IDEA Dividends

March 31, 2020

Growing dividends are at the core of Confluence's Increasing Dividend Equity Account (IDEA) strategy. Given the unprecedented nature of a national economic shutdown to combat COVID-19, it is likely that many companies, including some that may be held in the IDEA portfolio, will choose to not grow their dividends and some may even choose to temporarily suspend or decrease their dividends during the economic shutdown. With this possibility in mind we thought it would be helpful to proactively discuss the situation and our planned response prior to any changes companies might make with their dividends.

Why are growing dividends beneficial?

First, it would probably be helpful to review why owning companies with growing dividends is a good investment strategy. When you purchase a stock, you are buying a fractional portion of a company with the expectation of receiving a share of its ongoing cash flow. Each year a company's earnings (cash flow) may be used to reinvest to grow the company, repurchase shares, pay dividends to the owners, or possibly do all three.

Over the long term, a stock's total return will be determined by the cash flow growth and dividends paid out to the owners. As a result, a company with a history of consistent and growing dividends indicates a company with consistent and growing cash flow – a recipe for good long-term investment returns.

The team at Confluence has a long track record of identifying and investing in companies that not only have histories of growing dividends but also have solid prospects that those dividends should continue to grow well into the future.

Why would a company temporarily suspend or decrease its dividend in the current environment?

We are in a most unusual economic climate, something like a mass-mobilization war, except that today the government has mobilized to protect the public from a new and potentially fatal virus. In order to combat this new enemy, federal and state governments have ordered the shutdown of large portions of the economy. Some companies will be faced with the almost unthinkable scenario of virtually no revenue for the duration of the battle, when just a few weeks earlier business continued at normal levels. During this economic shutdown, companies will need to reevaluate how they will spend their cash reserves and their (potentially greatly reduced) cash flow. This will likely result in decreased reinvestment for growth, the halting of share repurchases, and (for some) a temporary suspension or decrease of the dividends paid to owners.

While there are many differences between big corporations that trade on the stock exchanges and small, locally owned businesses, the decisions these businesses face during an economic shutdown are surprisingly similar. A small business (everything from a restaurant or retailer to a manufacturer or professional services firm) evaluating the impact of an economic shutdown has several decisions to make. At the end of each quarter, a business owner usually reviews the revenue, expenses, and resulting profits of the business and then decides whether to keep those profits in the business's bank account to fund future growth or to pay it out to the business's owners (i.e., distribute a dividend).

With a decrease in revenue, the small business owner must first decide how they plan to lower expenses, which are primarily employee costs and everyday operating expenses (hopefully, the government fiscal package will help with this). Depending on the type of business and the duration of the economic shutdown the business may face no profits, or even losses, during that time. As a result, the business owner will need to decide if they will still distribute a dividend that quarter, although that may mean drawing from the business's savings or borrowing money from the bank to pay it.

In this situation, the most prudent decision by the small business owner is to hold off on distributing a dividend until the business is back up and running. This same logic applies to the large corporations owned in IDEA. Fortunately, many large corporations will be able to bridge the gap, but still some may make the prudent decision to temporarily suspend or decrease the dividend. In the IDEA strategy, we seek to partner with high-quality management teams, so in this situation a dividend adjustment could be a reflection of good financial stewardship rather than an indication of long-term deterioration in fundamentals.

Large publicly traded corporations may find yet another reason to defer dividends for a temporary period. Noting that the current environment is like a major war, with the entire country devoted to the cause of surviving and defeating this virus, most of the population has come to understand that this cause involves shared sacrifice. If all are sacrificing for the overall good of the nation, many companies may determine that their shareholders should likewise participate in the sacrifice by foregoing the dividends otherwise due them. We would not be surprised to see companies that otherwise have adequate cash flow and cash reserves to pay dividends decide not to pay dividends during this time of conflict. These companies may choose to do so in solidarity with their customers, employees, and fellow citizens who are likewise sacrificing.

What does Confluence plan to do if a company in the IDEA portfolio suspends its dividend?

While the IDEA strategy has core criteria for evaluating rising dividends (namely, the company has paid a dividend for 10 years, and has raised it for seven of those 10 years with no dividend decreases), we also have a team of analysts who evaluate a company's business quality, intrinsic value, and ability to grow the dividend into the future. With these resources we plan to take a thoughtful approach to evaluating any companies in the portfolio that decide to temporarily suspend or decrease their dividends. Given the volatility in the markets, we do ***not*** plan to take a "shoot first, ask questions later" approach.

In normal times, we analyze the companies in the IDEA portfolio in order to identify deteriorating businesses *before* they are forced to dial back the dividend, but these are not normal times. As a result, we plan to evaluate any dividend suspensions or decreases as they occur, rather than trying to sell the stocks proactively. We want to use thoughtful analysis of the current circumstances, rather than a mechanical "sell rule" such as would be used by a passive ETF or index fund. We believe this approach will be especially appreciated by taxable investors who would prefer not to pay capital gains taxes on stocks sold due solely to the unusual conditions of the moment, only to find those companies resuming and increasing their dividends in the future.

Our objective is to come out the other side of this economic shutdown with a portfolio of high-quality companies that have strong prospects for long-term dividend growth. The result we do ***not*** want is a portfolio of substandard companies, each of which stretched to avoid a temporary dividend suspension, constructed only in order to stay technically within the growing dividend criteria. Of course, if there is a company that suspends or decreases the dividend and our analysis determines it will be more than a temporary issue, then we will sell that company from the portfolio.

We take great care in managing the funds entrusted to us in the IDEA strategy. Hopefully, this report has communicated the merits of the investment strategy along with how the committee plans to navigate these unusual circumstances. Of course, it's possible that no dividend suspensions or decreases will occur in the portfolio during this time, but we do not want an IDEA portfolio owner to be caught off guard should one occur. If you have any additional questions, please feel free to contact your Confluence representative for more information.

– Confluence Value Equities Investment Committee