

Dividends Ahoy!

2nd Quarter 2024

May 1, 2024

Global trade was a new frontier in 17th century Europe. That was until a group of adventurous spice merchants recognized a trading opportunity. With advances in shipbuilding and navigational tools, these merchants forever changed global commerce.

This Amsterdam-based venture became known as the Dutch East India Company. In Dutch, the name was Vereenigde Oost-Indische Compagnie - VOC. Spice trading was perilous and fraught with setbacks, but VOC's business edge was building ships that could survive long voyages. VOC's ruthless ability to forge monopolistic alliances with East Asian countries and islanders further established their dominance.

The VOC was not just a trading company but a global powerhouse. With the support of allies and leveraging its quasi-military status, it not only dominated the spice trade but expanded into other markets. Between 1602 and 1796, the company employed nearly a million Europeans sailing on 4,785 ships, far surpassing its closest British rival, the East India Company.

VOC enjoyed huge monopolistic profits and was a pioneer in many aspects of capital market history. It was the **first** multinational corporation to borrow from the **first** central bank—the Bank of Amsterdam. To finance growth and create liquidity, VOC issued the **first** shares of publicly traded stock that Dutch citizens could buy. Because citizens wanted to trade their VOC stock, the **first** open-air public stock market was formed to facilitate transactions. Today, that market is the modern-day Amsterdam Stock Exchange.



Amid VOC's meteoric rise, internal conflicts surfaced. Issac Le Maire, an early board member of VOC and prominent Dutch merchant, was the loudest critical voice calling for governance changes. Ousted from the board shortly after complaining, Le Maire became an even louder critic of VOC's leadership for its lack of transparency and self-dealing. Le Maire's chief criticism was VOC's rising debt burden, which cut into profits and limited VOC's ability to **pay shareholder dividends**.

Soon after his ouster, Le Maire formed an investment syndicate (hedge fund). The syndicate was comprised of a group of disgruntled VOC investors with the shared goal of sinking VOC. To profit from this new campaign, Le Maire sold VOC shares for future delivery, attempting to profit from the fall of the VOC share price. Today, this activity is called short-selling, and Le Maire is credited as the **first** short-seller in history.

With the syndicate betting on VOC's fall, Le Maire and his investors doubled down on their negative VOC propaganda efforts. VOC's stock declined temporarily, but Le Maire didn't anticipate VOC's Board actions to thwart his efforts. VOC implemented a lucrative change for shareholders by declaring a 75% stock dividend and indicating more dividends were coming.

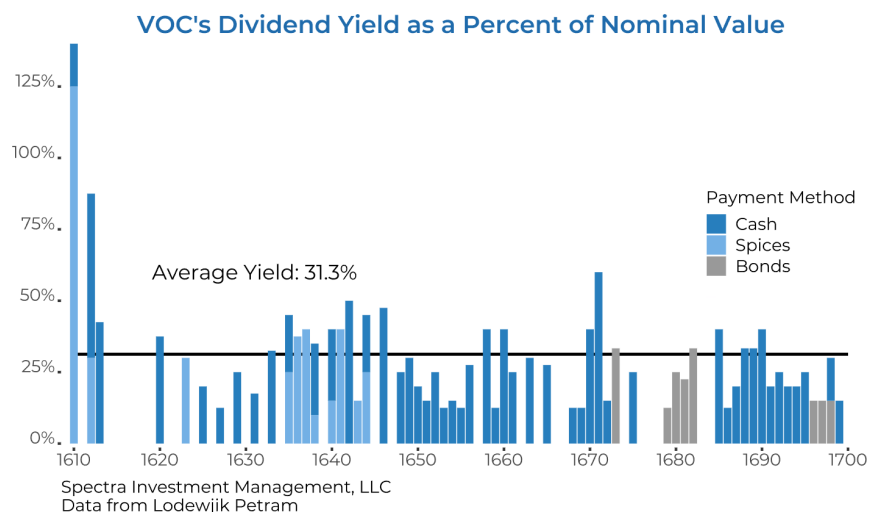
"The directors agree on a 75 per cent mace [nutmeg] dividend, with a dividend of 50 per cent in pepper and yet another of 7 1/2 per cent in silver to follow yet again in the autumn."



VOC – Declaring a Dividend

VOC became famous for its high dividend yield – see Exhibit A on pg. 8. From 1610 to 1700, VOC's average dividend yield on the stock's par (initial price) value was 31.3%. This sent VOC's market price to astronomic heights. Adjusting for 400+ years of inflation, VOC had a market capitalization of approximately \$8 trillion at its peak. Astonishingly, in today's dollars, \$8 trillion makes VOC the most valuable company in human history. This equals today's combined value of Amazon, Microsoft, Apple, Exxon Mobil, Walmart, Johnson & Johnson, and Alphabet/Google.

The unexpected 75% mace dividend and VOC's shift to a shareholder-friendly company devastated Le Maire's short position. As a result, Le Maire and his fellow short sellers' fate was bankruptcy and exile from Amsterdam. Despite his failure, Le Maire's activism showed how a group of shareholders can affect corporate governance. VOC's eventual downfall came from smuggling and corruption, leading to its dissolution in 1799. VOC's lasting legacy was the insight that dividends are a fundamental investor motivation.



VOC's history is a very useful story about the power of dividend investing. In the spirit of Isaac Le Maire, cash dividends hold management's feet to the fire. As **cash based facts**,

dividends can be better marks of success than the foggy opinions expressed in GAAP accounting standards.

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Despite a 400+ year history, dividend investing has provided inferior returns in the last 15 years. Like many aspects of finance, history rhymes, and dividends are cyclical. Our thesis is that the low cash return trend of the last 15 years will reverse in favor of a dividend investment regime. That regime change is based on **two structural shifts** that will refocus investor attention on cash returns -

1. We live in an increasingly risky world.
2. Money markets pay 5%, with borrowing rates nearly doubling in the last two years.

The seeds of the first structural shift were planted at the end of the Cold War. The USSR failed and was no longer a peer foe to the US. With an incredibly weak economy, the USSR was strategically useless for nearly 20 years. **As such, the global balance of power shifted entirely to the US.** This allowed the U.S. to patrol the oceans and set security policies, ensuring cheaper goods land safely on US and European shores. This sent a great deal of manufacturing offshore to cheaper labor countries, particularly China.

With the war in Ukraine, Russia has reasserted itself on the geopolitical stage. Starting in 2005, Russia regained strength and forged trade alliances with oil-rich countries and China. Look no further than Vladimir Putin's bromance with the Crown Prince of Saudi Arabia at the 2018 G20 Summit. Further, Russia strengthened its relationship with China—so much so that China is supplying Russia with arms to defeat the Ukrainians.

Today, we live in a risky **multipolar world**. The balance of power has broadened to include China and Russia. With several escalating conflicts and wars in the world, it's discouraging to see that **diplomacy is failing**; see Exhibit B, pg. 8, for a picture and discussion of the failed diplomacy effort to stop the war in Ukraine. The bottom line is that we are almost certainly entering Cold War 2.0.

From an investment perspective, this change disrupts 25 years of global supply chain infrastructure. The US will need to reindustrialize North America and reroute supply chains. So far, Mexico has benefited the most from the 'friendshoring' movement, surpassing China in February as the #1 source of imports to the US. Rerouting supply chains is difficult and likely inflationary, threatening profit margins, investors' status quo, and sense of security. We think this abrupt change will refocus investors' attention on more tangible financial matters - namely, **the clarity of free cash flow**.



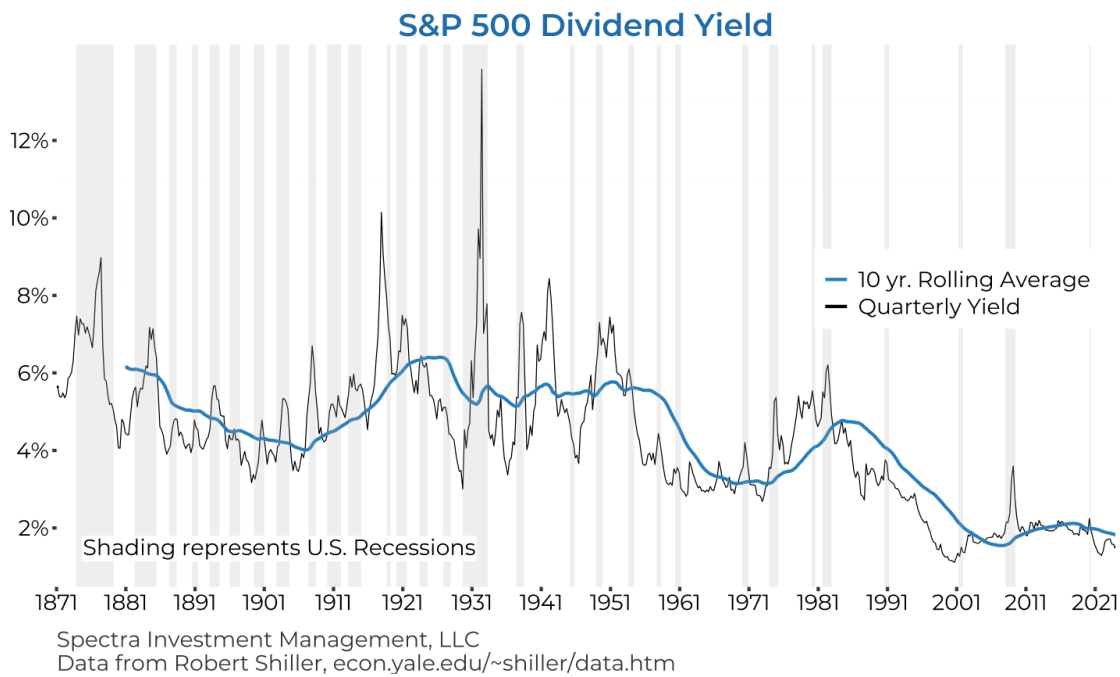
YouTube video link:

[Putin High Fives Saudi Crown Prince at G20](#)

The second structural shift is a by-product of the Fed's fight against inflation. As we said in our January piece "Money for Nothing," investors have enjoyed unusually cheap money for

15 years. From the 2008 Global Financial Crisis (GFC) until 2021, interest earned on cash was 0%, and the 30-year mortgage hovered around 3%. With the Fed still struggling to contain inflation today with higher rate policies, cash now earns 5%, and the 30-year mortgage rate is 7.5%. **A 5% risk-free cash yield is a compelling alternative for risk-averse investors over the S&P 500 dividend yield of 1.35%.**

Instead of a 5% cash yield, we present an alternative - high and rising stock dividends. It sounds intuitive that investors want cash flow from their stocks. But, the focus has been on increasing stock prices for the last decade. As long as investors accept a near-cashless investment, this trend could continue. We argue that the leading causes of this price focus have disappeared: ultra-low interest rates and peace.



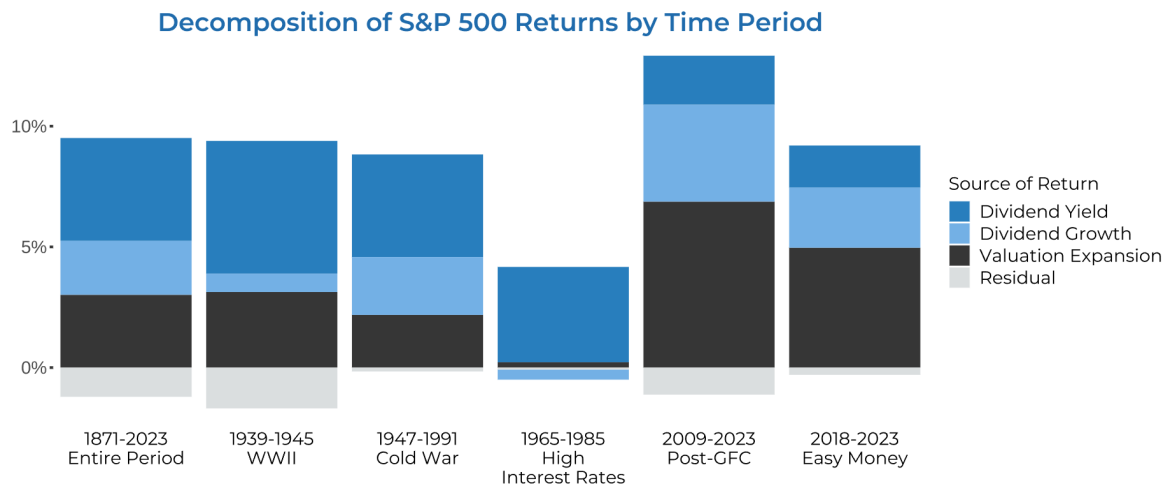
Whether or not a company pays a dividend depends on many factors. Keeping it simple, the starting place is free cash flow. Free cash flow is theoretically available to distribute to shareholders. Management can allocate free cash flow to shareholders or reinvests it back into the company for future growth. Further, management can use free cash flow to pay down debt or buy back shares – both shareholder-friendly choices. The **trifecta** is when management uses free cash flow to 1.) declare and support a growing stream of dividends, 2.) pay down debt, and 3.) buy back company stock. Other uses of free cash flow, which may be shareholder-friendly, are strategic acquisition and reinvesting into capital projects.

It may come as a surprise that Amazon hasn't paid a single dividend since its founding in 1994. Amazon has been a prime beneficiary of 30 years of peaceful oceans and 15 years of ultra-low interest rates. Amazon's lack of a dividend certainly has not hurt investors. But isn't it interesting that until 2022, Amazon couldn't afford to pay a dividend from free cash flow? Furthermore, Amazon continues to issue debt and more stock. This dilutes current shareholders' equity position and hurts Amazon's chance of paying future dividends. This begs the question: **Will Amazon pay dividends after 50 years in business?**

With a 150-year view of the S&P 500 dividend yield, investors have only tolerated a near-cashless return for the last 15 years. As investors have shifted their focus away from fundamentals like cash flow, speculative bubbles have formed in tech, biotech, and pockets of the real estate market. Non-profitable tech and commercial real estate bubbles have somewhat deflated, but portions of these segments remain overvalued.

To better understand dividends' contribution to annual total returns, we decomposed the S&P 500 return into return components. We started with the S&P 500's entire period from 1871 to 2023. Next, we picked six periods that approximate our hypothesis. **Do dividends contribute more to total return during geopolitical conflict and/or high-interest rates?**

The results didn't surprise us. In the entire period, dividends (**dividend yield** and **growth**) account for 77.47% of the total return from 1871 - 2023. By decomposing the S&P 500 total return into its components – dividend activity in **blue** and price/valuation expansion in **black** - we see that a) dividends have played a significantly greater role in the history of total returns, and b) periods of higher interest rates and geopolitical conflict warrant an intentional focus on dividends. We did find it intriguing that dividends played an outsized role in the total return during the Cold War period.



Spectra Investment Management, LLC
Data from Robert Shiller, econ.yale.edu/~shiller/data.htm

Dividend history parameters:

- Dividend Yield (**Blue**): cash paid during the year divided by the stock price at the beginning of the year.
- Dividend Growth (**Blue**): the growth rate in dividends year-over-year.
- Valuation Expansion (**Black**): the price-dividend ratio changes year over year. A positive ratio highlights that investors paid a higher price for the dividend stream. The investment industry vernacular is called valuation expansion.
- Residual (**Grey**): the return portion not explained by the other 3 components.

Dividends matter in the long term. We would add that a growing stream of dividend income is a superior segment of dividend investing. Supercharging a dividend strategy involves reinvesting cash into more shares—compounding the growth potential. As we know, Albert Einstein called compounding the eighth wonder of the world.

In 1990, Standard & Poor's created an index that tracks high- and rising-dividend stocks. The S&P 500 Dividend Aristocrats index consists of 60+ stocks that have raised dividends annually for at least 25 straight years. On a relative basis, the Aristocrats index has beaten the S&P 500 since 1990 with less volatility. But like all value-oriented strategies, the Aristocrats have trailed the S&P 500 the last 10 years. We anticipate this trend reversing and have positioned to benefit from the reversal.

This piece wouldn't be complete without a discussion of risk. While dividend growth investing seems less risky, it depends. First, a 1990 lookback isn't robust. Second, highly leveraged companies can also be good dividend payers until they have a near death experience. As always, diversification is important, with special attention to leverage. Lastly, dividend cuts are always a risk when free cash flow weakens. This risk can be managed with attention to the sustainability of free cash flow.

Key Takeaways:

1. For 400+ years, cash distributions have been a bedrock principle of investing. The story of VOC underscores an enduring truth: investors prize consistent cash distributions.
2. The 15 year transition away from a cash flow preference didn't happen in isolation. The S&P 500's near cashless return today slowly unfolded after a prolonged period of geopolitical stability and ultra-low interest rates, which are no longer present.
3. Understanding the drivers of total return in the S&P 500 reveals that dividend preferences are cyclical. A deeper look reveals that dividend investing loses appeal during speculative excesses—the Nifty-Fifty of the late 1960s and early 1970s, the dot.com bubble of 2000, and recent excess.
4. The shareholder-friendly “trifecta” is when a company's management uses free cash flow to 1.) grow dividends, 2.) buyback stock, and 3.) pay down debt. This is highly desirable all the time but could be particularly impactful in a cashless to cash flow regime change.

Shifting gears from theory to implementation, we have recently modified our US Large Cap Value Strategy in two ways. First, we are placing greater strategy emphasis on the “trifecta” of **dividend growth, buybacks, and debt reduction**. Second, because too few large-cap stocks are pursuing this shareholder-friendly focus, we expanded our investable universe to include smaller companies with a market capitalization of \$3 billion or greater. Judgment will apply to the mix of the three and the price we pay for the stock.

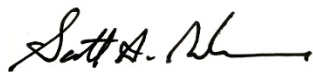
We didn't invent this focus on the “trifecta”. Trifecta is our buzzword. Scholars and practitioners in finance literature refer to this strategy as “Shareholder Yield.” Since 2005, several books and finance journals have highlighted Shareholder Yield as superior to conventional definitions of value investing. We studied the Shareholder Yield theory and

several firms successfully implementing Shareholder Yield strategies. Based on the weight of our findings, we are convinced this is a sound modification for our US Large Cap Value Strategy. Further, we intend to add a shareholder yield-focused fund to client portfolios that use mutual funds/exchange-traded funds instead of stocks. We look forward to discussing the modification with you during our annual reviews.

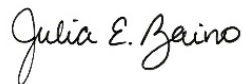
As some of you know, we recently added Micah White to our team. Micah first joined us as a summer intern in 2021. We liked Micah (we think he likes us) so much that we invited him back for the next two summers. While in college, Micah worked for 2 years at the Cyber Innovation Center. There, he wrote front and back-end web development code – JavaScript and Python – for internal web-based communications. As Micah finished his BS in Finance at Louisiana Tech, he accepted our offer and joined us in March. After three summers with us, we are excited to have him full-time, and with his prior Spectra experience, he is ramping up quickly.

We live in precarious times—limit your time watching the news and spend more time outside. Thank you for your ongoing trust and support. We look forward to spending time with you soon.

Very truly yours,



Scott A. Roads
Founding Principal



Julia E. Zaino
Principal

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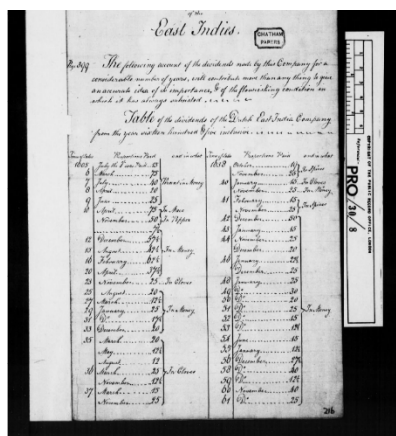
Exhibits

A. VOC historical resources

de Jongh, Matthijs, 'Shareholder Activism at the Dutch East India Company 1622-1625' (January 10, 2010). Origins of Shareholder Advocacy, Palgrave Macmillan 2011, Available at SSRN: <https://ssrn.com/abstract=1496871>

Gelderblom, Oscar and de Jong, Abe and Jonker, Joost, 'An Admiralty for Asia: Isaac Le Maire and Conflicting Conceptions About the Corporate Governance of the VOC' (24 2010 6). Available at SSRN: <https://ssrn.com/abstract=1633247>

VOC
Ledger of
Dividends



East India	
Table of the dividends of the Dutch East India Company from the year sixteen hundred by five hundred to the year sixteen hundred and twenty five	
1605	1606
1607	1608
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1675	1676
1677	1678
1679	1680
1681	1682
1683	1684
1685	1686
1687	1688
1689	1690
1691	1692
1693	1694
1695	1696
1697	1698
1699	1700

- B. Aborted diplomacy meetings two weeks after Russia invaded Ukraine.
Source: Doomberg Substack 4/23/2024, Foreign Affairs, April 16, 2024.
Link: [The Talks That Could Have Ended the War in Ukraine](#)

Russian
Federation
Flag



Ukrainian
Flag

“What happened on the battlefield is relatively well understood. What is less understood is the simultaneous intense diplomacy involving Moscow, Kyiv, and a host of other actors, which could have resulted in a settlement just weeks after the war began.

By the end of March 2022, a series of in-person meetings in Belarus and Turkey and virtual engagements over video conference had produced the so-called Istanbul Communiqué, which described a framework for a settlement. Ukrainian and Russian negotiators then began working on the text of a treaty, making substantial progress toward an agreement. But in May, the talks broke off. The war raged on and has since cost tens of thousands of lives on both sides.”

Important Disclosures:

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