

Financial Control Limited

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Thought of the Month - How should a potential war with Iraq factor into an investment plan?

As a general rule, I feel that investors should ride the roller coaster of politics like all of the others, including those of the natural business cycles and those that are not so natural such as oil shocks, terrorist attacks, and other man-made calamities. That is, the most important thing to consider is whether equity markets as a whole are under or over-valued. If over-valued, then the astute long-term investor should ensure that the portfolio has been rebalanced to reduce, but not eliminate, exposure to the equity markets. If under-valued, then the same investor should ensure that equity exposure is near the maximum acceptable level considering his or her investment time horizon and risk profile. After this simple assessment and rebalancing exercise, there are only two choices: i) let the exposure to the equity markets ride out the storm of an impending war; or ii) if an investor is more risk averse, hedge the equity portion of the portfolio perhaps by purchasing put options. But the benefits of diversification should reduce a strong need to significantly hedge equity exposure: in other words, if investors panic, they will typically rush into AAA credit rated bonds. The cautious investor who holds a diversified portfolio that includes an allocation to such bonds will therefore benefit from the rising tide in their bond portfolio, and will find it easier to stomach any losses in their equity portfolio.

Why is the Sky Blue? Why are guaranteed funds a bad idea with a good sales record?

At risk of letting the cat out of the bag, and of offending my friends in the investment community who offer guaranteed funds, I hope that any serious investor who reads this paragraph will take note: In principle, there are two basic ways to create a guaranteed fund: i) invest a substantial portion of the capital received from each investor (say 60% or more or less depending upon the number of years until maturity of the investment fund) in AAA rated, zero-coupon bonds and the remainder in risky assets such as equity securities or hedge funds. When the fund maturity date is reached, the zero-coupon bonds will have reached par (i.e., 100) and no matter what performance has arisen in the risky assets mentioned above, the investor will at least receive 100 from the bond portion of the fund thereby "guaranteeing" his or her initial investment. ii) invest all of the funds in risky assets such as equities or hedge funds and carefully monitor the performance. If performance happens to deteriorate, dynamically hedge the fund by liquidating risky investments and moving the proceeds to AAA rated, zero-coupon bonds that will ensure 100 is available at the end of the fund's life. The worse the performance of the risky assets, the more that is liquidated and transferred to "safe" assets.

It doesn't take a rocket scientist to replicate the above strategies without incurring any of the fees commonly embedded in such structures. But if there is any doubt, call FCL to see if we can save you the fees, net of our costs, by explaining how this process works in more detail! Unfortunately, many investors feel safe investing in guaranteed funds in these turbulent market times, which explains their popularity despite fees that can reach as high as 8% of the initial investment amount.

Nourishment - Questioning the use, or lack, of cash dividends

I sometimes wonder whether the theoretical purpose of cash dividends is consistent with their actual use. According to Benjamin Graham¹, some companies should periodically pay cash dividends to shareholders, such as those in mature industries where it is difficult for such companies to reinvest earnings in their businesses and exceed their cost of capital. On the other hand, some companies can reinvest earnings in their businesses and earn a return in excess of their cost of capital, which means that investors could be better off allowing share prices to appreciate over time instead of collecting annual dividend checks.

On a micro level, what about companies that hoard cash? Should investors let these companies sit on the cash until a favourable opportunity comes along or should capital be returned to investors? I believe that these questions are unrelated to annual dividends and that firms with vast sums of excess cash should strongly consider share buy-backs and/or one-time special cash dividends. On a macro level, should investors watch the one year bond yield (currently about 1.2% for US Treasuries maturing in one year²) and when it reaches a certain multiple of the average annual dividend yield of say the S&P 500 (currently less than 2% per annum³), should investors view that as a good time to lower their equity exposure⁴? It is difficult to generalise about such a ratio for the entire market in the same way that it is difficult to generalise about price/earnings ratios⁵ for the entire market. But industry by industry, such a ratio could be an interesting metric to watch.

So what about the current uses of cash dividends? Are such uses consistent with their theoretical justification as mentioned above? It seems fairly clear that there are at least four categories of companies: i) Companies in mature industries where periodic cash dividend payments of 100% of earnings would be optimal from an investor's standpoint ii) Companies that are in strong growth industries where investors would benefit more from share price appreciation associated with 100% earnings reinvestment iii) Companies somewhere in the middle of categories i and ii above and iv) Companies that hoard cash in case an appealing use is identified in the near future. Based on simple observations, although there does seem to be some correlation between industry growth rates and whether a particular industry pays out dividends or not, the level of dividends paid as a percentage of such growth seems to be quite random. In fact, I can remember in my auditing days when we used to notice that some of our clients proudly presented many, many years of smoothly rising dividend payments in their annual reports without any accompanying explanation of how the dividend pay-out ratio (as a percentage of earnings) was determined, and whether it made sense given the firm's investment opportunities and cost of capital. After reading many annual reports over the years, I don't think my early experience was an isolated exception but instead, was quite a common approach to cash dividends payments by modern corporations. This has led me to believe that many firms pay smoothly, rising annual cash dividends simply to give an impression that they are profitable, stable enterprises because perhaps many investors do not determine whether such a policy makes any sense. Then there are other firms that hide behind the veil of "the new economy" to justify paying no dividends, even though such firms may in fact be operating in very mature industries.

¹ See chapter 19 of *The Intelligent Investor*, Fourth Edition, 1973, Benjamin Graham,

² Source: Bloomberg

³ Source: Barclays Global Investors

⁴ Some observers think so. See <http://tal.marketgauge.com/dvmgPro/charts/CDIVTBL.HTM>

⁵ Some industries typically exhibit lower price/earnings ratios than others.

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