# April 2024

From the WSJ on May 1:

## Stocks Extend April Pullback

BY CHARLEY GRANT

Stocks ended their worst month of the year ....

The broad index fell 4.2% in April, its worst performance since September, after posting its best first-quarter performance since 2019. The Nasdaq and Dow dropped 4.4% and 5%, respectively, for the month.

... inflation is still running hotter than the central bank would prefer. Consumer prices have increased more than Wall Street had expected for three months in a row.

That trend has dimmed Wall Street's hopes for interest-rate cuts in the near future. Investors entered the year expecting as many as six cuts in 2024, and now many doubt there will be any cuts at all.

Fed officials are expected to hold their benchmark federal funds rate steady at its highest level in more than two decades at its policy meeting, which concludes Wednesday (they did). On Friday, April jobs data will offer a fresh look at the state of the labor market (jobs came in way below expectations, which was received positively by stocks).

The benchmark 10-year Treasury yield settled at 4.683% Tuesday, up from ... 4.192% on March 28 (and is now down to 4.5% after Friday's jobs report). It was the largest monthly increase in yields since September 2022. ...

Earnings season has been a relatively bright spot amid the recent gloom. S& P 500 companies are increasing first-quarter earnings by 3.9%, according to FactSet, when blending actual results with analysts' forecasts. ...

Two from Morningstar:

## The Dangerous Myth of 'The New Normal'

The odds are against those who believe this time is different.

**John Rekenthaler** Apr 11, 2024

**Another New Normal!**

On March 1, 2009, Ian Davis of McKinsey & Company published a short article entitled, "The New Normal." The phrase was preowned, dating back to at least 1918. Its meaning was also well-established. A New Normal occurs after a disaster overturns the existing conventions. After that, things will not be the same.

Davis, however, was the first to apply the term to the post-2008 economy. The global financial crisis had crushed the job and stock markets. In January 2008, the unemployment rate in the United States was 5.0%. Fifteen months later, it was 8.7% and rising. Meanwhile, the Dow Jones Industrial Average had dropped to 7,062 from 13,264. The same pattern occurred throughout the developed markets—Germany, France, Japan, and the United Kingdom. (None of which prevented voters in every country from believing that their nation's politicians were uniquely at fault.)

Davis phrased his argument cautiously. Every futurist errs; only the foolish get caught out. However, he did provide three tangible forecasts:

1. Companies that use high leverage will have lower profit margins.
2. Government regulation will be "permanently" higher.
3. Consumption growth in the United States will slow.

**The Reality**

The first prophecy was false. Today's US corporate profit margins are fatter than during anybody's investment lifetime. Even if companies with high leverage have fared less well than lower-debt firms—I cannot find the data to confirm or deny—their shareholders can have no complaints. The rising tide has floated all boats.

The second belief was technically correct, but inconsequential. The Dodd-Frank Act, passed in 2010, did increase federal oversight, particularly of banks. However, as evidenced by the rise in corporate profit margins, neither that bill nor the government's other post-2008 responses have prevented companies from doing what they wish. Such is the legislative process. Politicians propose; businesses squawk mightily; and when all is said and done, things proceed as before.

The third prediction, it must be granted, was spot-on. Consumption growth in the United States has indeed slowed, significantly.

**Enter Bill Gross**

Davis' article imparted strategic guidance to corporate managers. Going forward, they would need to reduce leverage (not so), accept more government interference (only modestly), and realize that increases in US consumption would cease to drive global growth (true). It did not offer investment counsel.

But Bill Gross would. In summer 2009, the then-manager of Pimco Total Return Fund PTTRX began making speeches that extended Davis' arguments. Portfolio managers tread less carefully than consultants. Brave predictions attract public attention, and where attention goes, investment assets often follow.

To be sure, Gross was brave. In "On the 'Course' to a New Normal," published on Sept. 1, 2009, Gross inked his thoughts. He adopted both McKinsey's terminology and framework. The New Normal would be marked by deleveraging, increased government interference, and declining American influence. However, Gross openly stated the investment implications that Davis had avoided.

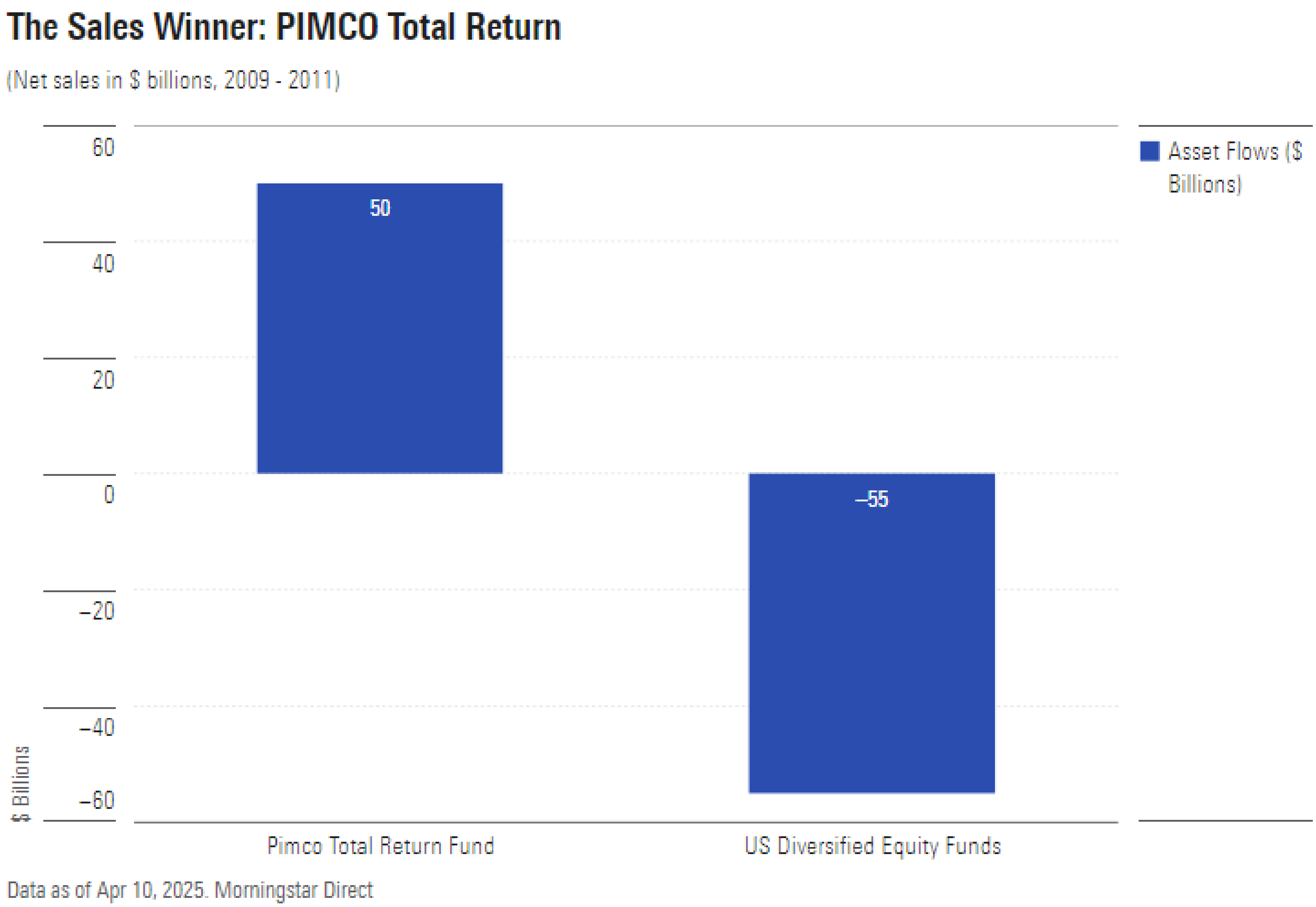
1. *Corporate US profits would stagnate.* Rather than increase their earnings by borrowing funds that cost less than their return on capital, companies would fly into a headwind by reducing their debt. When combined with sluggish consumer spending, wrote Gross, "economies will grow very slowly as opposed to growing like weeds, the way children do." Consequently, corporate profits would become "relatively static."
2. *Stock market returns would be commensurately weak.* Through recent history, wrote Gross, "it has paid to buy the [stock market] dips, because markets, economies, profits, and assets always rebounded and

went to higher levels." Those beliefs came naturally to children of the great bull market. After 2008, however, it was time to become a "chastened adult." Under the New Normal, investors would need to act "conservatively and avoid critical mistakes." How so? By recognizing the need for "stable and secure income."

### The Wrong Choice

Which fund might provide that stable and secure income? You surely can guess. In fairness, Gross did not contend that Pimco Total Return would outgain the stock market. Rather, the contest between equities and bonds would be a depressing draw, with each asset recording "seemingly inexplicably low total returns."

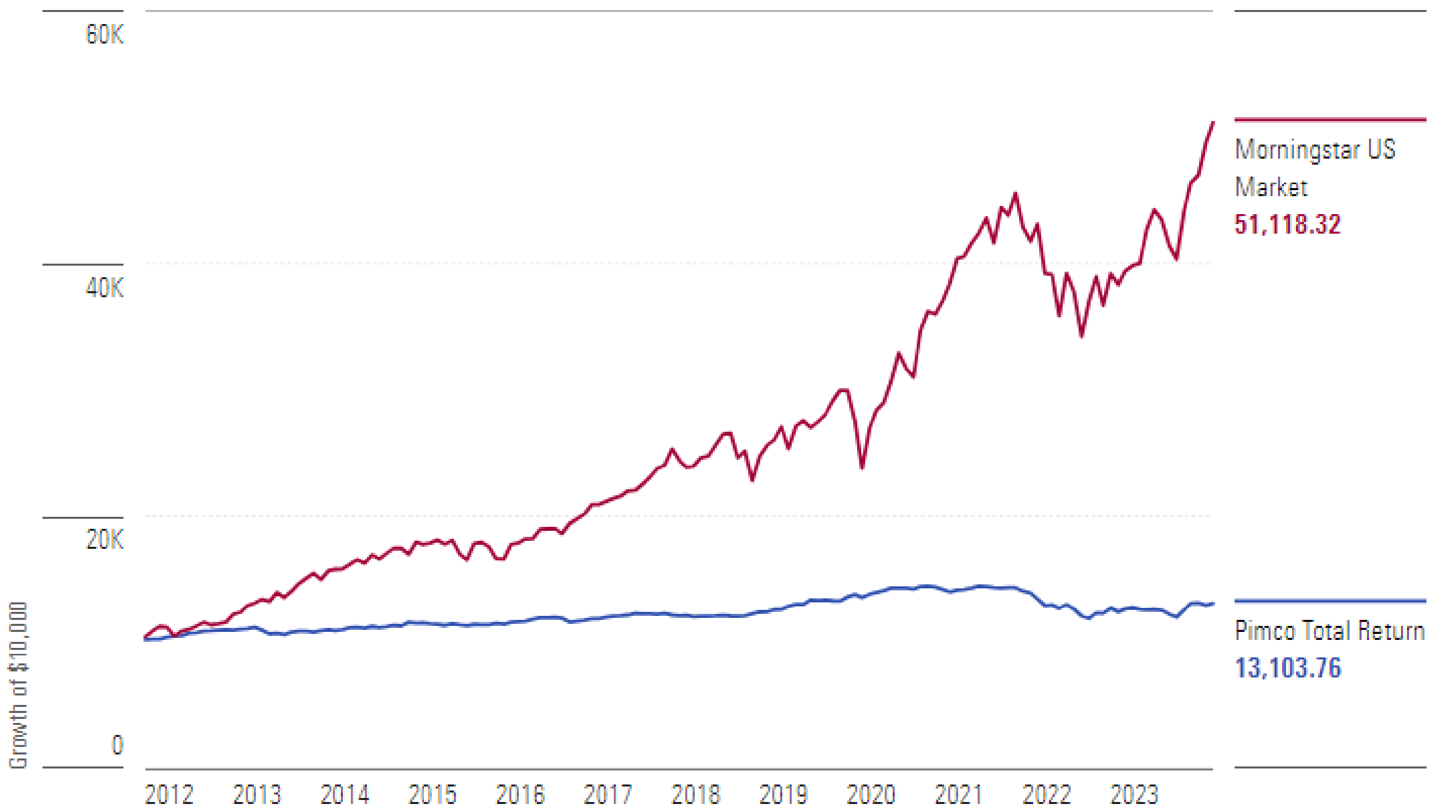
Gross' campaign was hugely influential. Of course, his arguments were scarcely the only reason why equity investors wavered. Once bitten by a powerful bear market, twice shy. But Gross' repeated assertion that stocks were destined for mediocrity certainly played its part in depressing sales. Expecting the worst, investors redeemed their US equity funds, while flocking to Pimco Total Return.




The outcome of their collective decision was worse than anybody could imagine, at least as measured in relative terms. The chart below shows the growth of $10,000 since January 2012 for: 1) US equities, as represented by Morningstar US Market Index and 2) Pimco Total Return. In the previous three years, more than $100 billion had headed in the wrong way.

The Performance Winner: US Equities

(Growth of $10,000, January 2012 - March 2024)




Data as of Apr 10, 2024. Morningstar Direct

**Human Nature**

I think that Bill Gross fully believed in his vision of the New Normal. Yes, that outlook was deeply self-serving, but so goes the investment business. Growth-stock managers perceive opportunities everywhere; any day now, value investors expect that their holdings will turn around; and bond-fund managers anticipate economic gloom. People see what they wish to see. Such is human nature.

The error Gross made—as did those who followed his advice—was in discounting the power of precedent. Revolutions are often proclaimed but only infrequently sighted. As a result, the odds are strongly against those who alter their investment practices because they are convinced that, at long last, this time will be different. The latest New Normal was not. Woe to those who believed otherwise.

# There Is Nothing Special About Dividends

Why they’re not a tax-efficient way to return capital to shareholders.

**Larry Swedroe** Apr 10, 2024

In my role as head of financial and economic research at Buckingham Wealth Partners, I am often asked by investors about dividend growth strategies—strategies that are popular among retail investors who, for behavioral reasons, have been found to have a preference for dividends. I'll review the financial theory about dividends and then the empirical evidence on the performance of dividend growth strategies.

## A Dollar Is a Dollar

In their 1961 paper "Dividend Policy, Growth, and the Valuation of Shares," Merton Miller and Franco Modigliani famously established that dividend policy should be irrelevant to stock returns. As they explained it, at least before frictions like trading costs and taxes, investors should be indifferent to $1 in the form of a dividend (causing the stock price to drop by $1) and $1 received by selling shares. This must be true, unless you believe that $1 isn't worth $1. This theorem has not been challenged since.

Moreover, historical evidence supports this theory—stocks with the same exposure to common factors (such as size, value, momentum, and profitability/quality) have the same returns whether or not they pay a dividend. Yet, many investors ignore this information and express a preference for dividend-paying stocks.

## Dividend Aristocrats

One popular dividend strategy is to invest in the "dividend aristocrats." For example, the S&P 500 Dividend Aristocrats measures the performance of S&P 500 companies that have increased dividends for the last 25 consecutive years. And there is an exchange-traded fund based on that index, the ProShares S&P 500 Dividend Aristocrats NOBL. In a January 2019 blog post titled "Dividend Growth Strategies and Downside Protection," S&P's Phillip Brzenk, global head of multi-asset indexes, examined the performance of dividend growth strategies, specifically during periods of negative market performance. He found: "Since year-end 1989, there have been six calendar years of negative performance for the S&P 500—and in all six years, the S&P 500 Dividend Aristocrats outperformed the equity benchmark by an average of 13.28%. In fact, the S&P 500 Dividend Aristocrats produced a positive total return in three of those years."

Examining the performance on a monthly basis, he found: "The S&P 500 Dividend Aristocrats outperformed the S&P 500 53% of the time, by an average of 0.16%. When isolated to down markets, the S&P 500 Dividend Aristocrats outperformed over 70% of the time and by an average of 1.13%. In up markets, the S&P 500 Dividend Aristocrats underperformed 56% of the time, but at a lower average magnitude (-0.34%). This shows that the S&P 500 Dividend Aristocrats has delivered downside protection in months when the S&P 500 lost ground." Of course, markets tend to be up more than they are down, so an advantage in down markets doesn't necessarily translate into an advantage overall.

Brzenk also found that "the lower the return of the S&P 500, the better the relative performance was for the S&P 500 Dividend Aristocrats. We see the batting average was typically better for the more negative months than the less negative months. Additionally, we observe that the average excess return over the S&P 500 was higher in the most negative months. Since 1989, the S&P 500 has lost 5% or more in 31 out of 348 months (~9% of the time). In these months, the average excess return for the S&P 500 Dividend Aristocrats was 2.46%, with a hit rate of 81%. The median excess return was of similar magnitude (2.32%); therefore, the results were not skewed by only a few months—rather, there was consistent outperformance."

## Is It Dividends or the Quality Factor?

The evidence seems to conflict with financial theory that says dividends don't matter, which raises the question of whether a focus on dividend growth adds value, especially in down markets: Is there something unique about companies with growing dividends? Or can the returns of the stocks with growing dividends be explained by exposure to common factors that have been found to explain the vast majority of equity returns—market beta, size, value, momentum, and quality? In other words, do companies with the same exposure to these factors have the same performance whether or not they have growing dividends or even pay dividends at all?

To answer the question, I'll examine the performance of the two largest dividend-growth ETFs (with a total of more than $89 billion in assets) demonstrating that investors believe the strategy adds value. I used the regression tool available at Portfolio Visualizer. The table below shows the loadings (how much exposure the funds have to each factor) as well as the funds' annual alpha.

**Performance of Two Largest Dividend-Growth ETFs**

| Data | ProShares S&P 500 Dividend Aristocrats (NOBL) | Vanguard Dividend Appreciation (VIG) |
|---|---|---|
| AUM (March 18, 2024) | $11.9B | $77.6B |
| Expense Ratio (%) | 0.35 | 0.06 |
| R-Squared (%) | 91.0 | 94.6 |
| Market Beta | 0.95 | 0.92 |
| Size | -0.01 | -0.12 |
| Value | 0.16 | 0.06 |
| Momentum | 0 | 0 |
| Quality | 0.33 | 0.28 |
| Annual Alpha (%) | -1.89 | -0.94 |
| Period | Nov. 2013-Jan. 2024 | June 2016-Jan. 2024 |

What do we learn from the above data? First, the high R-squareds (especially in the case of Vanguard Dividend Appreciation VIG) demonstrate that the returns of the two funds are well explained by their exposure to these well-documented common factors. Second, some of the outperformance in down markets is explained by the fact that the market betas of the two funds are below 1—they have less exposure to market beta than the market does. Third, the funds also have negative exposure to the size factor—their holdings are larger than those of the market. And large stocks tend to outperform riskier small stocks in bear markets. Fourth, the two funds have large and highly statistically significant (t-stat of at least 5) exposure to the quality factor. Quality stocks are "defensive," tending to outperform in down markets. And finally, and perhaps most importantly, the two ETFs both have economically significant negative alphas (negative 1.89% for NOBL and negative 0.94% for VIG), far greater than their expense ratios. That means the funds were subtracting value, not adding value.

The evidence is consistent with economic theory: There is nothing special about dividends, with the returns of dividend-paying stocks well explained by exposure to common factors. Dividends are neither positive nor negative, at least from a pretax perspective. For taxable investors, dividends have negative implications relative to share repurchases. In addition, a focus on dividends reduces diversification because about 60% of US stocks and about 40% of international stocks don't pay dividends. Thus, any screen that includes dividends results in portfolios that are far less diversified than they would be if dividends were not included in the portfolio design. Less-diversified portfolios are less efficient because they have a higher potential dispersion of returns without any compensation in the form of higher expected returns (assuming the exposure to common factors is the same). And finally, a focus on dividends often leads to investing in US equities, creating a home-country bias and a less diversified portfolio.

The bottom line is that dividend-growth strategies are basically quality strategies. The good news about the quality factor is that the premium (about 4.8% a year since 1958) has been persistent and pervasive around the globe. However, there are no generally accepted, logical, risk-based explanations for the quality premium because quality stocks are, by definition, safer investments. And safer investments should have lower returns. Thus, the quality premium is a behavioral anomaly. And without a risk-based explanation, it's possible that the premium could shrink or even disappear, especially because the premium has become well known since the publication of research such as the 2013 studies "Global Return Premiums on Earnings Quality, Value, and Size" and "Buffett's Alpha." The popularity of the strategy could cause the trade to be "crowded," driving valuations higher and expected returns lower.

### Investor Takeaways

First, there is nothing special about dividends except that they are a tax-inefficient way to return capital to shareholders, and they are certainly not income (except from a tax perspective); they are just a return of capital. Second, investors are better served by focusing on investing in strategies that provide exposure to the factors they want to invest in. A focus on dividends, whether dividend growth or high-dividend yield, is not likely to add value.

An article on the front page of April 5th's WSJ addressed 3 potential conflicts of interest that "Fee-Based Advisers", like Hughes Capital Management, may have:

# Hidden Conflicts Arise With Fee-Based Advisers

BY ANNE TERGESEN

A seismic shift in the way Americans pay for financial advice has better aligned investors' fortunes with those of the people managing their money. It hasn't erased conflicts of interest.

In the past decade, people have moved trillions of dollars to advisers who charge fees rather than commissions. These advisers typically charge clients annual fees, often between 0.75% and 1.25% of an investment portfolio.

The fee-based financial planners are a hit with regulators and consumer advocates, partly because they often don't earn commissions, a practice that has encouraged some brokers to push expensive financial products or recommend potentially costly moves, including frequent trading.

Still, the fee-based structure can tempt advisers to make recommendations that maximize a portfolio balance, even when doing so isn't in a client's best interest, according to academics and researchers. In one example, people who pay advisers portfolio-based fees claim Social Security earlier than what is often considered ideal, and at the same age as those who aren't getting any advice at all.

"Fee-based compensation is generally considered less prone to abuse than commissions, but we're seeing some behaviors among fee-only advisers that also represent clear conflicts of interest," said Michael Finke, a professor at the American College of Financial Services.

David Blanchett, head of retirement research at PGIM DC Solutions, an affiliate of Prudential Financial, co-wrote a study that found that people who used fee-based advisers took their Social Security benefits at 65, on average.

Though people can claim Social Security as early as age 62, holding off until later guarantees them a higher monthly check. It is often optimal for the spouse with higher earnings to delay claiming until age 70 (which HCM has always advised).

But advisers stand to earn more fees when their clients claim Social Security soon after retiring because clients don't take as much from their portfolios.

"I would have thought people with an adviser would claim later, since advisers should be aware of the benefits," Blanchett said. He concluded the way advisers are paid is likely influencing their claiming recommendations.

Those with fee-based advisers drew Social Security later than people with brokers, who took benefits at age 64, according to the study. Both tapped their benefits earlier than people who paid advisers an hourly fee, no matter the size of the portfolio. They claimed at age 66, on average.

The study examined 260 households with $500,000 or more in assets that the Federal Reserve surveyed in 2019.

Consider a man who retires at 65 with $2 million and spends $7,500 a month. If he has a choice between taking $3,400 a month in Social Security at 65, or $5,000 a month starting at age 70, he will maximize his lifetime benefits by waiting until 70, provided he or his spouse lives to about 83, said Blanchett.

If he waits until age 70, he would need to withdraw $450,000 from his investment accounts to support himself between 65 and 70. If he instead claims at 65, he would only need to withdraw $246,000, since his $3,400 Social Security check would cover some living expenses.

**Paying off mortgage**

Eliminating debt was once considered a key part of preparing for retirement (and remains our advice, although the interest rate you are paying on a mortgage is worth considering). As interest rates fell during the past decade, holding on to a mortgage later in life became more common. Advisers have a financial motive to agree with the strategy.

Consider someone with a $500,000 mortgage and a $1 million portfolio, who pays his or her adviser a 1% annual fee, or $10,000. If the client withdraws $500,000 from the portfolio to eliminate the mortgage, the account balance and adviser's pay halve.

In recent years, the percentage of households age 65 or older with mortgages has risen, from around 15% in 1989 to 29% in 2019, according to Boston College's Center for Retirement Research.

One reason: "There's a remarkable comfort among the adviser community with keeping mortgages in retirement," said Michael Kitces, cofounder of the XY Planning Network, whose 1,800 advisers charge fees.

Advisers said their clients have a better chance of earning higher returns by leaving their money in stocks than they would get by selling investments to eliminate a mortgage.

Recent history has proved them right: During the past five years, the S&P 500 has gained an annualized 14.7%, according to FactSet, far exceeding the carrying cost of a mortgage refinanced when the 30-year rate fell below 3% a few years ago. Some people might also get a tax deduction for paying mortgage interest.

But not everyone is comfortable using debt to bet on the stock market, said Alan Moore, chief executive of the XY Planning Network.

“Whether an adviser chooses to recommend the right thing for the client or not, it would be naive to think their own pay doesn’t enter their mind,” Moore added. (HCM provides a service to family & friends, and potentially those referred by them. I can't remember any time when my "own pay" entered my mind when making a recommendation. Perhaps that wouldn't be the case if my finances depended on client fees.)

**Buying an annuity**

Some fee-based advisers shy away from annuities, including a type some economists recommend. (We have written about annuities, advise against them, and will continue to do so even if "some economists", that we are unaware of, recommend them.)

An immediate annuity requires a retiree to pay a lump sum to an insurance company in return for a fixed income for life, often an irrevocable move. Currently, a 65-year-old man who wants $3,000 a month for life would pay about $480,000.

Annuities have critics, partly because many types have high fees. But some economists like immediate annuities because they remove the possibility of going broke in old age and typically have commissions of around 3%.

Advisers don’t generally share in economists’ enthusiasm, said Finke, perhaps because buying an annuity generally means moving money out of an investment account.

“They are so seldom used by advisers that one would have to question whether conflicts of interest are preventing advisers from presenting a solution that will likely make clients better off,” he said.

For example, Fisher Investments, which manages $265 billion for fees of up to 1.25% of assets annually, says on its website that its founder hates annuities because “anything you can do with an annuity can be done better with other investment vehicles.”

What Fisher doesn’t say is that the company earns more by steering clients away from annuities, Finke said.

A spokesman for Fisher said the company always works in its clients’ best interest. “While we don’t sell annuities, if they make sense for a client after our evaluation we tell them so,” he said.