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FINANCIAL STRATEGIES

Golden Eggs, Stocks and Dividends

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One of Aesop's Fables is "The Goose That Laid the Golden Eggs." The abbreviated version from Wikipedia goes like this: "A cottager and his wife had a goose that laid a golden egg every day. They supposed that the goose must contain a great lump of gold in its inside, and in order to get the gold, they killed her. Having done so, they found to their surprise that the goose differed in no respect from their other geese. The foolish pair, thus hoping to become rich all at once, deprived themselves of the gain of which they were assured day by day."

Having come across this fable recently, I could not help but think that we should think of our stock portfolios as the golden goose. The eggs, of course, are dividends. Sometimes, our stocks increase by quite a bit and we want to sell, not realizing that the reason the stocks went up is because the dividends increased. Cashing in the stock can be thought of killing the goose that is laying the golden eggs.

The reason that fable reminded me of stocks is that I have just completed new work on the 120 stocks that our clients own. My work focused on the dividend growth rate. In the past 5 years, the dividends on those stocks, on average, has nearly doubled. Not coincidentally, the value of the S&P 500 has nearly doubled in the same period of time.[1]

We don't need to cash our stocks in to realize the profits, we just need to keep collecting the dividends.

Stocks should be thought of in this context – income generators that differ from bonds in that the dividends can grow. And growth in dividends can lead to growth in the value of the stocks. Investors must keep in mind that stock dividends are NOT guaranteed and therefore prices of stocks can decline along with the dividends.

If we think of our stocks as income generators, it can change our perspective. When I took financial analysis courses in college (more years ago than I will admit), we were taught that stock prices are just the current value of all the dividends that they are going to pay in the future. This is even true of stocks like Amazon that does not pay a dividend. The expectation is that as Amazon becomes more profitable, it will likely pay dividends.

Dividends can only come if companies make earnings. Therefore, some investors can become obsessed with earnings and earnings growth. But we must remember that earnings are only good because they increase our dividends.

What is the outlook for Golden Eggs?

Many are now asking me if we are due for a correction in this stock market. In fact, I would go so far as to say that that is the expectation of most of our clients. In the context of this discussion, let's phrase the question as what is the outlook for potential increased dividends or more golden eggs?

The stock market has performed will recently, but not so much that you could label this stock market as a bubble and not even so much that a correction should be expected.

Since January 1, 2015, the S&P 500 is up about 17%. That is not annualized. The annualized rate of return for the S&P 500 in the last 27 plus month is a little more than 7%, or if we include dividends, a little more than 9%. That is actually less than the average rate over the last 50 years.

All of this is because of earnings. From 2015 into 2016, stocks suffered an earnings recession. Earnings shrank for seven quarters in a row with the streak ending in the fourth quarter of 2016. We often refer to the market as having the wisdom of crowds or having the collective wisdom of the millions of investors in the stocks. This is a good example. The market anticipated the earnings recession and did poorly for 5 quarters. It started to see the end of the earnings recession late last February and started going up. It correctly anticipated that earnings would hit a low with last year's third quarter and stocks have moved up since then.

In the first quarter, we saw stocks go up more. Why? FactSet reports that the collective forecast of first quarter earnings works out to a growth rate of just over 9%. For 2017, FactSet reports that earnings are expected to grow by over 10%.[2]

Further, the "quality" of earnings growth should be good. Investors want earnings growth to come from revenue gains, not from cost cutting. Quality earnings growth is from revenue growth. The reason investors like earnings to come from revenue growth is that cost cutting can only last for so long and because if all companies are cost cutting, that can bode poorly for the economy. Cost cutting usually means job cuts. Job cut can lead to consumers having less money to spend.

If we are getting revenue growth, we can get into a virtuous cycle with revenue growth leading to hiring or wage gains which are good for the economy. This is why we call earnings growth that comes from revenue growth as quality earnings growth.

FactSet estimates that revenue growth in the first quarter will be 7.8%, the best in some time. The maker of the S&P 500 Index, Standard & Poor's, is also forecasting higher earnings led by revenue gains.

Further, the good news is not limited to the United States as it has been for much of the economic recovery since 2008. According to the Brookings Institute and the Financial Times, an index of their creation called the Brookings – FT Tiger Index, suggests growth has picked up sharply in advanced and emerging economies in recent months.[3]

In summary, first quarter earnings are only the second quarter out of the last nine to show growth and because there is quality growth, it should be sustainable. Most importantly, earnings growth can lead to potential dividend growth and that is something we can actually spend.

Like all of you, we continue to be concerned about geopolitics. Tension between countries seems to have increased. We hope and pray that tensions will cool off. If they don't, not only will it likely threaten the economic growth that is just getting into higher gear, but it may lead to far more serious problems.

If not, for now we recommend staying the course, reaping the rewards of our golden goose, the dividends as our eggs and the stocks as our geese.

1 Financial Times, *Wall Street firmer as haven buying eases*, 18 April 2017, pp20
2 Financial Times, *Hopes rise for further S&P gains,* 16 April 2017, pp13
3 Financial Times, *Global economic recovery is 'broad-based and stable',* 17 April 2017, pp3