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Investing versus Speculating

We ended our last quarterly letter, “Bees for Their Honey,” with what we called “Williams’ Lament,” which described John Burr Williams’ concern that stock prices were far more volatile than the investment values of the underlying companies. He explained that investors trading on short-term earnings fluctuations, instead of long-term dividend paying power, produced the volatility. This fixation with the short-term, led to periods of gross over and undervaluation in stocks, which led to booms and busts in the economy. Williams believed that the cycle of booms and busts caused many people to lose faith in the free market economy, which ultimately led to the socialist-like economic policies of the 1930s.

His book was not about beating the market, or getting rich in the market, it was really a wake-up call to the investment elite of his time to offer them a theory of investment value that would encourage more long-term investing and less speculation. Williams realized that speculators would always be with us, but he wanted to provide tools for investors to aid them in making decisions based on the “investment value” of a company, not just its price momentum. Williams postulated that investors’ inability to properly value stocks, increasingly, led them to become speculators. Most people would not admit that they were speculators, but when they were asked to explain their buy and sell decisions, it was clear that they were not appraising the intrinsic value of companies, but betting that they knew something that the market did not. In one of Williams’s most insightful observations, he makes the following statement,

> “To gain by speculation, a speculator must be able to foresee price changes. Since price changes coincide with changes of marginal opinion, he must, in the last analysis, be able to foresee changes in opinion. Successful speculation consists in just this. It requires no knowledge of intrinsic value as such, but only what people are going to believe intrinsic value to be. . . . Hence, some old traders think it is a handicap, a real handicap, to let themselves reach any conclusion whatsoever as to the true worth of the stocks they speculate in.
>
> How to foretell changes in opinion is the heart of the problem of speculation, just as how to foretell changes in dividend is the heart of the problem of investment.
>
> Since opinion is made by the news, the task of forecasting opinion resolves itself into the task of forecasting the news. There are two ways to do this: either cheat in the matter, or study the forces at work.
>
> Cheating has been outlawed, so far as can be, by the Security Act of 1934. The other way to forecast the news, and thus the change of opinion and the movement of prices, is to study the forces at work, in the belief that ’coming events cast their shadows before.’ But, rare is the man so sagacious as to foresee, so certain as to believe, and so steadfast as to remember; he who is makes a good speculator.
>
> Every speculator’s life is strewn with regrets, vain regrets for the news that he did not understand until it was too late. That ‘time and tide wait for no man’ he knows full well; like a bird on the wing, must be shot in a jiffy, or she flies out of range forever. Hence, the first speculative opinions are usually wide of the mark, and as such, they usually need to be revised by the later trading of those who have had time to a sober second thought.”

John Burr Williams was not condemning the speculators, but he was trying to open the eyes of investors to the fact that, as Ben Graham said, “In the short run the market is a voting machine (popularity contest), while in the long run it is a weighing machine (measure of value).”

We at Donaldson Capital Management, like Williams, believe that the most important thing to weigh from a corporation is “what you get out of it,” and that is the dividend. In the remainder of this letter, we will acquaint you with what we call “the hidden value of rising dividends.” These ways of looking at dividends are very simple and, once revealed, quite logical, but Wall Street, because of its speculative mindset, ignores dividends. Speculators, by their very nature, buy and sell stocks for changes in price alone. The way in which we analyze (weigh) the dividend offers both an indication of present value, as well as a projection of future value.

The Hidden Value of Rising Dividends

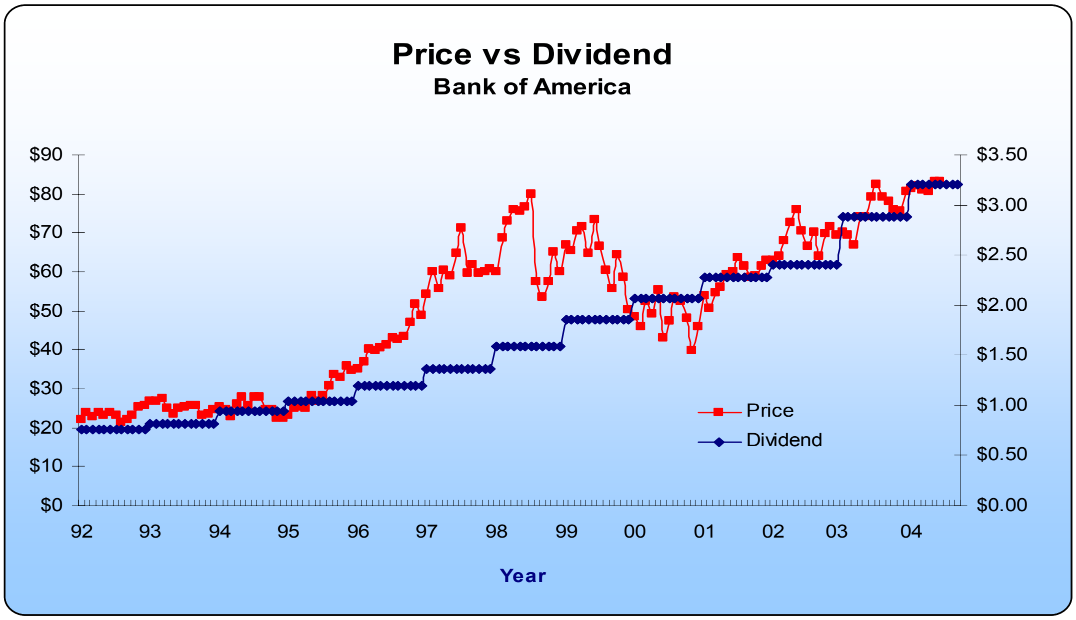
Table I shows yearly data since 1992 for Bank of America common stock. Bank of America is one of our favorite stocks, and over the next few pages, we will uncover many of the reasons why. The important thing to note about the table is the remarkable inconsistency between price growth and dividend growth, as shown in columns 5 and 6. This would appear to refute our argument that price follows dividend, but it does validate John Burr Williams' assertion that prices are much more volatile than the dividend-paying ability of the underlying companies. Indeed, BAC's dividend has risen every year and has averaged 12.7% annual growth. BAC's price, on the other hand, has ranged from a gain of over 50% in 1995 to a loss of more than 16% in 1999. Five times in the twelve years, BAC's stock fell on an annual basis, and its average annual price appreciation was 10.4%. The total return for a stock is defined as its price growth plus dividend yield, so BAC's total annual return for the period was the total of columns 4 and 5, 13.75% (10.40% annual price growth + 3.35% annual dividend yield).

Table I
Bank of America - BAC

1 Calendar Year	2 Year-end Price	3 Indicated Dividend	4 Dividend Yield	5 Price Appreciation	6 Dividend Growth
1992	25.70	0.76	2.95%		
1993	24.50	0.82	3.35%	-4.60%	7.90%
1994	22.60	0.94	4.15%	-7.80%	14.60%
1995	34.80	1.04	3.00%	54.25%	10.65%
1996	48.90	1.20	2.50%	40.20%	15.40%
1997	60.80	1.37	2.25%	24.60%	14.15%
1998	60.10	1.59	2.65%	-1.20%	16.05%
1999	50.20	1.85	3.70%	-16.50%	16.35%
2000	45.90	2.06	4.50%	-8.60%	11.35%
2001	62.90	2.28	3.60%	37.00%	10.65%
2002	69.60	2.40	3.45%	10.65%	5.25%
2003	80.40	2.88	3.60%	15.50%	20.00%
2004	84.00	3.20	3.80%	5.10%	11.10%
Average			**3.35%**	**10.40%**	**12.70%**

The table is informative, but it does not immediately jump out and answer the questions, "Is BAC a good value and, if so, is now a good time to buy it?" To zero in on these questions, let's look at a price-dividend chart. A price-dividend chart is not rocket science, but it is often a very good way to see that, ultimately, price does follow dividend. Chart I can also help us begin the process of determining an investment value for BAC. It covers the last 13 years of BAC's monthly price and dividend data. The jagged red line is the price, and the dark blue step-like line is the dividend. The first thing you notice about the chart is that both prices and dividends have moved higher during this time. The chart vividly shows that while they have both grown at about the same long-term rates, they have taken far different routes in reaching their present levels. In short, BAC's price has been much more volatile than its dividend.

Chart I



The chart reveals some fascinating interactions between BAC's price and dividend movements. The stair step action of the dividends appears to have placed a floor under the price, with the only significant downside breach occurring in 2000-2001. From 1992 through the middle of 1995, price and dividend moved in tandem. From the middle of 1995 to the middle of 1998, price completely disconnected from the dividend, reaching almost $80 per share, when the dividend would have predicted about $40 per share.

<u>We have studied price-dividend charts for many years, and it has been our finding that when price growth greatly exceeds dividend growth for two consecutive years, a correction is highly likely</u>. In the case of BAC, its price-dividend diversion lasted almost four years. The bank merger mania of the late 1990s caused the lift-off, and it continued until Bank of America and NationsBank merged. At that point, the market realized that the new company was too large for anyone to buy and the price began to tumble. As is often the case, once a stock gets overvalued, its subsequent fall will go too far, as well. As the chart shows in 2000, BAC fell to $35, well below the dividend line, which by then had risen to near $55. It was not until 2001 that BAC's price recovered to near its dividend line. Since that time, it has climbed the dividend steps in an orderly fashion and now appears to be about at equilibrium.

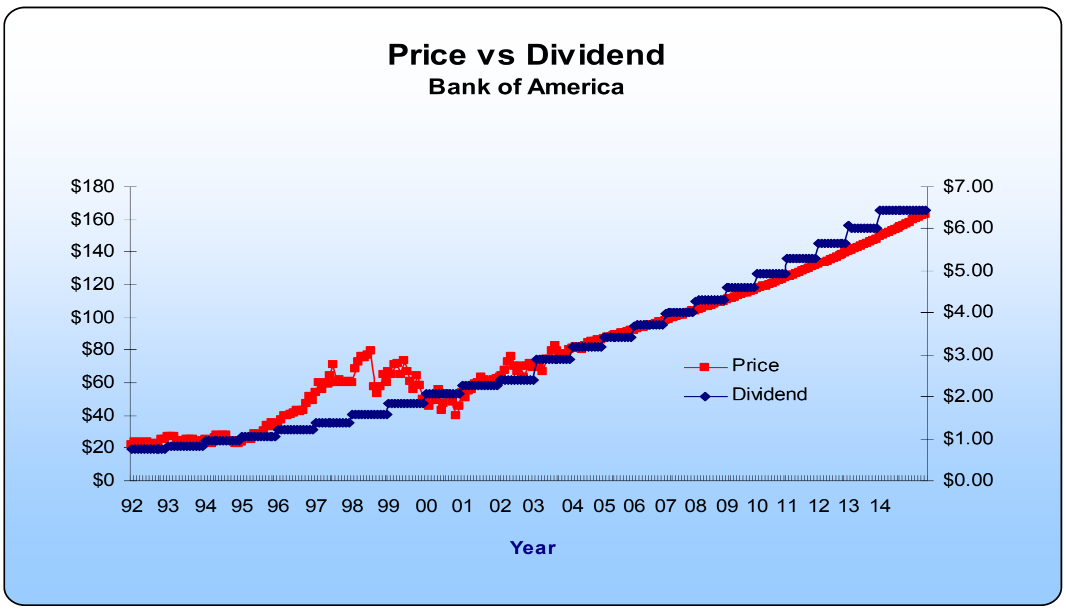
In all, BAC's stock price either was significantly over or under priced relative to its dividend from 1995 through 2002, for eight out of the 13 years. This is clear evidence of the random volatility that John Burr Williams was talking about in his book. By contrast, BAC's dividend payments to its shareholders grew steadily every year. Some of the volatility was due to fluctuations in interest rates, but most of it was the direct result of speculators betting on rumors of takeovers, or worrying that the merger would not work out well. Investors who were focusing on valuation as measured by the dividend could have profited nicely by buying the stock when it fell under the dividend line and selling when it rose appreciably above it. John Burr Williams believed this focus on dividends and their signaling value would be healthy for the market. Not that the speculators would change their ways – he knew that would never happen – but that investors who became skilled at recognizing value in this way would provide a buffer for the markets by going in the opposite direction of the speculators, and thus, diminishing the amplitude of the boom-bust cycles.

Intrinsic Value

The price-dividend chart, however, does not calculate intrinsic value in the way Mr. Williams computed it. It shows us a kind of relative value, or as we have expressed here, an equilibrium price. In addition, the price-dividend table and chart we have studied, thus far, look back in time, while Williams' dividend discount model looks forward. Mr. Williams' dividend discount formulae encompass the projected lifetime of a company, which in mathematical terms is nearly 50 years. This very long horizon is the reason many people stumble over his methodology. There are so many variables to apply over such a long time, that small changes in any of the variables can cause big changes in the intrinsic value. We will dig into Williams' formulae in a future letter, but to help you understand his concepts, we have developed a series of "rule of thumb" intrinsic value measures.

Chart II adds our estimate of BAC's dividend growth over the next 10 years to the historical data from Chart I. Again, we see the blue stair steps of the dividend and the red line of the price. We have shown price steadily rising from 2004 forward in concert with the dividend. This is for illustration purposes only.

Chart II



We are confident price will not follow this trajectory, but we are just as convinced that our estimate for dividend growth will be conservative. We normally use a ten-year horizon when analyzing a company. A ten-year horizon begs the questions of the company's financial strength, the growth of its industry, and its position in its industry. This is what we mean when we say that we enter the dividend world through the quality door. If a company fails any of the quality door tests, we are wasting our time making educated guesses about the future growth of its dividend. This is because the dividend is a voluntary payment declared by the board of directors, and in our judgment, it is silly to bet that both the financial strength and the good will of the board of directors will improve. We have to reduce the variables to a manageable few, and the place we begin is with financial strength. We have been burned too many times in the past by turn-around-situations that just keep turning around and around until they disappeared.

Tying Price Growth to Dividend Growth

In Chart II, we are projecting BAC's annual dividend growth at 7.2%. Recalling Table I, we saw that BAC's historical annual dividend growth rate has been 12.7%. The 7.2% rate of growth is our most conservative estimate of BAC's dividend growth, but we think this is the right place to start. If the numbers work out at our most conservative growth rate, a higher growth rate will be a bonus. BAC is currently selling for $84 per share and its current dividend is $3.20 per share. At a 7.2% growth rate, the dividend will double in 10 years to $6.40. We also know that if BAC's dividend yield is the same in 10 years as it is today, 3.8%, the price of the stock will also double to $168.

	2004	**2014**
$\dfrac{\text{Dividend}}{\text{Price}} = \text{Yield}$	$\dfrac{3.20}{84.00} = 3.80\%$	$\dfrac{6.40}{\text{Price}_{2014}} = 3.80\%$

$$\text{Price}_{2014} = 6.40 \div 3.80\% = 168$$

You can also see this relationship in Chart II by looking at the values of prices and dividend in 2014.

Implied Rate of Return

In making these calculations we have uncovered another of the hidden values of rising dividends: The Implied Rate of Return. Earlier, we said that the total return of a stock is the price growth rate plus the dividend yield. The Implied Rate of Return is the projected dividend growth plus the current dividend yield. The Implied Rate of Return substitutes the dividend growth rate (which we feel comfortable in predicting) for the price growth rate (which is anybody's guess).

At first, this may not seem intuitive, but as BAC's price-dividend chart shows, while price is unpredictable in the short run, over the longer term, price growth will intersect dividend growth. Thus, if we use dividend growth as a proxy for price growth and project it far enough into the future, we can have a high degree of confidence that price will eventually cross the dividend line and, at that point, Implied Rate of Return and total rate of return are the same.

In Chart II, we projected annual dividend growth at 7.2%. Next, we divided each annual dividend by the current dividend yield of 3.8%. In holding dividend yield constant, we hardwired price growth to dividend growth for purposes of the chart. The calculation for 2014 is as follows: $6.40 dividend, divided by the dividend yield of 3.8%, equals a price of $168 per share. We then plug these numbers back into the formula to determine Bank of America's implied rate of return over the next 10 years:

Price growth (same as dividend growth)	7.2%
Plus dividend yield	3.8%
Implied Rate of Return	11.0%

Simple Discounting

We have come a long way, but in calculating the data for Chart II, and the implied Rate of Return, we have been dealing with only half of John Burr Williams' formula for intrinsic value – dividend growth. To complete the other half, we must face the issue of discounting. There are people who have written their entire doctoral thesis on discounting, so it can be a very difficult subject, but we are going to offer a shortcut that we believe tells us all we need to know.

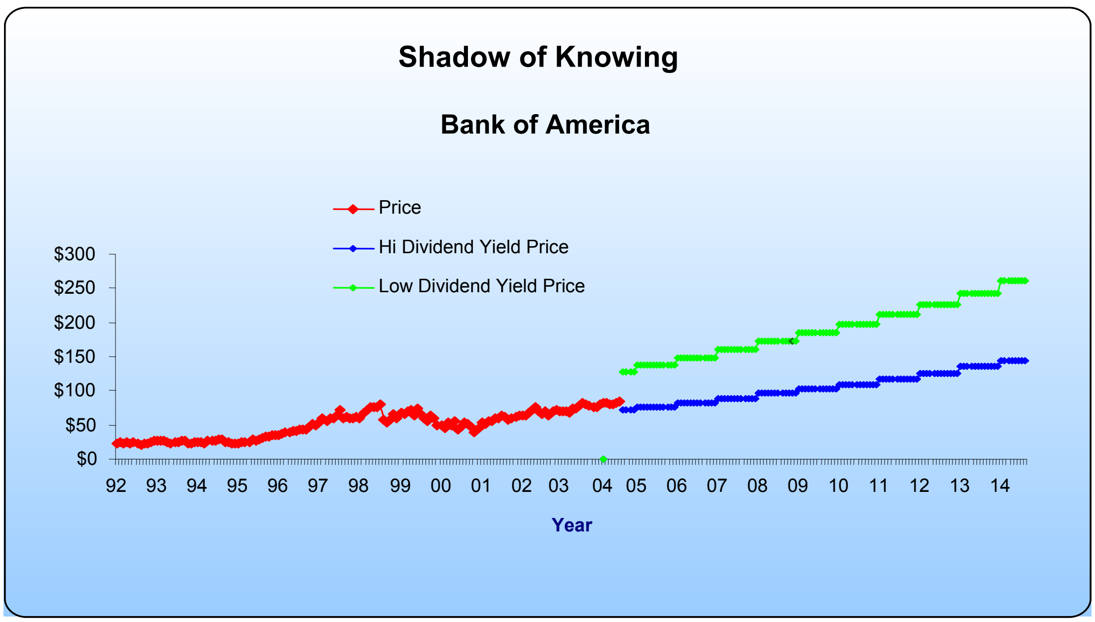
Williams discounted future dividend growth back to a present value using what he called the required rate. The required rate is the yield on long-term Treasury or AAA corporate bonds plus a premium for the perceived additional risk of a stock versus a bond. Today, AAA corporates are yielding about 6%. To that, we must add the risk premium, which we believe is approximately 3%. Adding the two together, we arrive at a required rate of 9%. As we showed earlier, Bank of America has an implied rate of return of 11%. Because BAC's implied growth rate is higher than the required rate, to determine its intrinsic value, we raise the price of BAC to the point where its implied rate of return is equal to the required rate of return. When we do this, we find BAC's intrinsic value to be $96.50. At that price, its dividend yield would be 3.1% and its price growth 5.7% for a total implied return of 9.0%.

Under our most conservative estimate of dividend growth, the simple discount model suggests that BAC is approximately 15% undervalued. As we move deeper into our analysis, you will see that it is probably even more undervalued than our first calculations reveal.

Shadow of Knowing

The above simple discounting mechanism provides us with a quick idea of the intrinsic value of Bank America, but it does so by using the fewest number of variables possible. In our final example of the hidden value of rising dividends, we will begin to add selected realistic variables that will help us gain a better idea of the probable range of prices BAC might experience over the next decade. We will also reintroduce our concept of the "Shadow of Knowing." The shadow of knowing is our term for the notion that, while it is not possible to project stock prices with any precision into the future, it is possible to project the range or shadow that prices are likely to follow. Chart III shows BAC's price since 1992 with two staircases extending from the present out through the next 10 years. This is a visual presentation of the shadow of knowing. Sticking with our most conservative estimate for dividend growth of 7.2%, we believe that BAC's stock price will spend most of its time bouncing around within these two staircases. Here's how we computed the shadow and why we believe it is valid.

Chart III



Looking back at Table I, we see in column 4 that BAC's dividend yield has ranged between a high of 4.5% and a low of 2.5%. In our previous analysis of expected price growth over the next 10 years, we used a constant dividend yield of 3.8%, which produced a steadily rising price that reached $168 per share and an implied rate of return of 11%. We realize that holding dividend yield constant is unrealistic, but we did so to help you understand the concept of implied return. In this chart, we will introduce the reality that just as interest rates go up and down, so do dividend yields.

The construction of the edges of the shadow is very simple. We just divide each projected annual dividend by BAC's highest and lowest dividend yields over the last decade. This would mean that in the terminal year 2014 we would be dividing the projected dividend of $6.40 by 4.5% and 2.5% to produce per share prices of $142 and $256, respectively. This is a wide range, but we believe it is impossible to know with any more certainty what the actual price will be in 2014. In addition, for our purposes, this wide range is fine because using our most conservative estimate, no matter where the stock ends up in the shadow, the rate of return is far better than bonds. Table II proves that statement with the following Implied Rate of Return calculations:

Table II
Implied Rate of Return
For BAC "Shadow of Knowing"

		High Yield	Constant Yield	Low Yield
2004 Yield		3.8%	3.8%	3.8%
2014 Yield		4.5%	3.8%	2.5%
2014 Dividend		$6.40	$6.40	$6.40
2014 Price (Dividend ÷ Yield)		$142	$168	$256
Annual Price Growth From $84 in 2004		5.4%	7.2%	11.8%
Implied Rate of Return (Growth + 2004 Yield)		9.2%	11.0%	15.6%

The Shadow of Knowing tells us the expected Implied Rate of Return for BAC should fall between 9.2% and 15.6% over the next ten years. Given the financial strength of this company, the amount of return provided by a very stable and growing dividend, and relatively low price volatility that the dividend will produce, you can see why we began this example by saying BAC was one of our favorite stocks.

Adding further to our enthusiasm for BAC is how undervalued the market has this stock priced today. If BAC's dividend yield ends 2014 at 2.5%, it is closer to 50% undervalued. By the same math, if its price in ten years is 142, giving BAC an ending yield of 4.5%, it is currently 10% undervalued – still a bargain.

Lots of Math

We realize that in this letter you have had to wade through a lot of math. The truth of the matter is that we have taken it easy on you. The real math that goes into performance and internal rates of return calculations gets far more complicated. Our intent in showing you these rules of thumb is to give you some confidence in our dividend investing strategy. For us, the numbers take the mystery out of the process. We hope they do that for you, as well.

But, the numbers do more than remove the mystery. For example, every day, individual investors, brokers, and mutual fund managers buy companies without knowing their intrinsic value. If an investor does not know the intrinsic, or as Williams says, the investment value of a stock, he runs a serious risk that a significant portion of that investment could vanish in a heartbeat. By calculating the intrinsic value of a company, we can eliminate a lot of the risk in buying it. Knowing the intrinsic value allows us to avoid over-paying for good companies. The only hope anyone who overpays for an investment can have is that a bigger fool will come along and bail him out.

Through these calculations we can create our Shadow of Knowing and on the day we buy a stock, virtually determine the range of returns we should make over the next several years. Then, the Shadow of Knowing allows us to track the progress of the stock toward our expected rate of return by monitoring the dividend growth and how well the stock price is correlating to that growth.

As the dividend for any of the stocks we own grows over time, the "value" of the stock to you, and us, grows. With any financial asset, its true value is defined by the cash it ultimately returns to the investor. It is far too clear that, in our example using Bank of America, when the dividend reaches $6.40 per share, it is twice as valuable to us as when it paid $3.20. By focusing on this aspect of your investments, we can eliminate a lot of the worries associated with watching the stock market's volatility. Your benefit becomes the cash flow from your portfolio (the cumulative dividends from all the companies you own). As the cash flow grows, the value of your portfolio increases, and sooner or later, the prices in your portfolio will match that value.

Calculating the intrinsic value for the broad market helps us keep an eye on the level and direction of speculation in the market. To paraphrase Warren Buffett, "It pays to become fearful when the market is greedy and greedy when the market is fearful."

As Important as Anything

When all of this talk about dividend growth, Implied Rates of Return, and Shadows of Knowing settles down and we look for the real benefit of investing in financially strong companies who consistently raise their dividends, it comes down to one thing: ***this strategy moves you and us out of the world of trying to outguess the market and into the world of investing in some truly great companies and sharing in their prosperity.***

Blessings,

Greg Donaldson Mike Hull