Commentary

Dividend Strategy
Third Quarter  2016

Key Takeaways
• The economy remains mired in a weak recovery despite very low rates that have supported stocks but done little to spark revenue growth.
• Stocks in the traditional dividend-paying sectors are highly valued, but still look attractive compared to the yields offered by government bonds.

Market Overview and Outlook
The French expression - the more things change, the more they stay the same - applies in current financial markets. This year has played out like most others since the financial crisis: stocks grind higher, economic growth proves elusive, and central banks cannot raise interest rates for fear of tipping economies back into a recession. What is going on?

The story of the last seven years can be reduced to three big factors: (1) the real economy has remained frustratingly weak, (2) fiscal policy on a global basis has been disappointing, and (3) the central banks have been hyperactive in lowering interest rates.

The persistent weakness in the real economy is a conundrum. Since the collapse of 2008, the Fed has unleashed a torrent of monetary stimulus but the effect has been much less than it anticipated. GDP growth since 2008 has been well below the long-term average, in spite of unprecedented monetary policy. Looking forward, the economic outlook is not particularly rosy. Global growth is weak and appears to be slowing and U.S. economic activity, while better than most places, is also lackluster. Revenue growth for companies is hard to come by and corporate profitability, while still strong, appears to be inflecting downward. Auto sales, which make up 20% of total retail sales, provided some strength as very old cars were replaced, but those sales are now weakening. Even restaurants are slowing from strong levels. Shale oil production, a formerly strong factor in job growth, is way off because of low oil prices. Those lower oil prices have provided some relief to consumers and companies reliant on energy for production of goods, but much higher costs for health and medical services, including insurance, have drained too many family pocketbooks. State and municipal pension plans are struggling to meet their needed rates of return, which siphons money from needed projects.

The disappointing economic performance is reflected in the current political climate. We do not have a good sense as to what markets will do, regardless of who wins. This is the most polarizing election we can recall and we find the tone distressing. Clearly there is a lack of shared prosperity. The rising tide of the American economy used to lift all boats. In more recent times, the gains have not been shared as equally. History shows that weak economies can lead to political upheavals.

For the first year in a decade, incomes seem to be growing, but they are distributed very unevenly. Higher paying jobs have often been replaced by lower paying ones. Unlike the 1990s, when technology's dramatic expansion in computers and the internet created an economic boom, the unintended outcomes from incredible software and artificial intelligence have enabled fewer workers to do what many had done before. Wages, while not completely stagnant, clearly have not grown enough to offset higher health and education costs. The subject of lost manufacturing jobs going overseas is worth an entire college course, as it is complex and has been going on since the end of World War II.

We feel certain that anti-free trade rhetoric by both candidates is not the solution. The jobs are not coming back if big tariffs or walls are set up. Rather, the fear is retaliation by other countries. That is what happened in 1930, as the Smoot-Hawley Tariff Act, designed to protect American jobs, created a shutdown of world trade and helped turn a recession into the Great Depression. One certain outcome of the election will be more deficit spending, particularly on needed infrastructure. Rates could rise somewhat on that but fiscal stimulus should contribute to GDP and wage growth.

With everything going on in the world, it seems bizarre that the focus in markets continues to be whether the Fed will raise rates by a quarter point. Central banks are in a bind. The ultra-low rates since 2008 saved the economy from further collapse, as homeowners refinanced and banks reliquefied. But, as we have said, savers got the short end of the deal.

"The yield on many stocks is still attractive compared to puny rates on risk-free investments."
This is where we go off on a rant of sorts. For years, we have been talking about dividend-paying stocks as an alternative way of getting a stream of income. It is most certainly not risk-free, as stocks can have large moves in either direction. However, so many companies have a record of sustainable and even rising dividends that for people or institutions that can look past monthly or even yearly price fluctuations, good streams of income from dividends are achievable.

Since 2009, when the world was near depression, many dividend-paying stocks have had large advances. In light of this strong performance, we are frequently asked if dividend-paying stocks, particularly utilities and consumer staples, are overvalued. Yes, those stocks are expensive on a price-earnings ratio compared to the past 50 years. But the yields compared to the 10-year Treasury note are still high. Further, we continue to expect solid dividend growth in the years ahead and this growth will (1) provide growth of cash flow to shareholders and (2) provide a meaningful offset to rising rates whenever that time comes. In fact, as we stated last quarter, we do not see any asset category that appears cheap. Why sell a stable company with a growing dividend that is twice that of a 10-year Treasury note to buy something else? It is a difficult thing for people to accept. So why is it that the market grinds higher when the underlying news flow is generally poor?

It is because of interest rates. The yield on many stocks is still attractive compared to puny rates on risk-free investments. Central banks have driven rates so low and held them there for so long that they have forced investors into the equity markets. One side-effect of this which bothers us is the lack of conviction by recent stock buyers. It seems like the market moves are being dictated by the news of the day. That means the buyers could be quick to sell on any negative news.

We always worry about earnings season, as so many stocks have been having violent reactions. We are hopeful, but not certain, that October earnings announcements will be helped by the recent stability in cost of goods and relatively stable dollar. Too bad that so many areas of the world are struggling with lack of growth. We started this note by saying that the more things change, the more they stay the same. As we think about the next quarter and all that lies ahead, we can’t help but wonder if our year-end letter will have a different set of circumstances to evaluate.

**Portfolio Highlights**

The Dividend Strategy portfolio underperformed its S&P 500 Index benchmark during the third quarter. On an absolute basis, the Strategy had gains in nine of the sectors in which it was invested for the third quarter (out of 11 sectors total). The main contributors to Strategy performance came from the information technology (IT) sector while the main detractors came from the consumer staples sector.

On a relative basis, performance was negatively impacted by sector allocation and stock selection decisions. An underweight allocation and stock selection in the IT sector detracted the most from relative performance during the period while stock selection in the financials and industrials sectors and an overweight to consumer staples also hindered relative performance. On the positive side, stock selection in the utilities, real estate and consumer staples sectors and an underweight to health care contributed the most to relative performance.

On an individual stock basis, positions in Kimberly-Clark, WEC Energy Group, General Electric, Wells Fargo, and Coca-Cola were the greatest detractors from absolute returns in the third quarter. The largest contributors included Apple, Microsoft, Brookfield Infrastructure Partners L.P., Texas Instruments, and Spectra Energy.

During the third quarter we established new positions in Mondelez International in the consumer staples sector and AstraZeneca in the health care sector and closed a position in AIG in the financials sector.

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