Crisis Cycle Investing

By John Mauldin | April 6, 2024

The Power of Dividend Portfolios
DC, Cape Town, Italy and London

Last year I wrote a series of letters reviewing different ideas of repeatable cycles in history. All four authors I reviewed, and your humble analyst, all foresee a major crisis/upheaval coming around the end of this decade.

However, we don't know what the crisis will actually look like. Most of the theories I reviewed see war as a possibility. Not to mention the brewing government debt crisis that will create its own dynamics. We really don't know how this will turn out. Who is going to be in charge politically? What compromises will have to be made in the midst of crisis and how will they affect our lives and portfolios?

A critical question is how do we get as much buying power as possible from the beginning of the crisis through to the other side? Part of the answer is Warren Buffett's admonition to never bet against America. Better to do as he does, investing in specific *parts* of America.

I said earlier this year I was transferring my portfolio management and partnership to an independent investment advisor firm called The Bahnsen Group founded by David Bahnsen. I have known David personally for well over a decade and knew his father (brilliant theologian Greg Bahnsen), even publishing some of his books. David and I met on the set of CNBC's *Fast Money* in 2010 and discovered that personal connection. Our friendship has since developed into a very close one.

David runs a blend of dividend growth stocks, alternatives, and special situations. David and his extensive research team excel in finding those companies you want to bet on—that will be around after the crisis.

David also focuses on the kind of "alternatives" which already comprise the bulk of my own portfolio. So why use TBG if I am theoretically enough of an expert to do it myself? Because David runs over $5 billion and has access to high-quality managers and funds that I simply can't get access to.

I have spent a lot of time observing David and his team. His rapidly growing firm is extraordinarily well managed, with over 60 associates and offices in 7 states. They can do bespoke portfolios, do taxes and estate planning, manage family offices, and see a large number of special opportunities. It is almost an art form in how they can make those opportunities and managers available to smaller accredited investors.

David is one of the most brilliant thinkers I know. Facts just roll off his fingers. Philosophically we are aligned in almost every important way. I believe he can adapt to whatever changes will have to be made in the future, and there will likely be many, in a way that I will be comfortable with. Further, I am 75 and Shane is (ahem) younger. I need to make sure that my portfolio outlasts me and there is someone to take care of Shane if I am not there. I trust David to make that happen, from both a personal standpoint and as a business professional.

Today David and I will start a series of letters on portfolio construction using dividend growth stocks coupled with alternatives. This isn't the only way to navigate the crisis I see coming, but it is the way I am going to utilize.

But first, it is Strategic Investment Conference time where the theme is appropriately ***Into the Storm***. We'll begin the conference with a dive into the crisis cycle with the authors I have reviewed giving us their insights. Then we have a number of extraordinarily successful investment professionals whose job it is to get their own assets as well as their clients' assets to the other side of the crisis. We will be asking them what they are doing. Others will be describing various aspects of geopolitical, political, and economic issues. Mario Gabelli, Leon Cooperman, Howard Marks, Ron Baron, Felix Zulauf, Joe Lonsdale (co-founder of Palantir), and over 40 other faculty will help us explore the future.

One of the most prominent and decorated combat commanders in American history, Gen. David H. Petraeus, USA (Ret.) will give us high-level insights into the current global geopolitical landscape and provide a clear perspective of the situation in Ukraine, Russia, the Middle East, and ongoing tensions that matter to investors.

No one has a crystal ball, but we do know what will come on the other side of challenging times and crises because something hasn't stopped: human innovation. Faced with problems, we find solutions. And faced with new problems, we find new solutions.

This process never stops. That's why I'm proud to announce that Matt Ridley, author of numerous books, including *The Rational Optimist* and *The Evolution of Everything*, will be joining our faculty at SIC 2024. (I place *The Evolution of Everything* in my top five most important books to recommend.)

For the first time at the SIC, celebrated investor Mario Gabelli will join us. In the late 1960s, Mr. Gabelli covered Pinkertons, which Warren Buffett owned. More important, Mr. Buffett was taught by Professor Graham at Columbia Business School and Mr. Gabelli was taught by Graham and Dodd's successor Roger Murray.

The conference will stretch over five days from April 22-May 1. You can watch it live, review at your leisure, read the transcripts, or listen to the podcasts. Sign up now and you can still get the early-bird discount. Don't procrastinate. You really will want this insight for your own life and world.

And now, let's look at dividends, courtesy of David Bahnsen.

The Power of Dividend Portfolios (by David Bahnsen)

The easy part in analyzing the current state of affairs is acknowledging the risks. The "trifecta" of concerns I most focus on is not mysterious, it is not opaque, and it is not even new. Each of the categories of concern involve multiple nuances and layers of sub-categories, and each has manifested itself differently in the last several years. More important, the way all of these will play out in the years to come will be different from how they feel and look now. What I want to do in this piece is lay out what that "trifecta" of concern is from my vantage point as an asset allocator and portfolio manager and make the case for dividend growth equity investing as a significant weapon in fighting against these risks and concerns.

The major categories I incorporate into this trifecta are:

- Excessive government indebtedness
- Distortive monetary policy
- Geopolitical uncertainties

All three categories have new dimensions to them. Government debt was $1 trillion when I was in high school 35 years ago; it is $34 trillion now. Public debt-to-GDP was 62% as we entered the financial crisis in 2008; it is 120% now. The balance sheet of the Federal Reserve was $600 billion before the financial crisis; it is $7.5 trillion now. We spent much of the 1960s and 1970s in a Cold War with the Soviet Union (with grave nuclear concerns); we are now looking at Russian adventurism in Ukraine and an uncertain outcome for Israel in its war with Hamas. But you will note—all of these "new" developments have an element of "old" to them, too. Then and now, we had excessive government debt, an interventionist central bank, and a dangerous world geopolitically. The new manifestations of these old categories have created a new paradigm.

Attempts to predict specific outcomes around these three categories have not gone well for the forecasting class. All at once, fiscal and monetary stability have worsened for years and years (with much more to go), yet corporate profits have grown, GDP has grown, and risk assets have produced attractive returns. It can lull someone into complacency if not careful, partially because we have grown used to the can being kicked down the road by policymakers and central bankers, and partially because too many doomsdayers have burned people with inaccurate forecasts with wailing and gnashing of teeth. Investors are real people with financial goals, cash flow needs, a timeline, beneficiaries, and particular elements of their own lives and situation that require tailored solutions.

A generic belief that "bad things are brewing" does not lead to a specific portfolio that generates specific outcomes. Just as much as Keynes was right that "in the long run we're all dead," David Bahnsen (I made this up) is right that "until then, we're all alive, and have wives and kids." In other words, ignoring the short and intermediate term while we wait for long-term inevitabilities to play out ignores pragmatic reality.

My view is that these three categories of risk, taken together and separately, put a burden on investors that disqualifies much of what has passed for traditional investing over the last couple decades, and redirects investors to a time-tested practice that ought to serve as a fundamental bedrock for those pursuing investment solutions that meet real-life financial goals. **In the paradigm we find ourselves in, dividend growth equity investing represents a solid, dependable, and time-tested way to play offense *and* defense in a contest that requires both.**

This week I will focus on the defensive components of dividend growth investing and how they are uniquely situated to protect during periods that require protection. Next week we focus on offense—how dividend growth generates excess returns both for withdrawers and accumulators of capital. What I will not advocate is the silliness or naivete that says, "nothing can go wrong here!" Dividend growth equity is a *long* equity strategy, and equities go up and down in price. If they produced no downside volatility the risk premium would be so low, it would be a completely unattractive investment proposition! Dividend growth equity is still equity, and therefore subject to the standard price fluctuations that any asset class will have when:

- It is owned by the highly emotional public,
- Has a P/E ratio embedded in price that moves around sentiment and comparative economic barometers, and
- Is highly liquid, marketable, and tradeable.

I argue that the reality of price volatility, liquidity, and public temperament in the stock market is an argument *for* dividend equity, not against. For it is the equity investors who have removed themselves from cash flow considerations who have the most to lose from price volatility. At the heart of this point is, well, math. If one is aiming for a 10% annualized return (to use a purely illustrative hypothetical), and the plan is to get 5% of it in dividend income and 5% in price growth, versus another aiming for 10% but with 1% in dividend income and 9% in price growth, the impact of downside volatility is not equally felt even if the 10% return ends up being averaged over time. A 5% dividend yield does not become -10% at times and +15% at others.

The yield is what it is, and properly managed does not go down at all, *but certainly never goes below 0%*. You never have to pay the dividend to the company; it only pays it to you. But price appreciation, on the other hand, only comes from "up and down" volatility.

A stock portfolio or index that averages 10% per year rarely is actually up +10%. Rather, it may be down -20% in some years but up +30% in others (and plenty of other variances in between).

The portion of a return coming from price appreciation is *by definition* subject to more price volatility than a portion of the return that cannot mathematically go below 0%. Therefore, the volatility of two strategies pursuing 10% where one seeks to get half of the return via dividends, and one is content for just a 1–2% dividend yield are categorically different.

But no matter what you have been taught, risk and volatility are not the same thing. The variance of a return around its mean is emotionally real, and in the context of a real-life withdrawal strategy, mathematically real (more below). But up and down price movements are not the same thing as the permanent erosion of capital. However, if one's portfolio strategy requires a compounding annual growth rate that proves to be far above reality because of valuations or because prices drop and never recover, those are not volatility concerns—they are risk concerns. Real risk. Existential risk. And it is that risk that dividend growth seeks to eliminate.

First of all, valuation concerns… The market's price-to-earnings ratio is high right now—very high. Any number of fiscal, monetary, or geopolitical developments could collapse that P/E substantially. The market has not priced in the very real possibility that:

- The structural growth rate of the economy has been altered by excessive government spending, and

- The monetary medicine in the next decade will be less efficacious than the last decade.

I do not view either of those contentions as even remotely debatable. The 2010–2020 decade saw significant earnings recovery post-GFC, but also monetary policy facilitating reflation that boosted multiples (and then some).

I believe holding a high multiple will be impossible in the aftermath of what the economy faces. Going from $1 trillion to $20 trillion of debt happened without much structural impediment and with significant monetary facilitation. Getting to $30 trillion fed a lot of mal-investment, created excessive leverage, and further entrenched the economy's dependence on something fundamentally unsustainable—namely a stimulative effect on monetary policy whose stimulative effects can only diminish over time.

Though the analogy is crude and uncomfortable, the high a drug addict gets from the initial stage of their addiction becomes less enjoyable over time. And worse, it requires more and more intake to get less and less of a high. The fiscal and monetary treatments we have used and will, no doubt, continue trying to use are in the "diminishing return" phase. Multiples may hold at a historical level (this would be an optimistic base case), but they are at a big premium to historical levels already, and require significant expansion, still, to achieve that aforementioned historical return.

Dividend growth equities, on the other hand, require less speculation than "growth stocks," feature less frothy valuations, and offer return strategies far more connected to fundamentally knowable and repeatable phenomena than simple valuation growth. Where free cash flow is growing, and a company has a past, present, and future inclination to liberally share that free cash flow at an ever-growing rate with its owners, the impact of valuation volatility is muted.

A company trading at 17X earnings is less exposed to a reversion to 16X than a company trading at 22X. And better still, a company paying 4–5% in yield has less price appreciation need to get to an 8–10% return than a company paying 0–2%.

All of this is self-evidently true. Less self-evident is the inherent truth about the maturity of a company that can pay an attractive dividend and grow it from 6–9% per year for year after year and decade after decade. These companies may be past a hockey-stick level of growth that requires very fortunate entry timing and even more fortunate exit timing, but they have achieved a scale, brand, balance sheet, and marketplace position (it can often be called a moat) that makes them superior companies. In other words, the capacity for such a dividend and such repeatable dividend growth is not merely the strength of an investment, but it is *evidence of the strength of the company*. It both presents and reflects a superior investment proposition at the same time.

What are the characteristics of a company that can grow its cash flow this reliably, and achieve the balance sheet strength, competitive positioning, and operating consistency necessary to be a perpetual dividend grower? Well, for one thing, it had better offer goods and/or services that are consistently needed. In other words, an apparel company making a hot line of clothing for 16-year-old girls is wise to hang tight on dividend payments, knowing that next year 16-year-olds might possibly change their minds (just a hunch). But a consumer staples company that makes toilet paper or diapers or dish soap or soda pop or bottled water (or, maybe, all of the above!) might just have a more defensive business model. In a given part of the cycle, that 16-year-old girls' clothing might print money compared to the consumer staple, but one leads to decades of dividend growth with good and sober management; the other might lead to Chapter 11 once the new school year starts.

There are many examples of companies that traffic in goods and services which are less subject to disruption or changing fads and preferences. Utilities, Health Care, Energy, financial advice, basic technology hardware and infrastructure, Real Estate, and many other sectors in commercial society offer opportunities for market leadership, profit generation, and consistency of results (with ongoing innovation) that lends itself to dependable cash flows.

And that is the story of the defense of a good dividend growth strategy—that it represents the best and finest exposure to the components of commercial society not prone to being blown over by the winds of cyclicality. Fiscal and monetary and geopolitical risk will still exist, and they will play out how they are going to play out. A remnant of companies will continue to generate profits (capitalism works), and they will continue to share those profits with us.

Another segment of companies will only monetize for investors if they time their entry well, time their exit well, and survive the vulnerabilities of policy error, policy distortion, and other macro events. They are exposed to hope, not strategy, unless that strategy is mere multiple expansion. It is an economic risk but also basic mathematical risk that exceeds logic and prudence.

The environment in which we find ourselves is screaming for reasonable valuation, a buffer of safety, a consistency of operating results, and a management team aligned with shareholders enough to share profits with them. In this environment the path to returns that can be "eaten"—truly received and made efficacious—is in dividend growth.

Next week we will look at some of the “offense” arguments for dividend growth, the miracle of compounded accumulation, and the historical arguments surrounding this thesis.

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John here: You can and should subscribe to David’s *Dividend Cafe* letter, a brief daily market update plus a short philosophical point. I have been reading him daily for years.

DC, Cape Town, Italy and London

I will be in Washington, DC, the weekend of April 13 and then back home that Tuesday. Shane and I will be going to Cape Town, South Africa, in early June and then spend some time in Italy (the Amalfi coast?) and London.

I want to write more but it’s time to hit the send button. I encourage you to learn more about dividend growth investing and be sure and reserve your spot for the SIC. Have a great week!

Your ready to sail into the storm analyst,

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