



Don't Make This Mistake! Advice From a Top Dividend Investing Expert

Description

Here at Motley Fool Canada, it's no secret that we're big fans of dividends. That brings us to today's interview with Daniel Peris, author of *The Dividend Imperative: How Dividends Can Narrow the Gap Between Main Street and Wall Street* and *The Strategic Dividend Investor: Why Slow and Steady Wins the Race*.

In both books, Mr. Peris, a portfolio manager with Federated Investors, makes a strong argument against the casino mentality that has taken over the stock market in favour of buy-and-hold dividend investing.

Below is a transcript of our conversation. It has been lightly edited for clarity.

Robert Baillieul: In both books you talk at length about investing like a "business owner". It seems that this concept is almost completely absent from most investing discussions. What do you mean by that?

Daniel Peris: I have to agree with your notion. It's an idea that is completely absent in the equity markets, at least in the United States.

It's regrettable that investors who build up some sort of wealth from businesses that they run, or are employed by, then turn around and invest that wealth or capital in the stock market in a way that they never would in their private affairs. The standards of analysis that one encounters in private business are strikingly absent in the stock market. It's often as if there are two parallel worlds.

It's not healthy on the side of the stock market. The daily decisions that people make in businesses are rooted cash flow analysis, present value calculations, and a real world conception of risk and return. But suddenly you put the money into the stock market and the standards that are seemingly acceptable don't involve cash flow analysis in the owners of the company. They don't involve risk.

Over the past two or three decades analysts have valued companies on eyeballs and clicks during the first stage of the internet, or various other forms for risky ventures that are available now and again through the stock market. They involve these parallel standards, which at various times have ranged from bad to ridiculous.

Most people who have been successful in business, if they just step back from the process, should be following the same standards as the private sector. Why do those same business standards not apply just because an investment happens to be publicly traded?

In both books and our portfolios, we bring to the table a businesslike notion of what's acceptable and what's not acceptable. There are a lot of stocks available for purchase every day between 9:30 a.m. and 4:30 p.m. The number of businesses that are available as an attractive option are fewer, and we tend to focus on those.

RB: In your first book, *The Strategic Dividend Investor*, your message seemed to be directed primarily to investors. However, in the *Dividend Imperative*, I feel you are also addressing CEOs, CFOs, and boards. What is your message to them?

DP: In the management of our portfolios we end up speaking to a lot of corporate executives. Positioned where we are with our client assets and with our view of the world that we want to invest in businesses, not stocks, we find that the preference in the United States for share repurchase programs over cash payments to company owners is a real impediment.

Around the office here at Federated Investors we refer to the first book as the "blue book". The second book, we refer to as the "red book".

The red book is really an articulation of that discussion with corporate managements as to why share repurchases are a bad idea and why dividends are better. We argue that the decline in the dividend payout ratio from two-thirds to one-third has not been helpful to shareholders. U.S. corporations, given their realistic growth prospects, should consider taking their payout ratios back up to that 50% mark or better.

We end up reviewing and engaging corporate managements in the capital allocation process. Over the last two or three decades, these share repurchases have emerged from basically zero to becoming the main location of excess capital. That's bad for investors. It's bad for the corporations. The red book is really an outgrowth of that argument.

RB: I think one critic of your thesis might be **Berkshire Hathaway's** (NYSE: BRK-A)(NYSE: BRK-B) Chief Executive, Warren Buffett. In his letters to shareholders, he has praised companies like **IBM** ([NYSE: IBM](#)) and **ExxonMobil** ([NYSE: XOM](#)), which have both repurchased more than 50% of their outstanding shares over the last 20 years. A lot of analysts would argue that buybacks are the superior method to return capital to shareholders. What your your response to them?

DP: The argument in favour of buybacks is great in theory. On a whiteboard, buybacks have allure. The reality, however, is that most corporations do not succeed in lowering their share count nearly as much as IBM or ExxonMobil. Few companies stick to their capital allocation discipline anywhere close to the two examples that you referenced. They are the exception to the rule.

The vast majority of cases of share buybacks have been demonstrated to be value-destructive. Companies are usually buying their shares at high prices, and in the case of financial institutions they have been issuing shares at low prices. But even those companies that don't issue shares at low prices, as we have shown in the red book, buy high.

What is it in the nature of a widget company, whose primary goal is to manufacture widgets, that makes it know where its share price is going? I understand that certain financial services firms would claim competence in the stock market. But most firms, including most financial services firms that are not involved in the stock market per se, their job is to manufacture goods and services that are unrelated to the stock market. Yet they claim some special insight into when their stock is cheap or not cheap. And the historical data says they're just flat out wrong.

Again, I can commend certain companies that have managed to reduce their share count. And that's really the question. Are you able to reduce your share count over a long period of time? You've mentioned two examples and they're good examples. And you should add to that list Berkshire Hathaway, which doesn't pay a dividend, it just reinvests all of the proceeds back into the business.

But they are exceptions to the rule in terms of making good investment decisions. It's easy to point out those exceptions and say that had you purchased a share in one of those companies two decades ago you would now own twice as much of the company as you did because of the reduction in the share count. But they are the exception.

Far more companies have increased their share counts rather than lowered their share counts. They have spent a lot of money to enact a very small change in their share count level. It's just so much easier to generate total return via a dividend; they game the stock market.

I understand the exceptions to the rule out there and they're easy to point to. But normally it just doesn't work out like that.

RB: Another topic you discuss in your book is the cultural change towards share buybacks at the expense of dividends. Just speaking from the perspective of a Canadian, I don't really see the change that you described in the book. There are a number of sectors — namely telecoms, pipelines, and banks — where there's still a culture of paying dividends. Do you see that difference internationally?

DP: Yes, your senses are correct. The U.S. is the outlier.

Most mature markets did not go as far down the path of following what I'll call modern portfolio theory. Modigliani and Miller are kind of the intellectual forefathers of justifying share repurchase programs over dividend payments. Modigliani and Miller's theory, which came out in 1961, provides an academic justification for all of this.

But the U.S. ends up being the outlier. In a number of developed markets — Canada, Australia, the

United Kingdom, Western Europe, and others — the notion that a profitable business would distribute its excess profits via dividends remains largely in place whether the company is private or publicly held.

We actually find Canada does have a higher payout ratio. It does have a higher yield. The global corporations based in the U.K. are attractive and they're well represented in our portfolio.

The U.S. is the outlier here. There are legal, cultural, and economic reasons. I don't have a 100% explanation as to why the U.S. became the outlier that it did, but you are correct that the U.S. has gone much further down that path than other mature markets in the Western world.

And that has created a business opportunity for us here in the United States by investing in dividend-paying stocks with higher payout ratios and higher distributions. It has also created an opportunity for our U.S. clients to import some of the dividend names from the U.K., Canada, and Europe for our U.S. customers.

For Canadian investors, it's actually an interesting situation because the largest market outside right next door behaves very differently from yours. What you see looking over the borders is very different really from how your own market works.

RB: Investors are chasing anything right now that generates safe, reliable income. Take **Enbridge** ([TSX: ENB](#))([NYSE: ENB](#)), for example. The yield on that stock is at a record low of 2.7%. The yield on **Canadian Utilities** ([TSX: CU](#)) is nearing a record low of 2.6%. Canadian banks like **Royal Bank of Canada** ([TSX: RY](#))([NYSE: RY](#)) and **Toronto Dominion Bank** ([TSX: TD](#))([NYSE: TD](#)) used to yield 6% or 7%. Today, their payouts are scanty above 4%. Are you worried about valuations?

DP: There is clearly a demand for income. Demand is strong and supply is not as available as it has been. That's partly due to government policies globally to keep interest rates low. It has really punished retirees, and I think has other implications in regards to risk rates in the financial system.

But it is what it is. It has been that case in the U.S. for the last five years or so. It's really the case globally in many ways. And that is creating demand for income streams. One way that is very healthy is investors, despite what the government is telling them, are still demanding income.

Our portfolio has a gross yield around 4%. Our international portfolio, which includes a number of Canadian investments, has a yield around 4.5%. Those are down a little bit from where they have been over the past decade.

Our valuation metrics tend to be a combination of dividend yield, dividend growth, and asset value protection. Those are the three driving elements of our investment decisions.

Dividend growth is reasonable right now in the mid-single digits. That's really within our target range. Yields are a little bit lighter than what we would like them to be, but they still a good positive net present value. And our asset value protection metrics, we basically invest in non-cyclical investments, are pretty much in place.

It takes no more than glancing over one's shoulder to see that yields are lower than what they have been historically. But glancing over from a portfolio perspective with a variety of income streams, it still amounts to something. We're pretty comfortable where we sit.

There's always the risk of overpaying when there's a lot of demand. The careful practitioners will do what's prudent without taking excess risk. We feel we're well positioned even though there's a lot of demand for income-ordinated investments.

RB: You hinted at that in your last question. A lot of income investors struggle with balancing dividend yield with dividend growth? What is your approach?

DP: That's the natural risk measurement for us. In the modern world of asset management, you balance out risk in terms of the benchmark, sector weights, all of these things that are intrinsic to modern portfolio theory but don't have a lot of meaning to the actual outcome. For us, the way that we manage risk is that combination of three factors: dividend growth, dividend yield, and asset value protection.

When we're looking at an investment or when we're looking at the portfolio as a whole, we are looking at the yield we can see based on the marketplace today. What's the dividend growth rate? Are we privileging dividend growth or are we privileging yield? If we made one change, do we want to balance it with another change? We want to have a combination of both.

And then just slightly in the background and a little bit harder to capture or quantify is asset value protection. Are these discretionary assets? Are these non-discretionary businesses?

That risk management is done in quite a different way than traditional modern portfolio theory would suggest. But it's done in the way of a business person running your business for cash flow. It makes perfect sense in that regard.

We have a balance of dividend growth and dividend yield and everyday companies. It's how we define and manage risk for us. Risk is really cash flows. We need to make sure they have a positive trajectory and they are not dancing around too much.

Most people are defining risk, as it's defined in modern portfolio theory, as minimizing co-variance of asset prices. Grandma doesn't really care about co-variance minimization. Grandma needs to pay the bills and keep up with inflation. We are making sure that she can do that.

RB: I should try explaining that to my grandparents sometime, "You have to minimize the co-variance of different asset classes." I wonder what kind of stares I would get?

DP: If you told every client the theory behind how their assets are being managed, there would be a revolution. There would be a degree of surprise, particularly by those who operated in business. *That's* how our money is being managed? That's weird to say the least.

RB: This is the last topic I wanted to touch on. In your book *The Strategic Dividend Investor*, you coined the term "Trader Nation". What does that mean?

DP: I don't have the data for Canada. In the United States, the average investor has earned an

average rate of return somewhere in the order of 2% to 3% over the last 20 years. It has been the greatest bull run in the history of bonds over the last 30 years. And the stock market continues to generally post high single-digit returns. Yet investor returns are 2% to 3%. That's a stunning shortfall.

There are many reasons. I'm currently focused on modern portfolio theory as a possible cause for that. Though part of that is the tendency is to not treat these assets as businesses but as pieces of paper to be traded.

Just like companies poorly time their share buybacks, financial advisors and investors frankly don't do a very good job in timing the capital markets. The cost of transactions is very high. This is a fee-based industry. There are a number of intermediates. Frankly, we're one of them. The bias towards trading stocks rather than investing in businesses is the biggest cause of this shortfall.

RB: We're coming up to 20 minutes, which is all the time I promised to steal from you today. Thank you for taking the time to speak with me today. Just as we're wrapping up, is there anything you would like to tell out readers?

DP: As you mentioned, Canada has not gone quite as far down this path of thinking of stocks rather than businesses as the United States. The Canadian market still has what I would regard as a greater sensibility and common sense to the ownership of businesses.

The risk is that temptation is to go down the path of the U.S., given that the American market is right next door and so much larger. I would encourage Canadian corporations and investors to keep their eyes on the ball like they have and to treat their investments like they would businesses. That's actually the healthier and long-term approach.

That's actually reflected in our portfolio, where we looked to Canada to try to bolster the dividend stream for our investors. Canadians more or less have it right in terms of how they treat their stocks. That's healthy and I'd hate to see that diminish in favour like what we're seeing here south of the border.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:BRKA (Berkshire Hathaway Inc.)
2. NYSE:IBM (International Business Machines Corporation)
3. TSX:CU (Canadian Utilities Limited)
4. TSX:ENB (Enbridge Inc.)
5. TSX:RY (Royal Bank of Canada)
6. TSX:TD (The Toronto-Dominion Bank)

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