

## The Decade of the Dividend?

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Stephen Goddard of the New Market Fund sees cash distributions playing a bigger role in investment – and he runs his fund accordingly.

Stephen M. Goddard, founder of investment firm The London Company and manager of its [New Market Fund \(AVMIX\)](http://host.businessweek.com/businessweek/Corporate_Snapshot.html?Symbol=AVMIX), expects "very modest returns" from stocks generally in a market with relatively high valuations. But he's not so worried because he expects dividend pay-outs to "increase substantially over the next several years." Indeed, that likelihood has Goddard comparing the next decade to "a period like the '30s and '40s, and even the early '50s," he says, "when investors purchased stocks simply for the dividend, not for speculation."

He also notes that most mutual-fund managers are "closet indexers," investing in 100 or so stocks, when 95% of diversification can be achieved with 20 or fewer securities. As a result, the New Market Fund is much more concentrated than most equity funds, yet it's among the lowest-risk funds listed by Morningstar and handily outperforms the Standard & Poor's 500-stock index.

Goddard says the fund looks for companies with rich cash flow and the ability to maintain dividends. Its top three holdings are all in financial services: Berkshire Hathaway (BRKB), White Mountains (WTM) and Markel (MKL). He also likes health care names Johnson & Johnson (JNJ) and Novartis (NVS), and consumer stocks such as Anheuser-Busch (BUD), Kraft (KFT) and Gillette (G).

These were a few of the points Goddard made during an investing chat presented December 23, 2004 by *BusinessWeek Online on America Online*, in response to questions from the audience and from Jack Dierdorff of *BusinessWeek Online*. The following are edited excerpts from this chat.

**Q:** Steve, do you think this Santa Claus rally has legs to take it beyond the holidays?

**A:** It's a little ahead of itself, relative to where the recent valuation levels should currently be. Usually, the market trades at about 100% to 110% of gross domestic product, and now we're at about 140% of GDP. So either the market needs to drop substantially or the GDP has to catch up to market valuation. Therefore, we expect very modest returns over the next decade. We expect that dividends will be a much more integral part of your returns going forward, and we expect dividend pay-outs will increase substantially over the next several years.

**Q:** With your cautious view of the market ahead, what should investors do? What's your fund doing?

**A:** We're positioning the fund to look for companies that have the ability to pay substantially higher dividends going forward. Therefore, we look at companies that generate a lot of free cash flow, have relatively minor capital needs, or have substantial amounts of cash on hand. For instance, our largest holding, Berkshire Hathaway, is sitting on almost \$38 billion in cash, and

they probably have an additional \$30 billion in short-term securities. They could do something similar to Microsoft, and if they wanted to, they could pay \$38 billion out as a special dividend. They also could have a much higher dividend going forward on an on-going basis.

Tyco is another example of a company that has a large amount of free cash flow, yet their pay-out are very low. You're starting to see larger companies increase their dividends by 15% to 25%. We will likely see other companies follow suit.

We really believe that the market is going back to a period like the '30s and '40s, and even the early '50s, when investors purchased stocks simply for the dividend, not for speculation. It used to be, up until the late '50s, that the overall yield on the stock market was higher than that on bonds. It's only in the last 20-30 years that dividends have become a very small component of your return because of the above-average appreciation in the marketplace of 18% per year.

As we go into the new decade, we'll probably have the other extreme – below-average appreciation and substantially higher-growing dividends.

**Q:** Can you sum up your strategy for the New Market Fund and for your investment firm, The London Company?

**A:** Our strategy for the fund and the firm are the same. We're simply looking for high-quality, predictable, free cash flow companies that have the ability to pay growing dividends over the next decade. More importantly, we believe that we don't overdiversify, so that we give the fund the ability to outperform the overall stock market. Some 95% of the industry tends to be closet indexers, buying 100-plus securities with no meaningful position in any one particular. That's the reason why most active money managers underperform passive indexes.

**Q:** And has the fund outperformed the overall market?

**A:** Oh, yes. Over three years, five years, since its inception. Year-to-date, we have outperformed the market significantly.

**Q:** If you don't overdiversify, how many stocks does the fund hold?

**A:** Currently, we hold 40 securities, which is more than we normally hold, but because of the recent fund that we acquired and for tax reasons we had to hold more securities than we normally do. Our top 10 positions are normally over half of the portfolio. In some cases, we have had individual positions which were well over 10% of the portfolio. You have to take a meaningful position somewhere in order to outperform over time.

**Q:** Besides BRK and TYC, what are some of your top holdings? Are they mostly large-caps?

**A:** Our average market cap is well over \$20 billion. We do have small-cap and mid-cap names in our portfolio, but less than 25%. Besides Berkshire, our largest positions are White Mountains, Markel, Kraft, and Gillette. All of these companies are very well managed, grow

cash at above-average rates, and have the ability to pay growing dividend pay-outs.

**Q:** Are there areas where you are most likely to find the kinds of stocks you like? I would guess tech doesn't have many of them.

**A:** Normally, financial services, consumer, and health care. Technology normally isn't predictable enough for our comfort level. We like to stick with companies we know are going to be around 10 years from now.

**Q:** Do you have any worries about rising interest rates?

**A:** Well, we don't try to make predictions as to whether interest rates are going up or down – although I do have to admit everyone seems to be betting on rates going up, which makes me think from a contrarian viewpoint that maybe they could be coming down. I can't ever remember a period in recent history where everyone is convinced long rates have to go up. We've seen short rates rising, but long rates holding steady ....

**Q:** What companies do you like in financial services?

**A:** Our top three holdings in the fund are all financial services: Berkshire Hathaway, White Mountains, and Markel. All of these companies are growing at a rate at least double the average company. Yet they trade at a discount to the market. One of our recent purchases, Genworth (GNW) is a recent spin-off of General Electric. GNW trades at a modest premium to book value, yet has the potential to grow at a double-digit pace.

**Q:** What do you like, and/or own, in health care?

**A:** We have positions in Novartis and Johnson & Johnson. Both have strong product pipelines, are well managed, and have strong financials.

**Q:** Where would you put new money at this point with a slightly conservative approach?

**A:** Despite the market being overvalued, we're being very selective in finding opportunities in stocks such as Berkshire Hathaway, Genworth, Anheuser-Busch, and Tyco. For example, Berkshire Hathaway has an adjusted book value well in excess of its current stock price. Anheuser-Busch is modestly priced, despite its dominant position in the beverage market, and it has a very low cash dividend pay-out.

**Q:** Any theories on why these solid stocks have such relatively low valuations?

**A:** Mainly short-term concerns. In the case of Berkshire, investors are concerned about Buffett's age, recent earnings disappointments, and just a general lack of popularity with insurance stocks. With BUD, the concern is over short-term earnings disappointments with respect to high-premium spirits taking share away from the domestic beer market. All of these short-term issues can be corrected. We tend to take a longer view than most.

Looking ahead of the immediate future, we have nothing to add over the 100,000+ other analysts focusing on next quarter or next year. Instead, we look beyond at a 5- to 10-year timeframe.

**Q:** Earlier you mentioned the cash and dividend potential in the consumer sector. What might you like there?

**A:** BUD is one that we just mentioned – Gillette, Cadbury, Kraft and Altria. Again, we have companies that are retaining more cash than they need, are way overcapitalized, and have the ability to pay substantially higher dividends.

Unfortunately, most management teams are still living in the '80s and '90s, thinking they'll be able to use the cash for internal growth opportunities or acquisitions. But with the new dividend tax law, general overcapacity in nearly every industry, a mature economy and a flat stock market, they'll feel increasingly higher pressure from shareholders to return the cash to them.

**Q:** If you look out 5 to 10 years, how do you do the research that gives you such a long-term perspective?

**A:** We simply look at the current cash-flow characteristics of a company, its competitive position, what it has done in the past, and what it's likely to do in the long-term future. We don't make bold predictions about the future growth of any company. Instead, we use extremely modest growth forecasts and wait for the market to bring valuations in line with our buy target.

Normally, companies that had very predictable cash flow generation in the past don't change dramatically over the long term, at least in the sectors we focus on (consumer staples, financial services and health care). We don't need to be exactly right on next quarter's earnings estimate or next year's growth forecast, but just roughly right about the company's long-term cash generation. There may be only 300 companies we have confidence in where we can make such long-term predictions, and that's the universe we focus on.

**Q:** And have you been "roughly right" with those predictions so far?

**A:** Well, I think the fund's performance speaks for itself. You don't have to be right all the time, but just a little bit over half the time, as long as you don't make any major mistakes. What kills portfolios are the positions where you're wrong on, when they fall in price 50%-plus. That's what we try to avoid with many safety measures.

**Q:** How would you rate your fund's risk level?

**A:** Very low. Morningstar has us ranked in the lowest-risk fund category. Our volatility is less than two-thirds the average fund. We normally participate in less than half of a down market, but 75% to 95% of an up market. That's due to our conservatism in the positions we buy. You would think, with our above-average concentration, we would be far more volatile, but we tend to defy conventional wisdom by having the opposite.

Normally, you can get 95% of your diversification benefit from 20 securities or less, yet the average fund purchases 100 or more securities, diluting the fund shareholders' performance. We don't think the average fund will have the luxury of hugging a benchmark over the next 10 years, due to the reasons I mentioned before – a modest market environment. One will have to focus on a select few high-quality, dividend-paying securities to generate satisfactory returns, instead of buying two of everything.

**Q:** Have you done anything with energy stocks, which are in the spotlight now because of oil prices?

**A:** Historically, we have underweighted our fund in energy because of the volatility in prices and the lack of predictability, longer-term. We do have a select few holdings in Royal Dutch and ChevronTexaco. These tend to be more predictable than the average energy company. We're not anxious to add more to this sector due to the recent run-up in energy prices and the respective valuations of securities in this sector. You typically buy these companies when oil prices are at \$10-\$13 a barrel, not \$40-\$50 a barrel.

**Q:** You referred to benchmarks a moment ago. How is the New Market Fund doing relative to the S&P 500?

**A:** The New Market Fund has outperformed by a significant amount. For five years, we have outperformed the market by nearly 8.5% a year. For three years, we have outperformed the S&P 500 by nearly 5% a year. For one year, we have outperformed the S&P 500 by 3%, with a 16% rate of return. And year-to-date, we're up nearly 15%, which is 4.5% above the S&P 500. ■

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