Benjamin Graham: How to Prevent Losses With a Margin of Safety

Description

The Coca-Cola Co (NYSE:KO) and **PepsiCo, Inc.** (NYSE:PEP) have long been the core holdings of many dividend portfolios. Who can resist these dividend-growth stalwarts?

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Coca-Cola and Pepsi have increased their dividends for 54 and 44 consecutive years, respectively. Only one Canadian company has raised its dividend for 44 years.

I've always treated Coca-Cola and Pepsi as core holdings. However, I parted with my last shares of both companies because of one simple reason–there's no margin of safety.

> "There is no such thing as a good or bad stock; there are only cheap stocks and expensive stocks. Even the best company becomes a "sell" when its stock price goes too high, while the worst company is worth buying if its stock goes low enough." —*The Intelligent Investor* by Benjamin Graham with new commentary by Jason Zweig

Margin of safety on their prices

When I sold, both were trading at more than 23 times their earnings. They last traded at these expensive multiples in late 2007 before the financial crisis. I'm not implying there's a causal relationship between the high multiple and the crisis.

However, whenever a stock trades at an expensive multiple, eventually it will revert to the mean. So, if their growth slows and their multiples contract, Coca-Cola and Pepsi could revert back to their normal multiples. Their five-year normal multiples are 19.4 and 18, respectively.

From their current prices to their normal multiples, Coca-Cola could fall 17% to under US$38 per share, and Pepsi could fall close to 20% to under US$85 per share.

So, there's no margin of safety on their prices. What about their dividends?

Margin of safety on their dividends

At under US$46, Coca-Cola yields almost 3.1%. Its quarterly dividend is US$0.35 per share, equating to an annual payout of US$1.40 per share and a payout ratio of roughly 70%.

This is the highest payout ratio Coca-Cola has ever had. Additionally, earnings growth is expected to be about 5% in the medium term. So, Coca-Cola's dividend-growth rate should logically be lower than previous years if the company doesn't want to expand its payout ratio.

There's a margin of safety for Coca-Cola's dividend as it's still retaining about 30% of its earnings.

At under US$106, Pepsi yields 2.8%. Its quarterly dividend is US$0.75 per share, equating to an annual payout of US$3.01 per share and a payout ratio of roughly 66%, which is slightly better than Coca-Cola's.

This is the highest payout ratio Pepsi has ever had. Its earnings growth is estimated to grow 6.5% in the medium term. So, Pepsi's dividend-growth rate should be lower than previous years if the company doesn't want to expand its payout ratio.

Conclusion

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There's no margin of safety in Coca-Cola and Pepsi's prices today. However, both of their dividends are sustainable, although Pepsi's dividend is safer because it has a lower payout ratio.

If you own these companies and care about capital preservation, you might want to take some chips off the table. If you only care about a safe, growing income, you can hold on.

It would be safer to buy Coca-Cola and Pepsi if they reach the price ranges of US$29-35 and US$70-85, respectively.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:KO (The Coca-Cola Company)

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