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David Van Knapp Positions For 2017: Ignore The Noise, Fit Your Portfolio To Your Goals

Jan. 9, 2017 9:30 AM ET7 comments
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Summary

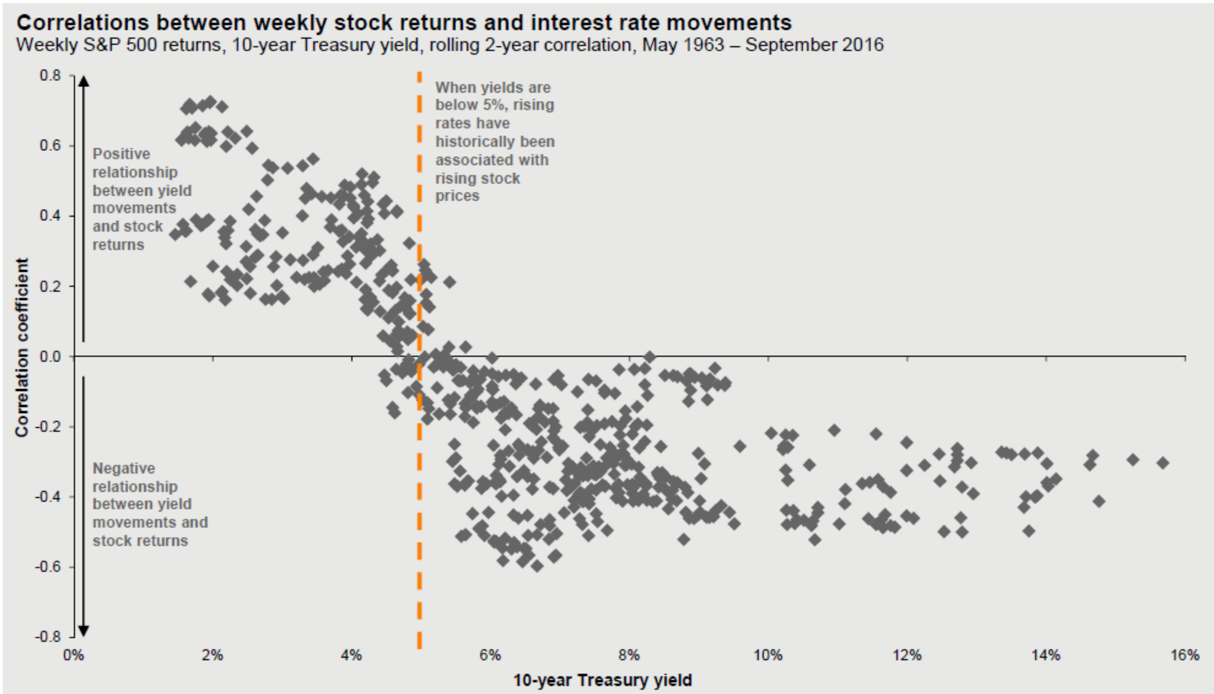
- I am still pretty indifferent to interest rates.
- I am most interested in yield and growth rate across my whole portfolio rather than individual stocks.
- My “evergreen” suggestion is to understand your goals. What do you want to accomplish with your investing? Have your goals changed since last year?
- Business planning gives you a platform to understand how to allocate the capital at your disposal, and it helps remove emotion from your decisions.

After a long and winding 2016, we begin another new year. As we have done for several years, we are checking in with some of our top authors for their views on the coming year and beyond. Our panel includes experts on a range of different asset classes and investing strategies. As always, the focus is on an overall approach to portfolio construction and investing outlook.

We turn today to David Van Knapp. Mr. Van Knapp is a frequent contributor and thought leader in the dividend growth investing community here on Seeking Alpha. Like most DGIs, Dave's focus tends to be on the long-term, big-picture outcomes of his investments, and less on the day-to-day "noise" generated in the markets and media. As such, he is a logical, goal-oriented investor, and for this reason, has a reputation for offering sound strategies and ideas rooted in research, reality and rationality for Seeking Alpha readers.

Mike Taylor: In past Positioning interviews, you've expressed some indifference to the direction of interest rates as expressed in 10-year Treasury yields. We had a bit of an adjustment in yields after the US presidential election. Have you updated your views on how interest rates might affect a dividend growth investor's strategy?

David Van Knapp: I looked again, and I am still pretty indifferent to rates. Here is the most recent version of the chart I have used to illustrate why.



Source: FactSet, Standard & Poor's, FRB, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Markers represent monthly 2-year correlations only.
Guide to the Markets – U.S. Data are as of September 30, 2016.

[Source: J.P. Morgan Guide to the Markets 4Q 2016]

As they state, “When yields are below 5%, rising rates have historically been associated with rising stock prices.” The 5% tipping point is shown by the vertical orange dashed line on the chart.

Yields are still well under 5% (the 10-year Treasury is at about 2.45%), so small increases may cause some short-term volatility, but overall, I don’t see them as having a major effect on stock prices.

Of course, some sectors of stocks, those that are more “bond-like,” may be more affected than others. Some investors consider REITs, utilities, and telecoms to be bond-like. Some of them are also overvalued at this time. So I would not be surprised if interest rate bumps are accompanied by short-term dips in some equity prices, particularly in sectors like that.

MT: Broadly, how has the U.S. election affected your investment strategy for the coming year?

DVK: Not at all.

MT: Many investors see the market as anticipating an adjustment in fiscal policy as well as monetary policy in the coming years. What are your views on fiscal policy as a factor investors might consider when looking at investment opportunities in the U.S.?

DVK: I don’t really consider it. Perhaps defense spending will go up more than it would have with different election results. But maybe not.

I pretty much follow Warren Buffett’s advice on macro matters. I don’t pay much attention to them. Years from now, one will be able to look back and see how fiscal policy affected certain companies, but I have no useful advice to offer about how to do it looking forward.

We do know that a lot of the speculation about those kinds of things will turn out to be wrong anyway.

MT: You have said you evaluate new opportunities in terms of how they'll meet the needs of your entire portfolio. How is your portfolio currently positioned, and where are you looking for new opportunities to help you meet your objectives?

DVK: I position my portfolios with an eye to:

- Making “enough” income
- Having a “sufficient growth rate” in the income
- Having “safe” income

Dividend growth investing is an approach used by investors to reach a variety of goals. Some investors are shooting for a portfolio whose income they can live off in retirement without ever selling a share. Others are looking primarily to build wealth. Still others have a hybrid growth + income goal.

There is also a full spectrum of styles in dividend growth investing. Some investors prize yield over all else. Others look first at dividend growth rate. Almost everybody looks in some way at dividend safety, which leads to examinations of earnings growth, free cash flow, and assessments of company business models.

For myself, the three general goals that I stated above are deliberately a little vague, because the answers to “enough” and “sufficiency” vary from investor to investor. Naturally, I bring my own bias to them and see each through my own lens.

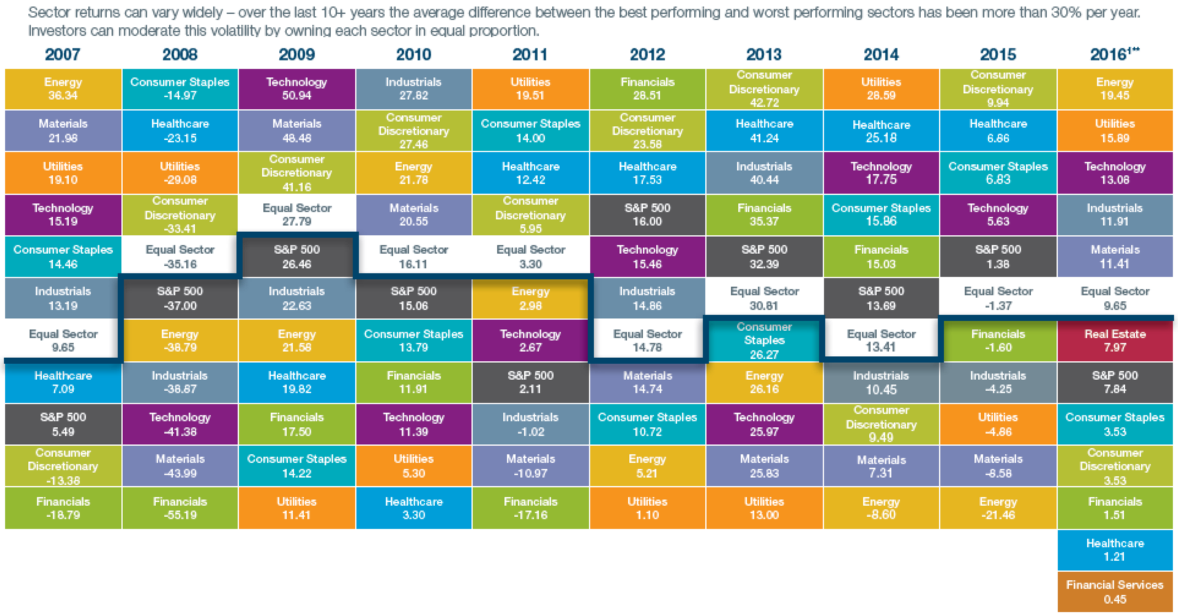
With that in mind, my personal answers are that “enough” is 3.5%-4% yield, “sufficient growth rate” means exceeding inflation plus a little extra, and “safe” means unlikely to be cut as measured by my own analysis and that of a couple of outside services that I consult.

I am most interested in yield and growth rate across my whole portfolio rather than individual stocks. I like to mix different yields and growth rates as a form of diversification, so some individual stocks will have yields below 3.5%, for example.

I seek dividend safety both stock-by-stock and across the portfolio. At the company level, I try to find companies whose dividends appear unlikely to be cut. At the portfolio level, I try to diversify enough that the impact of any single cut would be muted.

Diversification includes spreading money across sectors. They tend to rotate through thick and thin periods, and it’s hard to predict beforehand which ones are going to come out on top. In the following chart, follow a sector like Utilities or Healthcare as it bounces up and down.

2016’s winner, Energy, was dead last in 2015. Every sector has finished either #1 or #2 in at least one year (except for the new Real Estate sector).



[Source. 2016 returns are through 9/30/16.]

The bottom line is that when I have cash to invest, the decision is based on which stock I think will improve my portfolio in line with my goals. It could be more of a stock I already own, or it could be an entirely new stock.

MT: Among the stocks dividend growth investors tend to gravitate toward ("Challengers" and "Aristocrats," for example), what patterns and trends are you paying special attention to for the coming year?

DVK: I look at stocks individually, and I always pay attention to the same things:

- Dividend resume
- Company quality
- Company outlook
- Stock valuation

Dividend resume: I look for companies with sufficient yields and growth rates, that have raised their dividends for at least 5 years (longer is better), and whose dividends are rated “safe” with regard to the company’s financials, especially cash flow.

Company quality: I want to understand the company’s “story”: How does it make money; what are its durable competitive advantages; how long-lasting is its product/market space likely to be? Quality can also be measured indirectly by things like credit ratings, S&P Capital IQ’s quality ratings, Morningstar’s moat ratings, and other third party opinions.

Company outlook: As Buffett might say, will the company still be doing about the same thing successfully 5-10 years from now? Do secular trends impact the company? I look at company financials, estimated growth rates, and the like. I like to look at how the company presents itself in its investor and earnings presentations by thumbing through their slide shows.

Stock valuation: Every great company does not necessarily have a great stock to offer. It may be overvalued. I like to buy excellent businesses at sale prices, although I will certainly accept a fair price, depending on the alternatives available when I have money to invest.

One area of interest for 2017 is dividend growth rates. Many dividend growth investors have noticed a slowdown in dividend growth rates for the past 2-3 years. Most of us hope that trend stops or reverses. Of course, trends across large populations of companies may not apply to your particular companies. That is one reason to look at companies one at a time.

The slowdown in growth rates is illustrated by this 10-year table from WisdomTree:

WisdomTree Dividend Index (WTDI) Dividend Stream

Sector in WisdomTree Dividend Index (WTDI)	November 30, 2007	November 30, 2008	November 30, 2009	November 30, 2010	November 30, 2011	November 30, 2012	November 30, 2013	November 30, 2014	November 30, 2015	November 30, 2016		Growth 11/30/2015–11/30/2016	Growth: 11/30/2007–11/30/2016
Consumer Discretionary	$ 19.37	$ 18.29	$ 15.96	$ 19.42	$ 22.70	$ 27.59	$ 32.40	$ 38.78	$ 43.11	$ 44.03		2.13%	127.31%
Consumer Staples	$ 33.13	$ 34.88	$ 36.92	$ 39.88	$ 43.55	$ 45.02	$ 49.39	$ 52.55	$ 56.87	$ 59.12		3.95%	78.45%
Energy	$ 20.95	$ 22.89	$ 22.94	$ 24.34	$ 27.60	$ 31.87	$ 36.19	$ 40.84	$ 40.26	$ 35.97		-10.66%	71.70%
Financials	$ 95.72	$ 62.23	$ 29.36	$ 33.03	$ 45.33	$ 54.79	$ 65.25	$ 79.09	$ 89.46	$ 97.19		8.64%	1.54%
Health Care	$ 26.83	$ 29.03	$ 25.88	$ 27.97	$ 31.76	$ 34.54	$ 36.93	$ 39.48	$ 43.29	$ 46.17		6.67%	72.10%
Industrials	$ 30.77	$ 34.14	$ 25.35	$ 27.37	$ 31.60	$ 34.57	$ 37.98	$ 43.46	$ 45.96	$ 46.64		1.46%	51.56%
Information Technology	$ 16.17	$ 17.89	$ 19.27	$ 22.18	$ 27.51	$ 44.01	$ 51.96	$ 55.85	$ 60.02	$ 63.23		5.35%	291.05%
Materials	$ 12.73	$ 12.47	$ 8.75	$ 11.15	$ 13.70	$ 14.74	$ 14.49	$ 15.35	$ 14.00	$ 14.29		2.08%	12.24%
Telecommunication Services	$ 15.45	$ 16.96	$ 17.45	$ 18.33	$ 19.15	$ 19.12	$ 18.55	$ 21.19	$ 22.78	$ 23.48		3.09%	51.97%
Utilities	$ 17.40	$ 18.46	$ 19.04	$ 20.19	$ 21.08	$ 22.66	$ 23.19	$ 23.72	$ 25.19	$ 26.14		3.80%	50.24%
Total *Dividend Stream*	$ 288.53	$ 267.25	$ 220.92	$ 243.86	$ 283.98	$ 328.92	$ 366.32	$ 410.30	$ 440.94	$ 456.26		3.47%	58.13%
Total ex-Financials	$ 192.81	$ 205.02	$ 191.56	$ 210.83	$ 238.64	$ 274.13	$ 301.07	$ 331.21	$ 351.48	$ 359.07		2.16%	86.23%
Year-over- Year dividend Growth (%)		-7%	-17%	10%	16%	16%	11%	12%	7%	3%			

Sources: WisdomTree, Bloomberg, as of 11/30/16. Past performance is not indicative of future results. Dividend Stream is reported in billions of U.S. dollars. You cannot invest directly in an index. Subject to change.

[Source]

WTDI is WisdomTree's broadest and most inclusive dividend index. They rebalance it each December based on data through November, and that data includes dividend growth rates by sector.

As you can see, several of the sector growth rates were anemic last year, including negative in energy and less than 4% in Consumer Discretionary, Consumer Staples, Industrials, Materials, Telecommunications, and Utilities.

Along the bottom, you can see year-over-year dividend growth overall. In the past three years, it has dropped from 12% to 7% to 3% for the stocks in their index.

MT: What should be on any dividend growth investor's agenda when reviewing his or her portfolio heading into the new year?

DVK: My "evergreen" suggestion is to understand your goals. What do you want to accomplish with your investing? Have your goals changed since last year? Goals, of course, can change as life events happen – getting married or divorced, having kids, having grandkids, getting laid off, retiring, and so on. Every one of those events can cause you to re-think your goals.

I suggest writing out a business plan, just the way companies do every year. I see personal investing as exactly like running a small business. Cover your goals, strategies, and tactics. Business planning gives you a platform to understand how to allocate the capital at your disposal, and it helps remove emotion from your decisions.

Once you have your goals firmly in mind and your business plan in place, then portfolio reviews can be made from those vantage points. As to each holding, ask yourself how it helps attain your goals, whether it advances your business plan, and so on.

Include a feedback process. Reviewing your portfolio may give you ideas about how your business plan ought to be altered. Over time, the feedback loop should help you improve your portfolio.

MT: What 'surprise' do you see in the market that isn't currently getting sufficient investor attention?

DVK: I'm always struck by the intense focus that the investment industry and media place on the short term. That emphasis steers investors to concentrate on the short term. As an investor, sometimes I feel that I have to fight my way through the noise to see long-term information and insights.

Long-term information is almost never presented first or with the most prominence. Flashing lights are reserved for instantaneous reporting.

So I suggest that investors might be surprised by long-term market trends and information if it were easier to access. They might make fewer decisions based on short-term noise and more based on long-term factors.

Last year was a good example. The S&P 500 fell 10.5% in the first 28 days [Source]. That caused a lot of angst. "End of the bull market." But by the end of the year, the S&P 500 was up double digits. The fear early in the year probably steered a lot of people in the wrong direction.

Buffett has famously said "*Only buy something that you'd be perfectly happy to hold if the market shut down for 10 years." I would change that to "Buy stuff that you would select if you knew that you would have no access to financial media and industry hype for 10 years."*

MT: What key comment would you make for a do-it-yourself investor as 2017 gets underway?

DVK: To make it easier to read, I will present my key comment as a series of bullet points.

- Know yourself.
- Know your goals.
- Invest to reach those goals.
- Make a plan.
- Think long term.
- Ignore the noise.
- Don't buy anything that you don't understand.
- Use checklists (don't skip steps or take shortcuts).
- Keep learning about your craft.