Dividend Equity Strategy

Most investment managers will claim that their portfolios have some element that is unique versus its competitors. Whether that is true or not, we have managed the Dividend Equity Strategy for the past ten years with a different investment philosophy than other managers in our peer group. This includes our ability to invest in small to large-cap stocks, domestic and international companies, and equity styles that include value and growth securities. The portfolio will adjust its allocation to these various market sectors based on our top-down outlook for the economy and current position in the market cycle.

When investors are rational, and the economy is functioning in a normal cycle of recovery/plateau/decline/recession, it is easy to make any necessary adjustments to a portfolio. Likewise, portfolio management becomes very difficult when an economy has no sense of direction, or when investors are extremely risk tolerant and ambivalent about rising valuations. Patience is a virtue under those environments, and this has been the case for several years.

In February 2009, we saw many signals that the worst of the meltdown in the financial sector was behind us and the economy had found its footing. We reduced the portfolio’s weighting in “defensive stocks” and moved the funds into mid-cap and higher-beta stocks. Excess cash was put to work. A few weeks later, the market began its eight-year recovery that continues in 2017.

Along the way, there have been few signals from the economy or the market that encouraged us to make significant changes in the portfolio’s holdings or sector allocations. That is a drawback from an economy that grew between 1-2% each quarter with no movement in interest rates. There was a reason why the markets became obsessed with the Federal Reserve and whether they might raise interest rates to 0.75%. That reason was “boredom,” and not because that level of interest rates would have any impact on the economy.

In 2016 and early 2017, the portfolio’s weighting in Western European stocks was increased to 16% as their valuations were at a significant discount versus the US market. The portfolio also reduced its exposure to value stocks and increased its weighting in core and growth stocks based on our tepid outlook for U.S. economic growth. We also moved to a significantly higher average market capitalization as the Strategy realized long-term gains in several mid-cap stocks.

The three adjustments have paid off. While Brexit delayed the expected recovery in European markets until 2017, they have been a significant contribution to this year’s performance. A Morningstar peer group of 150 dividend managers indicates that the average allocation to international equities is around 2.5%. Many dividend managers completely avoid non-domestic securities.

The movement into core and growth stocks occurred in 2016 and 2017, and value continues to significantly underperform growth stocks (more than 1,200 basis points in 2017). The same is true in market capitalization as large-cap stocks are outperforming mid-caps by nearly 300 basis points.

These three portfolio adjustments were strategic decisions based on forward valuations and the current market cycle. Similar adjustments have been made over the years but were never implemented to capture short-term swings in the market. We leave that to a completely different group of investment managers. Our portfolios are always built for the long-term results.