Ken Kozlowski Podcast – May 2022
Investing in income producing stocks

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Transcript

Intro

Hi, I'm Sean Nicholason with Equitable Investment Management. We are part of the investment arm of Equitable Financial. We manage the money individuals invest with Equitable, through variable insurance products, 1290 mutual funds, and model portfolios. We often hire from among Wall Street's most prominent firms to bring institutional-caliber money management services to individual investors. In this edition of our podcast series, our chief investment officer, Ken Kozlowski, talks to a portfolio manager at Barrow Hanley Global Investors. Brian Quinn specializes in what we call income-producing equities, another way of describing stocks of companies that pay attractive or consistent dividends. Brian and his team of analysts and portfolio managers have made a career of studying inexpensive companies that fall into this category. This discussion may help you understand how dividends can be important for individual investors. Let's listen in, as Ken starts the conversation with a question about finding companies with attractive dividend yields—a technical way of describing companies that pay a relatively high proportion of their share price in dividends each year.

Ken

Hello and welcome back. After many years of growth-stocks outperforming, value and income-producing stocks have made a comeback over the last year. With that, and the recent market volatility, I thought it would be a good time to explore income-producing stocks. So joining me today is Brian Quinn from Barrel Hanley Global Investors. He has over 21 years in the industry, and he has been a portfolio manager with Barrow Hanley since 2005. He has a BS from Fordham and an MBA from Texas Christian University and is a CFA. Brian, welcome.

Brian

Hi, good afternoon Ken, glad to be here.

Ken

So you look for value companies with high relative dividend yields and a long history of paying cash dividends. You probably look at “the multiples,” various ways of comparing stock prices based on earnings or book value or the cost of doing business. Can you tell me how your specific process helps you find these companies?

Brian

Yeah great, so our process really focuses on buying good companies; and we define good companies as companies that grow their earnings faster in the market, have higher return on equities than the overall market, and have both a dividend yield and dividend growth profile that are higher in the market as well. Yet we want to buy these companies when the valuations; and we look at multiple valuations from price to earnings multiples, Price to book, EV (Enterprise Value) to EBITDA (earnings before interest, taxes, depreciation and amortization), and dividend yield; we want those valuations to be cheaper than the overall market. Typically, there's some temporary reason whether that's earnings. headwind from inflation like we're seeing now, merger and acquisition risk, legal or regulatory uncertainty, but typically some temporary reason that causes an individual stock to become cheap. And with a holding period of 3-5 years, we're able to capture that inefficiency in the market and buy these high-quality companies at discounted prices. We collect the dividend over this 3-5 year period that is higher yielding and growing faster, and we wait for that temporary issue to work itself out. So, we generally participate in 1. The growing earnings profile of the company, 2. the multiple expansion of the company and the growing dividend of the company. So, we really look at it as a total return, not just a dividend yield strategy. The reason we like dividend paying stocks really twofold. 1. we think it protects the downside of your investment because you're getting the income today. And 2. we love the compounding characteristics of dividends. Just an interesting stat - if you had $10,000 invested in the S&P in 1970, and the S&P didn't pay dividends, your return today would be $495,000 or 7.8% annual return. With the compounding dividend effect that same $10,000 investment would be $2.1 million, so roughly 10.8%. So you could really see the value of dividends and how they compound shareholder value.

Ken

Thanks Brian. And why do these kinds of stocks tend to do well during periods of high volatility or uncertainty? I mean, we know these periods can be associated with falling profit margins at some companies—or perhaps generally falling stock prices as investors sell in a panic. Why are dividend-paying stocks often attractive in these periods?

Brian

Yeah, I really think there's a few reasons why these types of stocks do well. First, these stocks are already trading a discount to the market. Expectations are pretty low, and bad news is already priced into the stock, so multiple compression should be pretty limited. Second, typically we are buying stocks where earnings are already depressed like the example I gave before. - margins were already being impacted by inflation. So we try to avoid situations where we see a large number of negative earnings revisions coming to us. If we're doing our job correctly, we try to buy the stocks and we're closer to the inflection point where we see positive earnings revisions. Third, more often than not these companies that have a long history of paying dividends and they're more sacrosanct to the company, they have strong balance sheets because they want to protect themselves on downside. So really they have more financial flexibility in these periods of stress. And then fourth, when you just think about a CEO of a company that has paid a dividend for 20-25 years, they're not going to want to cut the dividend and the investors enjoy that because they want this level of income today in periods of stress, and so it reduces that downside volatility in the stock.

Ken

So going into this year you had big underweights in tech and communications and I'm sure you were really glad about that. What kinds of sectors are sending value signals now?

Brian

Yeah, as I mentioned earlier, given our focus on valuation, we were underweight technology and communication, and that really hasn't changed much. We're still having a hard time finding value in those sectors. Valuations still look a little stress stretched to us, especially in a rising interest rate environment. Where we are finding some value is in the healthcare sector, especially the managed care stocks. We view managed care as a really attractive business. They typically grow earnings at the low double-digit pace, have high returns on invested capital, and they're really great inflation handlers. If you think about the healthcare industry as a whole, they've had a battle inflation a lot longer in the past two years, they've been dealing with that for the past 20 years, and so these managed care companies have been able to pass on inflation to their customers for a long period of time. There are few stocks within this managed care space that have gotten the pricing wrong this past year and they really sold off pretty dramatically, some of them are trained as low as 11 times earnings. And as we know with managed care, they re-price annually and so they're going to recoup some of those lost profit they have. And when you're getting them at a low price of 11 times earnings, and some peers are trained as high as 25 times earnings, we see a lot of opportunity there. We're also seeing some opportunities in the material sector.

Ken

And given your bottom-up style, you probably don't use a crystal ball much, but do you have any thoughts about interest rates and inflation? Have you learned any lessons over multiple market cycles about how these factors might impact the search for high quality companies?

Brian

Yes, so we think inflation is much higher than the headline CPI numbers that we've read at 8% there, there's. So many anecdotal evidences that that share this view and Federal Reserve is significantly behind the curve and needs to play catch up to combat inflation. Our view is that there are really two groups of stocks that will have a bigger impact from this. One is growth in technology stocks, and two is cyclicals. When you think about the technology stocks, these typically have long equity durations, meaning that they're not generating cash flow until sometime way in the future in a higher interest rate environment when you're discounting those future cash flows at a higher discount rate, it's going to have a much larger impact on valuation. And then with the Fed trying to play catch up and navigate a soft landing that just really increases the probability that they make a policy error and leads to recession. And we think this is bad for one discretionary stocks and other cyclical stocks as well. So in general, we think value stocks are a great place to be right now because 1. most value stocks are generating cash flow today, so the discounting mechanism of future cash flows has a lower risk profile for value stocks, and 2. most of these value stocks are paying a lot of dividends. If you think about the past 80 years of the total return in the market, and you break that down to components, dividends typically made up 32% of the total return, multiple expansion was around 11% and earnings growth was around 57%. If you look at the past 12 years, the contribution of return from dividends and multiple expansion has completely flipped, where multiple expansion was roughly 32% and dividend is only 11%. In an environment with rising interest rates which should lead to multiple contraction, dividends have to be a larger portion of your total return, and so when you think about investing in stocks and what stocks are going to outperform in the market going forward, it's going to be dividend paying stocks and so that's where we're positioned, that's where we have the portfolio today - these companies that are paying the dividends and growing the dividends. And when I think about lessons learned over the cycles, I guess the biggest lesson for me is that cycles could last a really long time, much longer than you can anticipate as an investor. If you think about this past growth cycle, it's outperformed value for really the past 12 years. That's a phenomenally long time. But what I've learned here is it's been nearly impossible to time when the cycles do change, and so how we manage that is we stay very disciplined to our overall process of buying these value stocks that are trading at discount to the market but have fundamental premiums to the market, and waiting three to five years to play out.

Ken

Brian, thanks for your thoughts today about finding value in this market. It was great having you thank you.

Brian

Thank you, Ken. It was good talking to you.

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