SEVEN SUMMITS CAPITAL

1853 William Penn Way, Suite 9 · Lancaster, PA 17601 · 717 735 0013

# AUGUST 2016 INVESTMENT COMMENTARY

## THERE IS NOTHING MAGIC ABOUT DIVIDENDS

As children, it is likely that we all were amazed by magicians. We watched with wonder when they pulled rabbits out of otherwise empty hats, they put people in boxes and sawed them in half, and they made large items disappear in a cloud of smoke. As adults, we learned that magicians do not possess special powers, but instead are practiced illusionists. The illusions are created by distracting from or masking the makings of the trick.

As we wrap up a very good month in the equity markets, following a volatile but positive month in June, investors seem to be encouraged by the prospect for "lower for longer" interest rates and the resilience of the markets following the unexpected Brexit vote and numerous horrific terrorist attacks around the world. Like a magic trick, the good feelings that accompany the positive price action is part of the illusion that conceals very real building risks.

I have had numerous conversations of late with clients who are questioning whether or not they should have more exposure to high dividend-paying stocks. It is only natural that investors want to gravitate to where the most recent strength has been in the markets. This is especially true when the most recent strength is coming from stocks that pay the investor "free" money in the form of dividends. The stock market can be like a magician because investors' attention can get diverted away from what is real (value) to what is enticing – price action and dividends.

Price action can cut both ways; strong positive price action creates a desire among many investors to chase after the gains that they are seeing. On the other hand, weak performance is a signal for many investors to step aside and avoid short-term losses. It is no wonder why I have been asked several times over the last couple weeks about investing in high dividend stocks. High Dividend stocks, as represented by the IShares High Dividend ETF (HDV) rose approximately 3.50% during the month of July versus a price return of just under 1% for the S&P 500. What is not overly apparent is that the portfolio of companies that make up HDV has a weighted average P/E ratio of 20.19 and a long-term earnings growth rate of 6.38%. Comparatively, the ETF that represents the S&P 500 (SPY), which is largely considered fully valued, has a P/E ratio of 18.34 and a long-term earnings growth rate of 8.79%. Thus, the market attracts the attention of investors with high yields and strong near-term performance, while unsustainably high valuations continue to rise and become ever more risky beneath the surface.

Seven Summits Capital's primary equity research service, Valuentum Institutional, is the creation of Brian Nelson. Brian is a CFA and a very accomplished equity analyst. Brian worked as a director at Morningstar, where he was primarily responsible for training and methodology development within the firm's equity and credit research department. Brian is very good at keeping the clients of Valuetum Institutional abreast of his market observations. Just this month he wrote an article titled "Nelson's Warning to the Boardrooms of America.". In this article, he wrote "Today, with most of the world muddling through a negative interest rate environment, I believe we're in the early stages of a "dividend" bubble, and I am writing this note because the future consequences are unknown. I am concerned. I believe that most shareholders do not know that when they receive a dividend, they are being paid with their own money." The reason that I am so comfortable using Valuentum Institutional equity research is how closely aligned my philosophy on valuation is with Brian's.

Brian did a good job in this article breaking down how to look at a company from the standpoint of a shareholder and how to think about dividends.

I have always seen dividends as a return of free cash flow to investors by companies that having nothing better to do with excess capital. If a company has limited reinvestment opportunities, one has to either be very skeptical of management's competence and/or the health of the industry that the company operates within. In the article above Brian Nelson stated, "Here is the deal: shouldn't the focus of investing be on the company, not on the company's arbitrary dividend policy? Shouldn't management teams do a better job of explaining what a cash dividend is and what it is not? The value of a company is based on its net cash position on the books and the present value of its future enterprise free cash flows. I don't want to see investors hurt, and I think management teams would perform a great service by working with their owners in explaining the concept of a dividend--that the value of the company is reduced once the dividend is paid, that they own the company, including the balance sheet, or the source of the dividend payment." Brian is spot on in his comments about the responsibility of management teams to explain what a dividend is and what it is not. Many investors love dividends. They love them so much that they buy shares at virtually any valuation to obtain a discretionary stream of cash payouts which lower the value of the underlying company.

In the August 1, 2016, edition of Barrons magazine, Lawrence Strauss wrote an article titled "Utility Stocks Could Shock Dividend Investors". Mr. Strauss quoted Royce Bergman of UBS Wealth Management, who stated "yield, yield, yield – that is what they want right now. What is concerning is that they want yield, but they don't necessarily understand what it's coming from." It has been obvious to me for almost two years that there is a growing risk that low-interest rates are contributing to a potential bubble in high dividend yielding stocks. I am confident that my skepticism and prudence when it comes these types of stocks will limit portfolio risk if these yield-induced frothy valuations begin to regress toward more fundamentally supported valuations.

At Seven Summits Capital, we will not be drawn into the behavior that this current environment of ultra-low interest rates is motivating. Whenever investment decisions related to equities are motivated by metrics which are not fundamental to the value generated by the underlying company, these decisions raise the risk of malinvestment. If this malinvestment becomes systemic or pervasive within the market, this is how imbalances and even bubbles are created.


**CURT R. STAUFFER**

(C) 717 877 7422

(O) 717 735 0013

cstauffer@ssummitscapital.com



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