FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

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Who Needs Dividends?

The value of any financial security is equal to the present value of its future cash flows, discounted by an interest rate that reflects its risk. Theoretically, (other than asset sales in a liquidation) the future cash flow of a stock equals the company's free cash flow (from which dividends are paid), but management (especially if they don't own many shares themselves) often squanders this money on expenses that harm shareholders, such as executive perks, a fancy new headquarters, share buybacks (to goose the stock price just before insiders exercise their stock options) or an expensive acquisition (empire building).

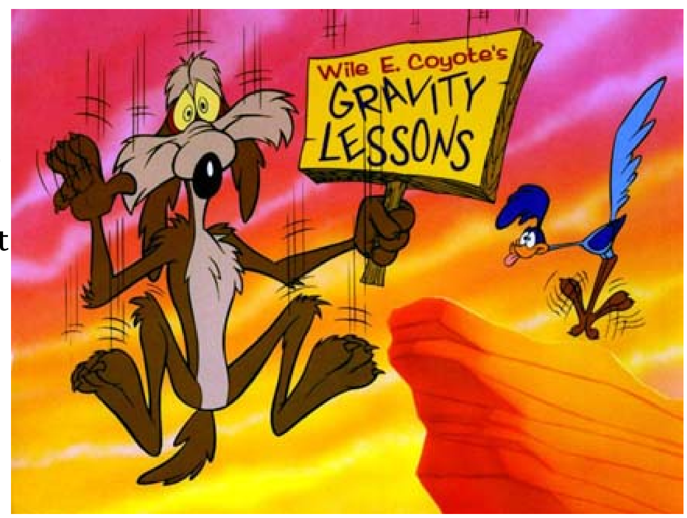
The people who work on Wall Street often talk about companies' earned income (AKA earnings) because they want to distract you from what you should be paying attention to, which is free cash flow and especially dividends. Earnings is an accounting measure that does not involve actual cash flows, and is therefore easily manipulated. Earnings is for accountants, free cash flow is for investors. So the intrinsic value of a stock has nothing to do with its earnings, although its earnings do cause the price of its stock to move since so many investors think they matter.

Investors go wrong when they focus on narratives and "earnings" instead of actual cash profits and dividends paid. As an investor, I don't want to hear BS stories about the future or see heavily footnoted earnings statements, I want to see cash on the barrel. *Show me* *the money*. Only then will I believe.

For many years, I've maintained a massive spreadsheet that I use to track over 1,500 companies (domestic and international) that either pay dividends or did so until recently. Many companies reduced or eliminated their dividend during the COVID-19 ~~pandemic~~ panic. Many companies needed to do that to survive, but some just used it as an excuse to get off the treadmill of serving their shareholders/owners. Although real estate investment trusts (REITs) usually pay above average dividends, they are quick to cut them if they start to experience any financial distress.

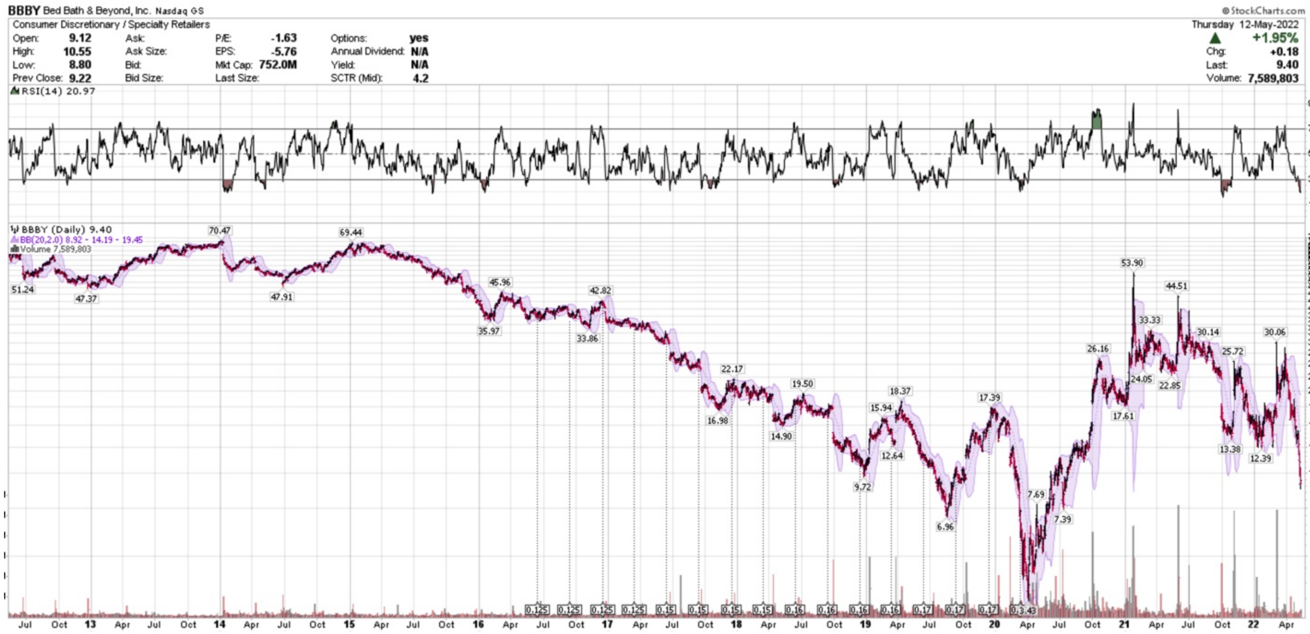
In the last couple of weeks, I've been going through my list of companies that cut their dividends in recent years. Many of them subsequently went bankrupt. Some of them were acquired by (or merged with) another company. A number of them started paying what I call a "Why bother?" dividend of $.01 per share, after they had previously been paying say $.25 per share. I guess they want to be able to say that they pay a dividend, but don't want to actually pay one. A handful of them changed their name, but a new name can't change a bad business model and poor financial statements, and often those companies subsequently went bankrupt.

A surprising number of them experienced significant gains in their share price when interest rates were artificially low thanks to the Fed's massive currency printing. Investors probably figured that they didn't need dividends when their capital gains were so large. (It reminds me of the Chinese apartment investors I wrote about who never bothered to rent out their apartments because any rental income would have been trivial compared to their expected capital gain.) In the last couple of months, however, these stocks have been looking like Wile E. Coyote after he chases Road Runner off a cliff. Suddenly—after the recent spike in interest rates--borrowing money to speculate in a margin account is no longer essentially free, and money market funds and newly issued bonds have actually started to pay interest (though not enough to keep up with inflation and taxes).



Perhaps the most common fate of companies that cut their dividend has been a long, painful erosion in their stock price, often curling downward into a waterfall in recent weeks. I'll show you some examples of companies you've heard of.

The first chart (below) is Bed Bath & Beyond. After increasing their dividend every year from 2016 through 2019, they eliminated it in 2020, and then the stock price exploded over 11 times higher in less than a year. Who needs dividends when the Fed is printing dollars like crazy? Ah, but that causes price distortions, malinvestment, too much leverage, higher interest payments, broke consumers and a ruined economy. BBBY shareholders are now taking a bath.

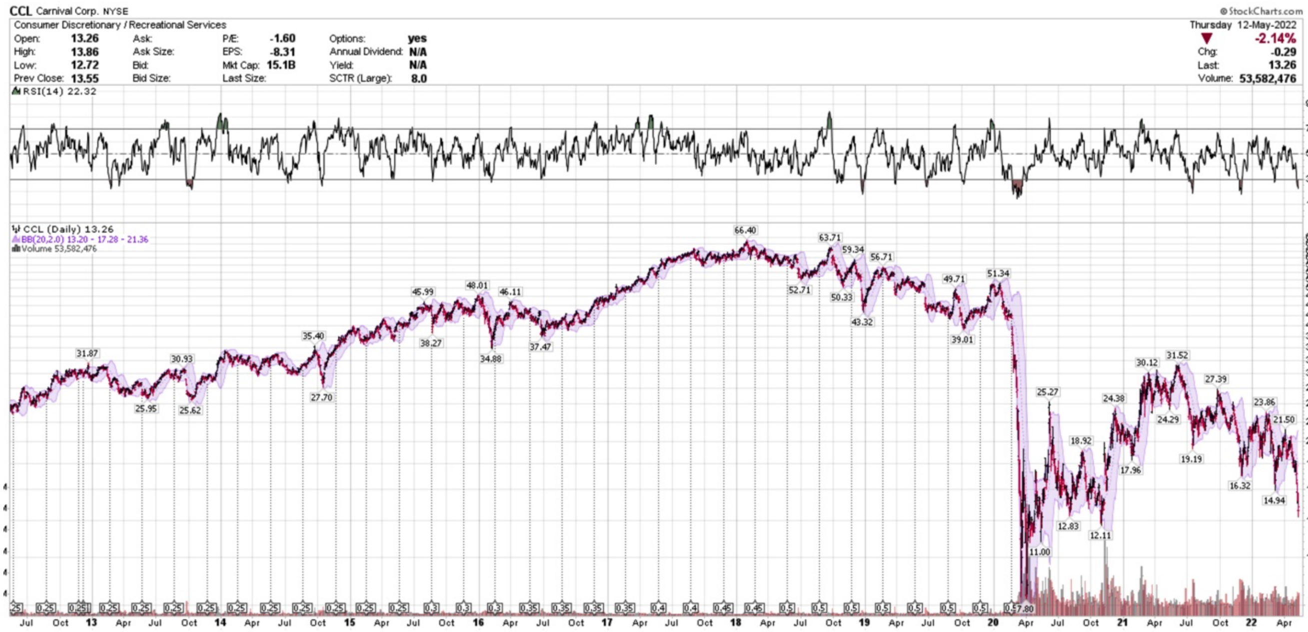


Bed, Bath & Beyond

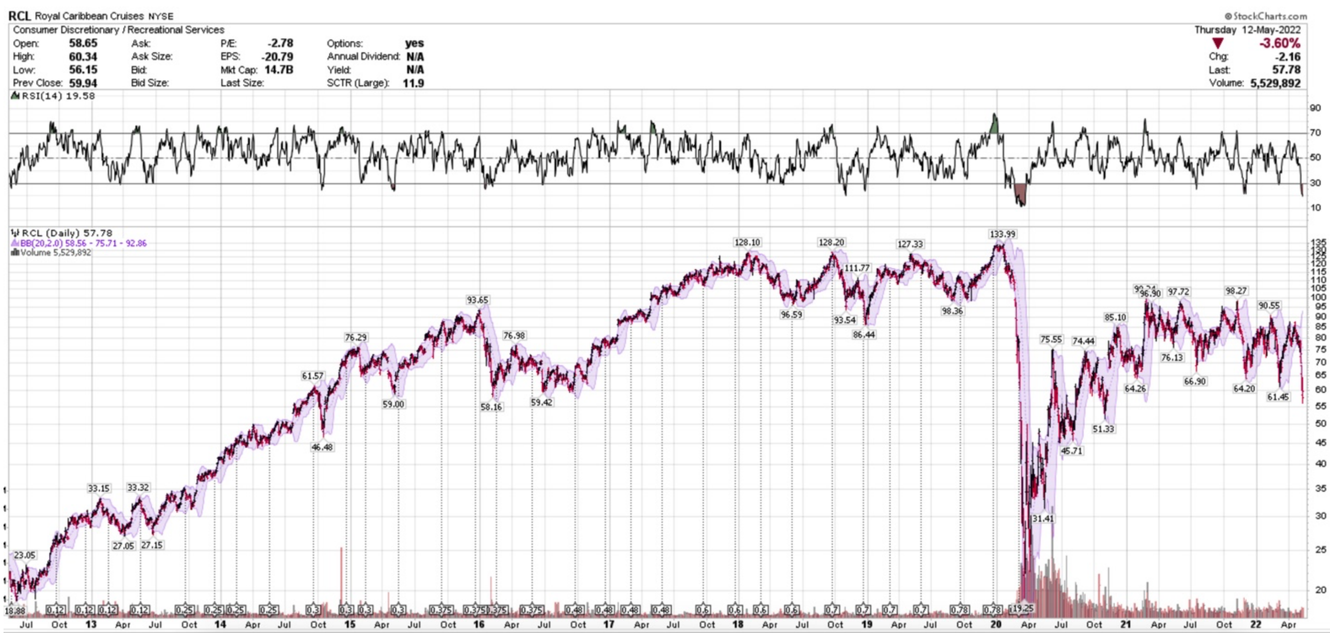
Next up is Boeing. A few years ago, its CEO signed the Business Roundtable statement that sought to redefine the purpose of a corporation away from the traditional "to maximize shareholder value" towards providing benefits to a handful of different "stakeholders," of which shareholders were listed last. After its stock crashed early in the pandemic, Boeing eliminated its dividend, only to see its stock price soar. For a while there, a lot of people were talking about the huge gains they were getting from Boeing stock. Who needs dividends when you're making bank? Do profits matter? We're about to find out!

Boeing

Now that COVID-19 is pretty much over, you would think that cruise lines such as Carnival and Royal Caribbean would be doing very well, catering to two years of pent-up demand from vacationers sick of lockdowns. Unfortunately for their shareholders, neither has reinstated its dividend, and now their stock is sinking faster than the Lusitania.

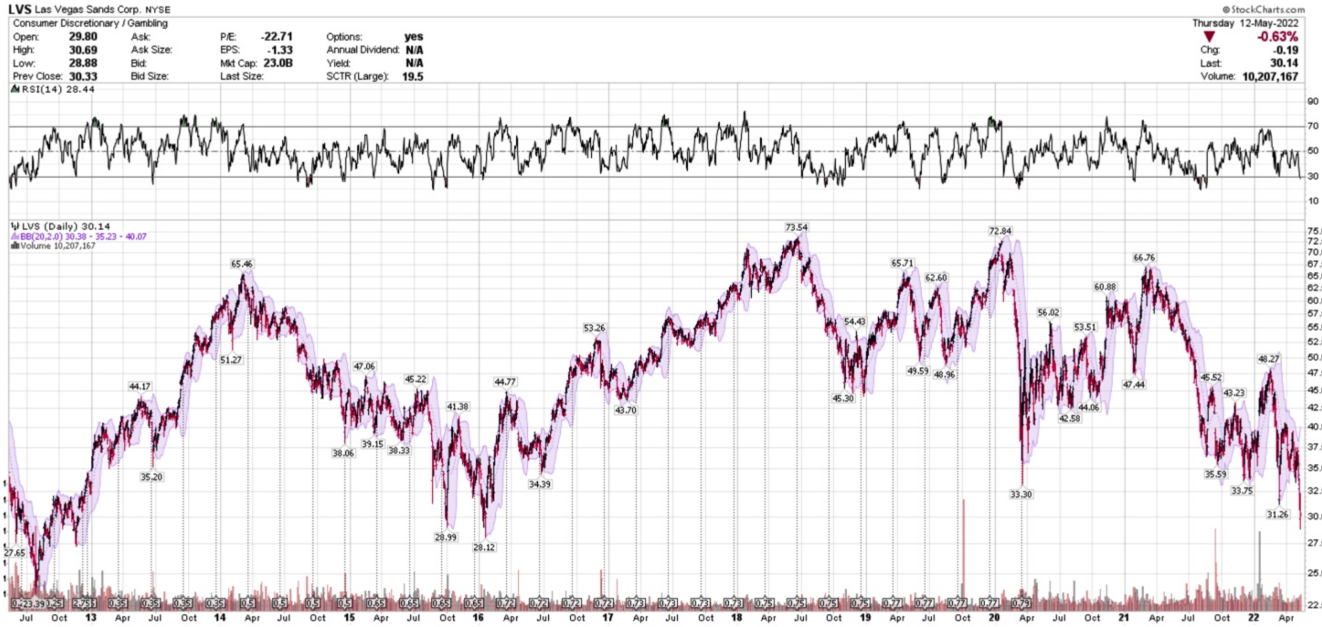


Carnival

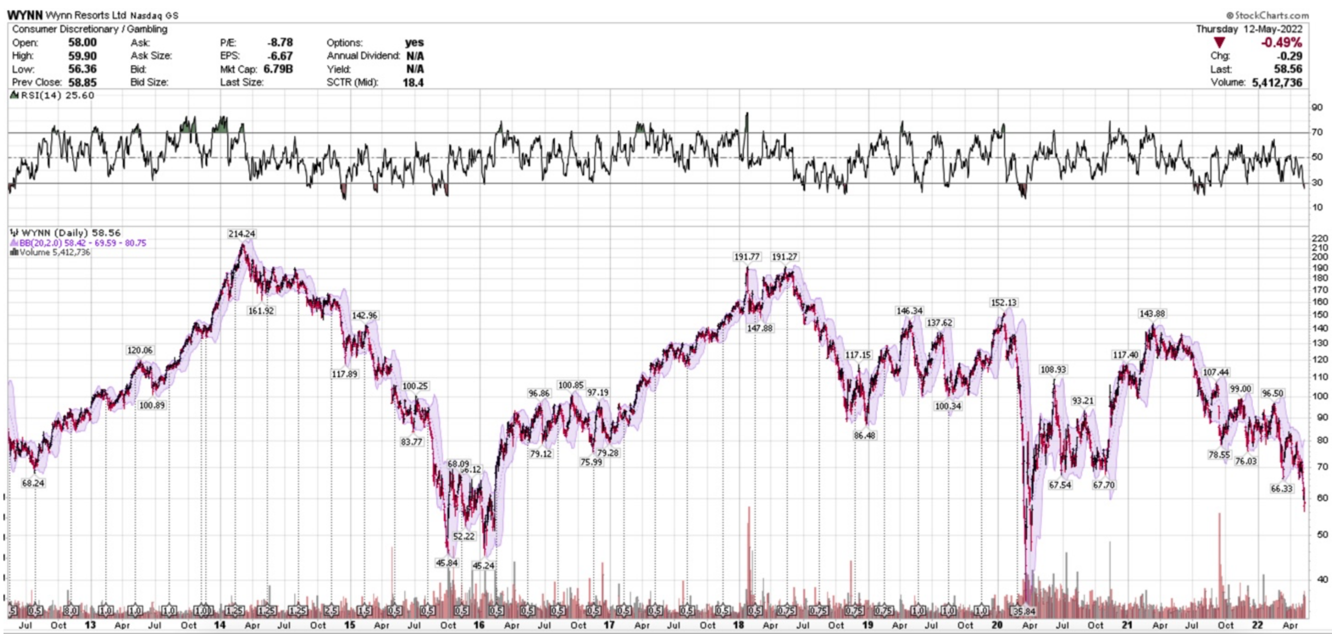


Royal Caribbean Cruises

Casino companies such as Las Vegas Sands and Wynn Resorts made a wager that their shareholders would stick around without being paid a dividend after their stock doubled or tripled from their pandemic lows. I wouldn't bet on that!

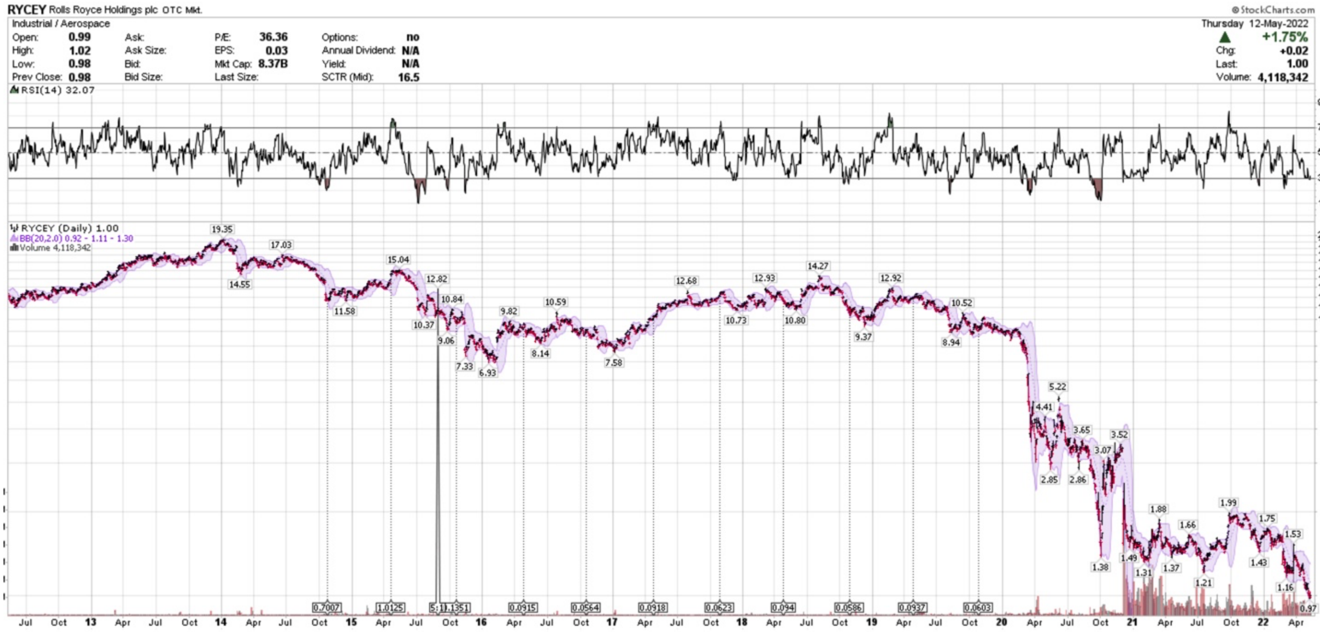


Las Vegas Sands



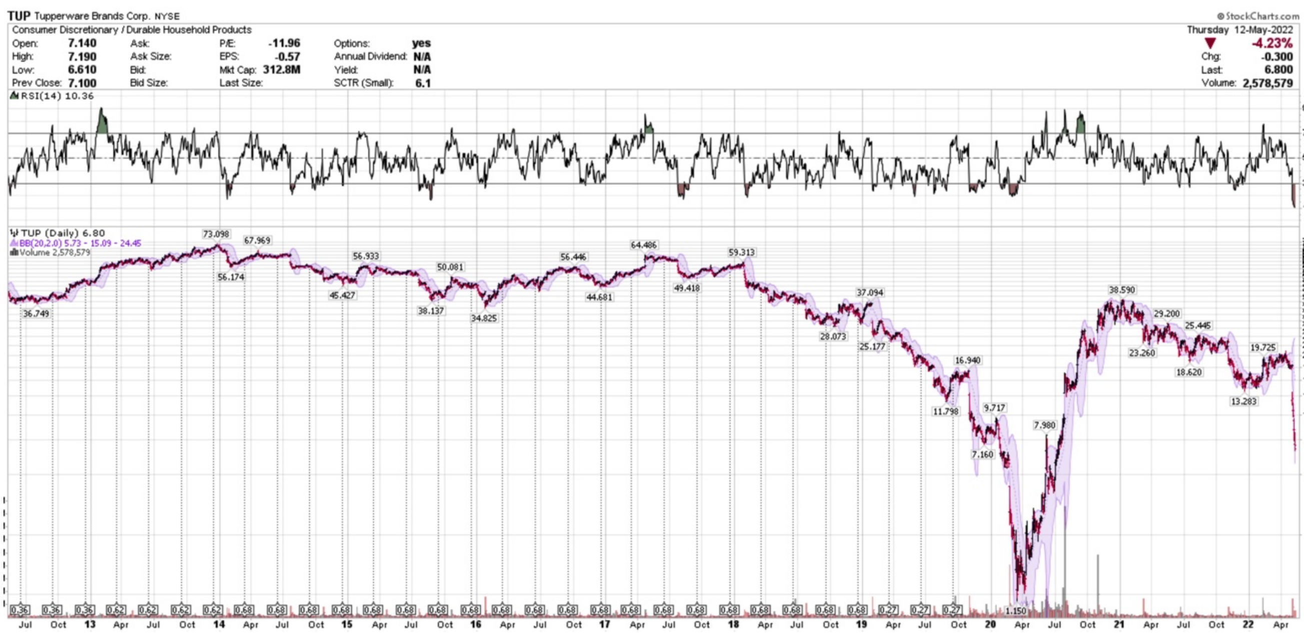
Wynn Resorts

After making jet engines and paying dividends for years before eliminating them in 2020, Rolls Royce has crashed to the ground. The former luxury car maker is now a penny stock. With an Altman Z-score of just 0.24 (which indicates extreme financial distress), it will almost certainly go bankrupt soon.



Rolls Royce

Seems like the shareholders at our next company just opened a Tupperware container and found no dividends inside, just some rancid fundamentals, and now they're puking up the stock.



Tupperware

During 2020, Disney gave $5 million to social justice groups, but not a dime to its shareholders, the capital of which kept the company alive during the pandemic. The stock price subsequently more than doubled anyway. Now shareholders are realizing there's nothing magic about owning a stock that pays no dividends.

Disney

These are just some of the companies that have survived (so far) after eliminating their dividend. I can't show you any of those that didn't because StockCharts doesn't maintain a chart for them.

Henry David Thoreau wrote, “Some circumstantial evidence is strong, such as when you find a trout in the milk.” Dividends are strong circumstantial evidence that (1) a company is generating positive free cash flow and is probably not a massive fraud (like Enron), (2) management is confident enough about the future financial health of the company that they are willing to part with the money, and (3) management has shareholders' best interests at heart (at least to some degree). Management usually does a pretty good job of generating profits, but unless some of those profits are taken away from management in the form of dividends, they will often squander them on things that benefit management but destroy shareholder value.

Stocks can be categorized into four different groups:

1. Stocks that pay a dividend and increase it every year.
2. Stocks that pay a dividend but don't increase it.
3. Stocks that don't pay a dividend.
4. Stocks that reduce or eliminate their dividend.

Over the long term, the first group performs the best, followed by the second, then the third, then the fourth. If I own a stock and the company reduces or eliminates its dividend, I try to sell it immediately, as usually nothing good is going to happen after that.

What You Should Be Doing Now

Last week I said that if silver dropped by another 5% or so, it would be a buy. It did (to the lowest price since July 2020, so before the last presidential election, before we knew the country's trajectory for the next four years), and I've been buying. Yes, the dollar price was lower back then, but there were also fewer dollars on the market then. The silver Hedgers Position is bullish, and silver's Optimism Index (37 out of 100) hasn't been this low since April 2020. Silver's Relative Strength Index of 21.3 (anything lower than 30 is generally a buy signal) hasn't been this low since silver crashed along with everything else in early 2020, and the price of silver is at the bottom of its Bollinger band (which is bullish).

I have also been accumulating shares in select very profitable and financially strong British dividend-paying stocks at attractive prices.

Quote of the Week

My teenage son was telling me about "fintalk," which is where other teenagers dispense financial advice on TikTok, invariably about cryptocurrencies and always bullish. He said, "We're now way past the shoeshine boy giving stock tips." I thought about how fortunate he is to know about that contrary indicator.

This week my HVAC guy asked me what I thought about the market. He said he hadn't opened his monthly brokerage statements in a few months. I told him that when you feel the urge to brag to others about your returns or what you own, it's probably a good time to sell. And when you're so depressed and despondent that you don't even want to open your brokerage statements, it's probably a good time to buy. If the thought of buying something makes you sick to your stomach, then you should definitely consider buying.

Generally, you get compensated (eventually) for taking the hard, lonely trade, for catching the falling knife, for providing liquidity when everyone else wants to sell. You don't get compensated for buying a stock that appreciated a great deal in the last year, or that you can brag about owning at a cocktail party.

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I would love to hear from you! I thrive on feedback from readers. If you have any comments, suggestions, insight/wisdom, or you'd like to share a link to a great article, please email me.

Generally, I don't have time to answer questions about your specific situation, but if you have a general question that I think other readers also have, let me know and I will provide an answer in a future issue.

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