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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Dividend Deadbeats

On the spreadsheet I use to track about 2,100 dividend-paying stocks from around the world, I keep the stocks in different groups, generally based on their current characteristics. If a stock can pass all of my other screens (e.g., a 10-year average return on invested capital of at least 8%, insider ownership exceeds short sales, low odds of earnings manipulation, not woke, etc.), then I categorize it based on its dividend yield and how management has been changing its dividend (if at all) in recent years.

Stocks that increase their dividend every year perform the best. This makes sense since the value of an asset is equal to its future cash flows discounted to the present at an interest rate that's appropriate for its risk. Increasing dividends are pretty good proof that a company is generating free cash flow and that management is looking out for shareholders.

Stocks that keep their dividend flat perform second best, followed by stocks that don't pay a dividend (which is actually where most of the Dumb Money invests). Stocks that reduce or eliminate their dividend perform the worst, since it's a sign that either the company is having trouble generating free cash flow, or management is no longer concerned about shareholders.

Given the significant real inflation we have every year, even if a company keeps its dividend flat, it's still a cut, so these stocks are not the stream I want to go a-fishing in. Any experienced fisherman will tell you that it's all about choosing the best pond in which to fish.

Having said that, every asset is an attractive investment at the right price. Flat dividend stocks remind me of the discarded cigar butts that Benjamin Graham (the father of value investing) wrote about. You can probably get a few more puffs out of them, but that's it. These butts are especially attractive if they have a high (and safe) yield and the company is financially strong, profitable and value-priced. I'm willing to use any method to get a good return wherever one can be found.

On my spreadsheet, I place stocks that have kept their dividend flat for less than four years into three categories based on their current yield: high, medium or low. I'm primarily interested (somewhat) in the first category.

Stocks that have kept their dividend flat for between four and say 15 years go into the Dividend Deadbeats category. I'll check on their dividend occasionally when I have some free time just to see if anything has changed. Rarely is there a change. I think either management falls for the money illusion, they think shareholders have fallen for it, or management suffers from inertia and lack of forward thinking.

If a company has kept its dividend flat for 15 years or more, it goes into the Dividend Coma category. My reigning champion is Ingles Markets (31 years) followed closely by Insteel Industries (30 years).

I've noticed that in recent years, many companies have reduced or eliminated their dividend or kept it flat. COVID provided the initial cover, as it was reasonable to do so when sales and revenues were collapsing. But that got management off the treadmill of having to provide value to shareholders; both quickly became accustomed to that. The era of ultralow interest rates (thanks to the Fed) made low-yield stocks much more palatable to investors, who basically had to accept them because “cash was trash.”

Finally, the increasing popularity of index funds (thanks to their generally low expense ratio, which is still higher than the cost of holding individual stocks) and ETFs among investors and 401(k) providers and participants gave corporate management a place to hide bad behavior (including reducing dividends), unless they were among the handful of companies that currently comprise the S&P 500 index. That's because if there are 500 or thousands of stocks in your portfolio, you're not going to have the time or energy to keep tabs on what each of them are doing. And even if you knew, you still wouldn't do anything about it since it represented a tiny percentage of your portfolio. And even if you wanted to, you *couldn't* do anything about it because the stock was bundled inside an index fund or ETF.

This is the same problem of packaging bad mortgages into a security: Individually, it's not much of a problem, but collectively, you have a security that looks good on the outside (e.g., it's stamped AAA by a rating agency, it's diversified, it has a low expense ratio, it's managed by Vanguard, etc.) but is rotten on the inside.

In conclusion, all three of these phenomena (COVID, Fed-determined interest rates and passive investing) are (or were) based on lies. And for some reason, the market hates lies, and reacts violently when it discovers the truth, especially if the returns that were supposed to be earned by placing capital at risk have suddenly been revealed as a mirage.

So don't tell me stories (tune into CNBC for that), show me cash on the barrel.

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