Why Dividend Growth?

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We are portfolio managers. We don't "play the market" or try to guess which investment style will be the most successful over the next business cycle. To get the true benefits of investing in stocks, we must own dividend growth companies. We must create compounding wealth machines over a long period of time. In the long-term, growth of both principal and income are essential to wealth sustainability. Fixed income unfortunately does not qualify for either of these criteria. Don't misunderstand the message. Bonds have an appropriate place in an investment portfolio, but to create true long-term wealth - generational wealth - we need dividend growers and share price compounders.

Mature companies pay dividends from their earnings. Every quarter these companies send cheques to their investors. As history has shown, a significant number of these companies ***raise their dividend every year***. This may seem like a nice feature but most underestimate the strength of this factor. It is the fuel that makes the dividend growth wealth compounding machine run.

It may sound simple, but it is one of the single most important factors for long term investors. What makes rising income from a dividend growth stock so attractive? You not only receive growing income as the years go by, but you also get a rising share price because the company producing the income is worth more as the income it produces increases. You get to "double dip "when you invest in stocks that increase their dividends. You get the income and the annual growth of that income that meets or surpasses inflation (a very underrated attribute), and you get the effect from that rising income on the stock price, which propels the stock price higher.

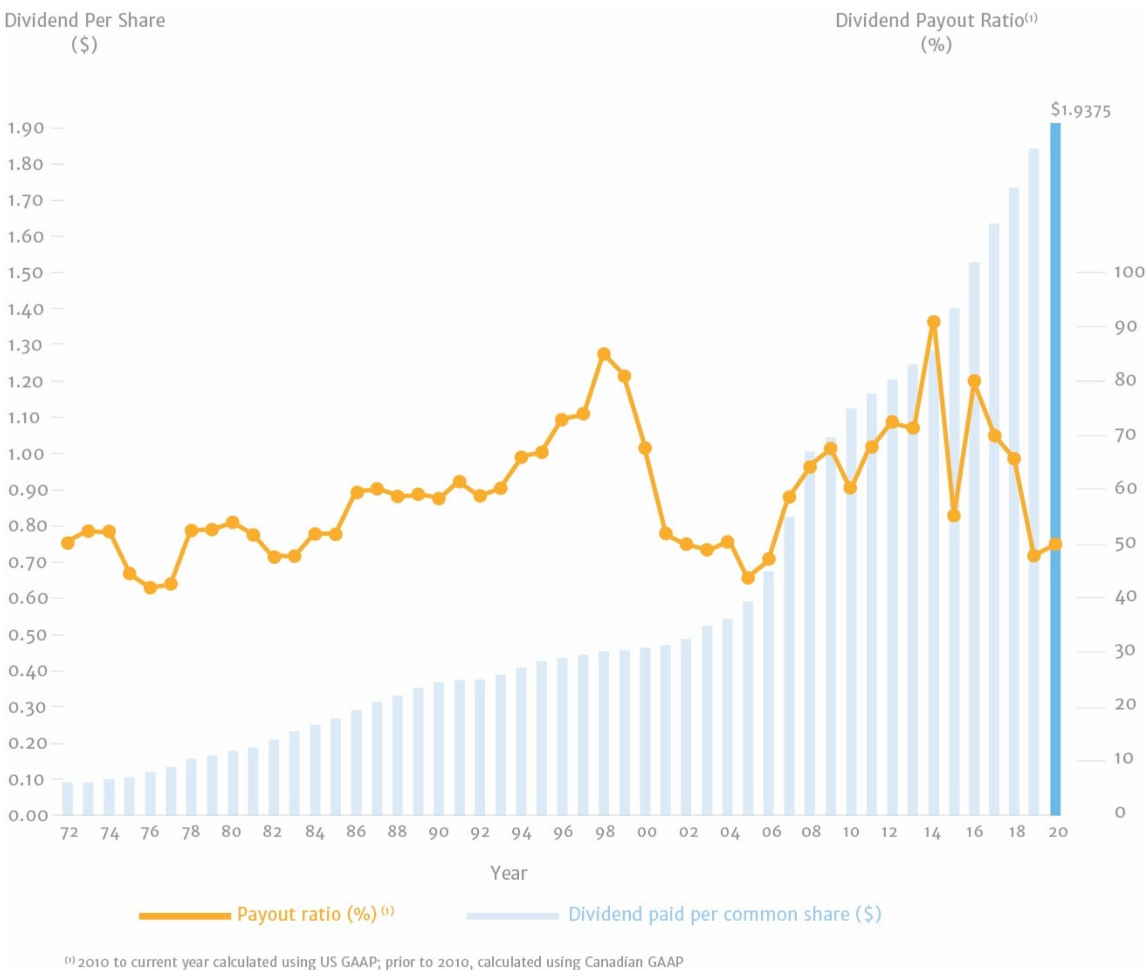
Dividends Don't Lie

Dividend increases are a real-life signal that a company has the financial ability to pay its dividends. The very attention we place on rising dividends puts us squarely in the position of owners of a company, of a true investor, who understands that a reasonable return from a stock investment isn't a gift of the market or pure luck, but the inevitable result of investing in a company that is doing well enough to pay dividends and increase them on a regular basis. Dividends are paid from earnings. When a company has reached a certain level of maturity and stability, it begins to pay dividends. Dividends are a kind of litmus test that reveals the true state of a company's finances. Earnings cannot be some accounting trickery. They must be there in cash to pay increasing dividends.

Further, a company that raises its dividend is truly signalling the state of the business to investors. The Board of Directors knows exactly how well a company is performing. They also know that lowering a dividend is a deathblow to stock prices. The one thing a board never wants to do is to decrease its dividend. A company can tell you about its earnings but there is always flexibility in accounting choices. There is no flexibility when it comes to paying and increasing a dividend. So, dividends are real, like the income from an apartment block or a retail store. And dividend growth is real. Neither dividends nor dividend growth are propaganda from a company; they are not some hype from a brokerage firm or an investment newsletter. They are cash and the foundation of building a wealth compounding machine.

An Example

Fortis Inc. (TSE: FTS) is an energy delivery business. Ninety-three percent of its total assets are investments in infrastructure that support the safe and reliable transmission and distribution of electricity and natural gas to customers. Historically, Fortis has increased its dividend for 48 consecutive years. It's considered a true Canadian Dividend Aristocrat. In Canada, only Canadian Utilities Limited (TSE: CU) has increased its dividend for more consecutive years (49 years) than Fortis. A graph below highlights in blue the dividend increases by Fortis over the past 48 years. The payout ratio is also important to know how much of a company's annual earnings is being dedicated to dividends. A lower percentage means a company has more room to increase its dividend based on its earnings. At a 50% payout ratio, Fortis has ample room to potentially increase its dividend. In late 2021 Fortis stock hit an all-time high of $61.54 per share.



There can be several reasons for making an investment in a business such as a compelling valuation, long-term secular trends in the industry or simply consistent profitability. However, the one defining factor BCV looks for is dividend growth, as that has proven over time to be a significant source of returns. Instead of guessing which sector or style will be in favour next year, we'll stick to collecting our growing stream of income, and letting the compounding machine do the work for us.

The Siren Song of Speculation

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In Greek mythology, Sirens, creatures that were half woman and half bird, sang beautiful songs that were so enrapturing that sailors would unintentionally crash their ships into the rocks as they tried to get nearer to the source of the wonderful sound. The term 'siren song' now refers to something that is very alluring, particularly one that is seductive or deceptive. You don't have to look far in the current financial markets to see many siren songs at work.

When the Federal Reserve of the United States looked at the financial and economic repercussions of a global pandemic back in March of 2020, they decided that there was no limit to the amount of financial support they would provide. One of the unintended consequences of accommodative monetary policies is the increase in speculative activity across many classes of investments: stocks, bonds, private equity and even art and collectibles. The lure of quick and sometimes extremely high returns has even come from new assets such as cryptocurrency and non-fungible tokens ("NFT").

It's very easy to succumb to the desire to make easy money. Who wants to put in the hard work of investing where you read annual reports, listen to conference calls, build financial models, and assess long-term economic trends, when you can throw some money into a crypto and be a millionaire in days or weeks? The financial press and social media make the situation worse for investors who don't have the discipline or knowledge to understand the risks being assumed with some of these new investment assets.

Recently, there have been two platforms within virtual arena that have captured investor interest: NFTs and the metaverse. NFT's are a recent innovation that has attracted speculative dollars. Essentially, investors are paying money for digital code that is unique and based on blockchain technology. Some of these have sold for tens of millions of dollars. For "code" - something that isn't tangible. The metaverse is also one of the latest songs we've heard from the Sirens. The metaverse is essentially a digital world where individuals can do many of the same things as the real world, such as going to a concert or socializing with friends. There has lately been a land rush for digital property, where investors are spending real dollars on some lines of code for a piece of land in the metaverse. There could be is a business case for selling products in a digital realm, but with an unlimited amount of digital space, the question of why that be particularly valuable remains unanswered.

Speculation and investment are often used interchangeably, but we would argue they are very different. A speculator will often be taking much higher risk as the outcomes tend to be highly uncertain. In addition, there will often be no income stream, such as a dividend to support the initial outlay. The volatility or change in the value of the speculative investment will also be much higher than a traditional "investment". You only need to review a price chart of a cryptocurrency to establish this point. Finally, speculation will more often result in significant losses as the only investment thesis is based on the Greater Fool Theory, which states that the reason for holding an asset is that the price will go up when another fool will pay a higher price.

Investment - as we practice it - means minimizing the risk of loss, while providing a satisfactory income stream and a reasonable return on the capital outlay. This requires more time and effort, as we want to put in the time and effort so that we have a complete understanding of the business and underlying fundamentals. And the real problem with this approach is that it takes time. When the media is bombarding you with stories about teenagers getting rich overnight, it takes great discipline to stick to your investment process, but that is what we do at BCV.

In Homer's story "The Odyssey", the hero Odysseus makes sure that his sailors have covered their ears to avoid hearing the Siren's song and preventing them from destruction. Meanwhile, he has himself tied to the mast of the ship so he can hear the song but stop himself from doing something stupid. Your portfolio managers are skilled enough sailors to listen to these siren songs, while steering your portfolio in the right direction.