning about the era was how long it took for some stocks to recover. It took 13 years for the S&P 500 to fully put the damage of the dotcom bust behind it, and the Nasdaq didn't reach a new high for 15 years.

Imagine if a similar correction and lengthy recovery period occurred today. How comfortable would you be waiting 15 years to get back to even while getting ready to retire, or while in retirement and drawing money each year to live? A bond component is one way to potentially mitigate significant losses during more unpleasant environments. When stocks go down, bonds will most likely hold their value, making them look a lot less boring.

You can also take comfort knowing that while the market may be down, you are still making money from your stocks by way of a healthy dividend yield. As you are probably aware, stocks pay a dividend based on the number of shares owned, not based on the share price.

Dividends are not like the interest earned on a bond or in a savings account. The interest from these is fixed; in other words, if you receive 3.5% on your bond this year, you will receive the same interest next year. Dividends from stocks, however, are not fixed. And while dividends can be cut, we focus on those with a history of being increased annually, ideally in all types of economic environments.

Stock markets are volatile, and volatility is typically one of the first things investors consider before investing. But perhaps equally or more damaging to investors is the threat of inflation. Annual dividend increases help offset the nasty effects of inflation.

Higher Dividend-Yields Not Always

Better

The mistake many novice investors make when choosing dividend stocks is to focus on the highest-yielding companies. Yield is, of course, an important factor in dividend investing, but a high yield may indicate the dividend is not sustainable at current levels.

The last nine decades of stock market history show that, when you sort stocks into five groups based on yield, higher-yielding stocks outperform lower-yielding stocks. However, when you sort stocks into 10 groups based on yield to ferret out the highest yielders, you find that bucket ten, the highest-yielding 10% of stocks lags the performance of buckets eight and nine, the next two highest yielders.

Dividend Growth a Necessary Ingredient

Dividend growth is an important factor when selecting dividend stocks. At Richard C. Young & Co., Ltd. we craft global dividend portfolios focused on companies offering above-average dividend yields which also have records of making regular, annual dividend increases.

With Dividend Stocks, Stock Market

Volatility is Less Worrisome

When you invest in companies that pay dividends and increase those dividends consistently, share price fluctuations become less worrisome and capital appreciation tends to take care of itself.

Consider the hypothetical example of a company offering a 3% yield today that is able to increase its dividend at 7% annually over the next decade. Assume an initial dividend of $3 today would imply a purchase price of $100. After 10 years of 7% growth, the dividend will have increased to $5.90 per share. What would investors be willing to pay for $5.90 of dividends from our hypothetical firm? All else equal, probably something close to $196 per share, which equates to a 3% yield on the $5.90 dividend.

Now, of course, everything else is not always equal. Ten years from now, the economic environment could change, or the company could run into trouble. But when you put together a portfolio of firms offering solid dividend yields and solid dividend-growth prospects, you stack the odds of success in your favor.

That's the strategy we pursue for you at Richard C. Young & Co., Ltd. The dividend yields of the firms we purchase vary, and the growth rates are merely projections, but the concept is the same: Buy dividend-payers that make regular dividend increases, remain patient, and allow capital appreciation to take care of itself.

Solid Dividend-Payers

Johnson & Johnson:

For 130 years, Johnson & Johnson has been innovating solutions to health care problems. Robert Wood Johnson began tackling medical problems as a pharmacist's apprentice during the Civil War. With breakthroughs from Louis Pasteur, Joseph Lister, and Robert Koch in medicine coming shortly thereafter, Johnson was in the midst of a revolutionary time. In 1873, Johnson and his partner, George Seabury, founded a medicated plasters company, which grew quickly. After achieving success with Seabury, in 1886 Johnson began a new business with his two brothers, Johnson & Johnson. From there the company went on to achieve success in innovation and production of medical supplies, equipment, technology, and pharmaceuticals that would power an unbroken 74-year streak of dividend payments, which includes the 15th-longest record of consecutive annual dividend increases: 53 years counting. JNJ yields 2.55% today with strong, dependable cash-flow streams.

ExxonMobil:

Colonel Edwin Drake and Uncle Billy Smith sound like two characters from an episode of Green Acres; but those are the real men who drilled the first successful oil well in Titusville, Pennsylvania, in 1859. The result was an “oil rush,” leading to the 1870 creation of the oil market giant Standard Oil by John D. Rockefeller. In 1911, the U.S. Supreme Court broke Standard Oil into 34 pieces, including Jersey Standard, which would become Exxon in 1972, and Vacuum Oil, which became Mobil Oil in 1966. In 1999, Exxon and Mobil merged, forming Exxon Mobil Corp., reuniting two of the original pieces of Standard

Oil. In its lineage formats, ExxonMobil has been paying a dividend each year since 1882, with an unbroken record of annual dividend increases dating back 35 years. Shares of XOM yield over 4% today.

Lowe’s:

This home improvement giant is a Mergent Top 10 dividend-increasing powerhouse, with the ninth-longest record of consecutive, annual dividend increases, stretching for 56 years straight. After being founded in 1946 as a small hardware store in North Carolina, the retailer has paid a dividend since it first went public in 1961. Lowe’s growth can be credited to Carl Buchan, brother-in-law and partner of Lowe's founder, James Lowe. Early on, Buchan bought out Lowe and implemented his vision of a hardware store chain capable of feeding America's post–World War II building boom. The company has grown from offering tiny neighborhood hardware stores to 103,000-square-foot stores in larger markets. Over the last 10 years, Lowe's has increased its dividend at an average annual rate of 19.31%.

Cracker Barrel Old Country Store:

In 1969, Dan Evins opened the first Cracker Barrel Old Country Store in Lebanon, Tennessee. With cornbread made from scratch, the company worked hard to create an atmosphere of warm hospitality and homestyle cooking. Despite Cracker Barrel's focus on the little things, Evins began expanding in 1977, with 13 stores across the South. It turned out people across the country liked the way Cracker Barrel is run, and the restaurant chain now has 656 locations across 45 states. Cracker Barrel has paid dividends since 1972 and has increased dividends over the last 10 years at an average rate of 22.86%. Shares of CBRL yield over 3% today.

Visa:

In 1958, Bank of America created a credit card for the masses. It had a $300 limit and was made of paper. In 1973, what had become National

BankAmericard launched the first electronic authorization system, along with an electronic clearing and settlement system. This would be the basis for a payment revolution. By 1976, Visa was born, and by 2001 had one billion cards held by consumers. In 2008, Visa began trading on the New York Stock Exchange. Today the company has 3.3 billion cards in use and processes over 173 billion transactions in a year through VisaNet. Visa has paid a dividend every year since it went public. That dividend has compounded at a rate of over 20% over the last five years.

The Bond

Environment

Markets are volatile. We all know this. What tends to be more troubling these days are the wild fluctuations. We went from no volatility in 2017 to some whipsawing in the first quarter of 2018 to a relatively good summer and early fall to a turbulent October.

The main market-related headlines we read today include the trade war with China, the Fed, and the election cycle. What tends to receive some attention but hardly falls into the camp of being over-reported is the rise in longer-term rates.

The rise in longer-term rates is a significant development. In October, we woke up in the morning and had the benefit of reading the following headline in the *WSJ:* U.S. Government 10-Year Note Yields Climb to Seven-Year High. Now, granted, the use of the word “high” in the headline is a description to be viewed loosely, as the yield climbed up to 3.22%. Nonetheless, progress is being made. It’s beneficial to us all if we can see the yield on full-faith-and-credit-pledge Treasuries get back to more normalized levels.

Jamie Dimon, CEO of the world’s largest bank, thinks 10-year Treasury yields could reach 5%. A 5% 10-year yield could do wonders for retired investors and those nearing retirement. In corporate bonds, we are finding some attractive bonds with yields of over 4%. A 5% yield on at least a portion of your fixed-income portfolio may soon be within reach.

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. Brazil has a new

president. Jair Bolsonaro won Brazil's run-off election 55% to 45%. Bolsonaro is a hard shift to the right for Brazil. The Brazilian real has rallied sharply on the news. Interest rates are down and the stock market is up. It remains to be seen how much Bolsonaro can get done, but we are encouraged by the news. Brazil is the second-biggest economy in the Americas.

P.P.S. Counterbalancing. Gold is still down year to date, which is not surprising given the strong economy, a strong dollar, and rising interest rates. But did you notice what happened to your gold position in the past month? As most stocks were declining, GLD actually rose almost 3.5%.

P.P.P.S. This has been one of the longest economic expansions on record. At some point, the cycle will end. Recent price action in the stock market—including weakness in interest-sensitive sectors, transportation stocks, industrial shares, and weakness in foreign markets—sends signals of caution. On the flip side, the economic data remains strong, sentiment is hitting record highs, and wages are beginning to rise. We are watching carefully for signs of weakening in the data.

P.P.P.P.S. While P&G is down on the year, it was nice to see its share price rise 7.5% during the month of October when the S&P 500 fell 6.84%. Procter & Gamble has increased its dividend every year since 1955. Over the last decade, the dividend has compounded at 7.25%. Investors buying shares today are earning a yield of 3.25%.

P.P.P.P.P.S. Each year, *Barron's* ranks the nation's top independent advisors. Richard C. Young & Co., Ltd. was again recognized on this list, appearing for the seventh consecutive year.