Tandem Investment Advisors

Q1 Rebound Stretches Valuations...Again

Last quarter we stated that not every bear market is a crisis and that they certainly create opportunities. We did not expect the opportunity of the 20% December decline to be so widely recognized so quickly. Now we find ourselves back at the lofty valuations we experienced in September, with one considerable difference.

Last September, as the S&P 500 reached its last all-time high on the 20th, the economy was humming, corporate earnings were strong and the Federal Reserve was hawkish (inclined to raise interest rates). The market began its sell-off, culminating in a sizable move down on Christmas Eve. Suddenly the market was concerned about a slowing economy and no growth in corporate profits. Then the Fed blinked.

And that is what is different today from the last time we were here. The Fed is now perceived to be dovish (inclined at least to no longer raise rates, if not lower them). It would seem obvious that the backdrop was far more appealing in September than it is now. Corporate profit growth could actually be negative this year, and some would argue the yield curve (considered an accurate predictor) has foretold recession. Why have stocks recaptured nearly all of their losses in so short a time?

Like much of this 10-year bull market, fundamentals matter less than Fed policy. If the Fed appears accommodative, the market takes that as an all-clear. And quite frankly, the market is wise to have such a reaction. Every time the market has stumbled, the Fed has made clear its intention to be supportive of conditions conducive to strong stock performance. Fundamentals be damned for now. Reckoning can come later.

As we have discussed many times, fundamentals always matter ultimately. Overpaying today limits the potential long-term return. Sometimes the long-term takes longer than we anticipate. And as Keynes once noted, in the long-run we are all dead. So there is that.

In the meantime, the market is likely to follow the Fed's cue and go higher. Eventually the economy will regain its footing, corporate profits will resume a healthy rate of growth and all will be right in the world. And when that time comes, the Fed may be forced to interrupt (or worse) the party again!

Fundamentals cannot adequately support current stock valuations. Only Fed policy can. And if the economy picks up momentum, the Fed may start to reverse course again and become more hawkish. These circumstances set up an expectation of increased volatility as the Fed, the economy and profits all ping pong back and forth. We like volatility, as it too creates opportunity.

Please remember that we do not invest your money in "the stock market". The Castle Tandem Fund is invested in individual companies that meet our very strict criteria and that we believe are better equipped to weather market turbulence. And we are poised to take advantage of opportunities resulting from market volatility. We have ample cash to deploy with another correction or sell- off. We believe that the Castle Tandem Fund is well-prepared for whatever lies ahead.

The Dividend

According to the Cambridge Dictionary, a dividend is a payment by a company of a part of its profit to the people who own shares in the company. A part of the profit indeed! But how big a part? Some companies with plenty of profit don't even pay a dividend. Others, with little or no profit, pay a dividend that exceeds the company's profit. Why the disparity?

Tandem has always believed that dividend policy tells investors a great deal about the way a company treats its shareholders. Each company must decide what, if any, dividend it will pay to shareholders, and how much profit is appropriate to share.

Some companies prefer to retain all of their earnings to reinvest them in the business. These companies tend to have greater opportunities for growth than most, or they exist in a hyper-competitive and ever-changing industry. There is merit to this decision, but for this conversation, we will focus on those companies that do share a portion of their profit.

Dividends can be quite impactful on total return. In fact, since the end of World War II, roughly 40% of the S&P 500's total return can be attributed to dividends. They are clearly an important component of total return. Some investors value dividends chiefly for the income they produce. Dividend yield is what they seek and growth would just be icing on the cake. Others believe that dividend growth is the Holy Grail and the best way to potentially produce consistent and superior returns. Tandem falls in the growth camp, not the income camp.

Tandem pays little attention to dividend yield. In fact, we find that many (though certainly not all) high dividend stocks pay such a high dividend for one of two unfortunate reasons: either they choose not to reinvest enough earnings to provide for future growth, or the dividend is potentially in danger of being reduced.

Many dividend growth investors value dividend growth so much that they make it their primary objective in screening stocks. There is even an index called S&P 500® Dividend Aristocrats® that includes all S&P 500 companies that have paid and grown their dividend annually for at least 25 years. There are currently 57 companies that meet this criteria and are included in the index.

Tandem takes a considerably different view of dividend growth. While we require dividend growth for any company in the Fund, we do not seek dividend growth. We seek companies that consistently grow earnings, revenues and cash flow through any economic environment. For these companies, dividend growth is a by-product of good corporate management. Unlike most dividend growth investors, we do not seek dividend growth, we require it. More importantly, we seek companies that grow and reinvest in future growth. This makes dividend growth sustainable.

It is our belief that companies producing the results that we demand will produce a more consistent, repeatable investment experience. It is our opinion that if a company can increase the cash flow it pays to investors in the form of dividends, the value of that company is likely to grow. And if that company can repeat this growth in dividends year after year, it is even more likely that the value of the company will increase.

And this is the beauty of Tandem's approach to dividend growth. We don't seek it. We don't try to identify it. We simply demand it of any company that grows earnings, revenues and cash flow over any economic cycle. Without all these qualities, a company cannot be in the Fund. We believe our approach produces a more consistent, repeatable and less volatile experience.

There are many ways to invest successfully. Dividend growth strategies are one such way. We believe that Tandem's distinct approach to dividend growth - identifying growing companies rather than growing dividends, and then demanding dividend growth - produces a consistent, repeatable and less volatile experience. Less volatility means that investors are more likely to stay invested, even in the most volatile times. Some may enjoy the excitement of being the hare, but we all know that the tortoise wins the race.