

Red Flags for Income Investors

Yield-chasers often follow dividend increases but overlook warning signs of a potential cut, say the managers of Tweedy, Browne Worldwide High Dividend Yield Value.

Fund Manager Q & A | 06-01-11 | By Esther Pak

William Browne, John Spears, Tom Shrager, and Bob Wyckoff Jr. are comanagers of Tweedy, Browne Worldwide High Dividend Yield Value (TBHDX). They recently answered our questions on their criteria for determining whether a company's yield payout is sustainable and provided their insights into some red flags to avoid when seeking high-yielding stocks.

They also commented on the suitability of this fund for very conservative investors as well as the potential consequences inflation could have on the fund's heavy consumer staples stake. Finally, they discussed whether currency fluctuations have increased the fund's volatility given the fact that the fund does not hedge its currency exposure.

1. Management looks for stocks with high and sustainable yields. The first part is easy to quantify, but how do you determine if a company's payout is sustainable? What is a high-conviction name in the portfolio that scores well on both criteria?

The focus of our research in general is to find companies that are trading at an acceptable level of discount from intrinsic value and that have had a sustainable and/or increasing dividend over time. We are not trying to maximize dividend yield but rather we are looking for companies that have an above-average dividend yield.

When we evaluate a business and try to understand the sustainability of its dividend, there are several factors we consider. First we look at the characteristics of its industry. We prefer industries that hold up well during difficult economic periods because companies in these types of industries generally continue to pay dividends. In contrast, companies in highly cyclical industries such as auto, housing, and airline, tend to reduce their dividends during volatile periods.

Next, we examine the company's position within the industry; this analysis includes key questions. Does it have pricing power? Is it growing organically? Is it growing geographically? Many of the

companies we own sell products which consumers need to buy on a continual basis. Many of our companies have significant exposure to the faster-growing emerging markets. Many have a competitive moat which tends to limit competition.

From a financial point of view, we look for companies which generate significant free cash flow above and beyond their internal needs (specifically, after capital expenditures and working capital) because ultimately this is what funds dividends. We analyze the dividend-payout ratio to see if it is appropriate and capable of sustaining dividends. We tend to avoid companies which have high fixed costs, too much leverage, or volatile margins.

We tend not to speak about our individual holdings as high conviction because it is the overall portfolio of high dividend payers with compelling value characteristics that gives us comfort. As of April 30, 2011, we owned 39 stocks in this portfolio. The overall group of stocks in this approach has served us well over long periods of time.

Sysco (SYY) is one of our portfolio holdings. It is the undisputed leader in the foodservice distribution industry in the U.S. and Canada (approximately twice the size of the next closest competitor). The company has a diverse mix of more than 400,000 customers. Although the core customers are restaurants, the company also sells to hospitals, schools, and hotels among others. With more than 360,000 products, Sysco has the largest breadth of products provided by any foodservice distributor in North America. At initial purchase, the annual dividend yield was approximately 4.2%. Sysco also had a strong balance sheet with modest debt leverage (rated AA- by Standard & Poor's). At purchase, we estimate that we were entering the business at approximately 76% of appraised value.

In our opinion, Sysco is a business with a wide competitive moat which serves to better protect the business from competitors. Sysco's competitive advantages include its overall size, its strong local customer relationships, its ability to successfully execute logistics and

supply-chain management, its history of superior customer service, its large inventory of offered products (one-stop shop), and the largest salesforce in the industry.

Although Sysco seems to have clear qualitative competitive advantages, its historical financial track record validates the strength of those advantages. At the time of our initial purchase, some of those validating characteristics included: an average of 50 basis points of market share gained per year through acquisitions and organic growth since 1972; increased revenue for 38 consecutive years and increased net income in almost every year; a paid dividend for 41 straight years and an increased dividend for 32 straight years; a 53% dividend-payout ratio; a history of earning steady margins (an earnings before interest and taxes margin of about 5%), which were approximately double what the competition earned; and during the prior decade, an average return on equity of 31%.

Sysco is a diversified bet that we have made in our high-dividend-yield portfolios. It is impossible to know today whether the stock will work out well for us in the years ahead, but the probabilities certainly appear to be in our favor with a company like this.

Another holding, U.K.-based British American Tobacco (BTI) is the third-largest tobacco company in the world. It operates in 180 markets and has 250 brands. It also has a 42% position in Reynolds American (RAI), the second-leading U.S. tobacco manufacturer, and a 31% stake in ITC, the leading cigarette manufacturer in India. BAT is a high-return-on-capital, recession-resistant company that, at purchase, was trading at a discount from our estimates of intrinsic value. The following characteristics made it appealing: a consistent earnings pattern even during recession years; high free cash flow; a dividend yield of approximately 4.5%; and a history of dividend increases every year since 1999. Its payout ratio is 64.0%, which is about normal for a tobacco business, and it has increased its dividend by 14.7% per year for the past 10 years. The company has a history of buying back its own shares, and it is growing volume in key global brands. BAT also enjoys strong brand loyalty and has a wide competitive moat.

2. Income-oriented investors often fall into the trap of reaching for yield. What are some red flags to avoid when seeking high-yielding stocks?

Warren Buffett, in his recent annual report for Berkshire Hathaway (BRK.A) (BRK.B), quoted writer Ray DeVoe on this very issue, "More money has been lost reaching for yield than at the point of a gun."

We have to look no further than the recent financial crisis to see the consequences that can result from that kind of behavior. We are not at all trying to reach for yield in our dividend fund. This fund is different from many dividend-oriented funds in that we are not trying to maximize dividend yield, focusing instead on above-average yields.

First and foremost, this is a value-oriented portfolio, and we are trying to buy stocks at an acceptable level of discount to a conservative estimate of intrinsic value. Along with this acceptable level of discount, the stock must have an above-average dividend yield, and our holdings typically have a history of an above-average dividend. Academic data and our own experience suggest that dividends have been a very important component to long-term investment results. Additionally, increases in dividend payments are often indicative of a company's financial strength and management's confidence in the company's future prospects.

In our opinion, reaching for excessive yield can sometimes be a risky proposition in dividend portfolios. We are always wary when we see yields which are too high. This might mean that the dividend is ripe for a cut. To minimize our portfolio's risk, we try to avoid companies with too much debt. Typically, we will not own a business that has more than 2 times net debt to earnings before interest, taxes, depreciation, and amortization. We try to avoid companies with high payout ratios, even if they have a good dividend history.

For example, ConAgra Foods (CAG) was, at one point, an S&P Aristocrat (The S&P 500 Dividend Aristocrats Index includes S&P 500 companies that have followed a policy of consistently increasing dividends every year for at least 25 consecutive years). The payout was high and getting higher every year, as management kept increasing the dividend. This was a red flag for us, and as a result ConAgra was not considered to be a viable candidate for our fund. Finally, new management came in at ConAgra and cut the dividend, and the stock was greatly punished.

3. You recently commented on Worldwide High Dividend Yield Value's holdings and how they are currently selling at less of a discount to your estimate of intrinsic value in comparison with other Tweedy, Browne funds. In essence, the holdings in Dividend Yield Value are more expensive but also higher-yielding than those in your other funds. Would you say the fund is your firm's best option for very conservative investors?

We do not require, as a criteria for purchase, as deep a level of discount in the dividend fund as we require in our traditional funds.

That said, most securities that qualify for our traditional funds and have an above-average dividend yield also make their way into our dividend fund. It's hard to know how the fund will perform going forward and whether it is the best option for more conservative investors when compared with our traditional funds.

There is considerable empirical evidence, however, that suggests that over time, dividend stocks hold up well in difficult market environments. Stocks with apparent high and sustainable dividend yields that are competitive with high-quality bond yields might be more resistant to deep declines in price than lower-yielding stocks because the stock is, in effect, yield-supported.

4. The portfolio has a big emphasis on the consumer staples area. Are you worried about the impact of inflation on those holdings? Why or why not?

We do own a number of consumer-oriented businesses, and inflation with its potential impact on input costs could put pressure on margins if these companies do not have pricing power. On average, companies that have a product and brand differentiation will have a better chance passing along some of these costs to the ultimate users of the product than those that do not have such a differentiation. A good example of this would be in cigarettes. We believe that the companies we own should be able to reasonably handle the impacts of inflation and perhaps be less affected than others. Most of our companies sell products that are number one or number two in their specific market category. These categories are typically growing and consist of products that are often aspirational with respect to a rapidly rising middle class around the globe, more specifically, the populations of many of the faster-growing emerging markets.

If you have these factors working for you, we think it's probable that you will have some pricing flexibility in your products. This pricing flexibility, along with some cost-cutting efforts, we believe can offset, in large part, much of the raw-material price increases that will occur in an inflationary environment.

While inflation has a way of destroying wealth for all investors, particularly long-duration bondholders, we believe that a portfolio of well-selected equities can offer a better chance of preserving one's purchasing power, as such equities did in the late 1970s. Fearing the worst, many investors, of late, have been drawn to gold and commodities. We think this is probably a mistake. Good, well-run businesses, we like to remind ourselves, are adaptive,

income-generating enterprises, and many have shown a remarkable ability to anticipate and adapt over time in the face of always-changing conditions, while increasing profits in the process.

A prime example for us is the significant exposure that many of our investments today have to rapidly growing markets where middle classes are reasonably expected to double during the next decade. Simplistically, let's compare two alternatives: first, a 10-year government bond yielding approximately 3% with no chance of increasing the cash coupon we receive; and second, an interest in a conservatively financed company with a global business footprint and global brand recognition, with one third of revenues coming from markets where the universe of middle-class consumers could well double in the next decade, and with a dividend yield of 3%-4%. After looking at this comparison, we want to own the business, not the bond. We believe we might be wealthier for having picked the business*.

5. This is the only fund in your lineup that does not hedge its currency exposure. Have currency fluctuations added substantial volatility thus far?

We now have two funds that do not hedge foreign currency exposure. Worldwide High Dividend Yield Value and Tweedy, Browne Global Value Fund II - Currency Unhedged (TBCUX). By establishing the Tweedy, Browne Global Value Fund II - Currency Unhedged, we were acknowledging that some investors may view exposure to foreign currency as another form of diversification when investing outside the United States, and/or might have strong opinions regarding the future direction of the U.S. dollar. We are simply offering our investors a choice of how they want currency treated in the management of a portion of their international assets.

Our decision to run Tweedy, Browne Worldwide High Dividend Yield Value on an unhedged basis is based upon a slightly different concept. First, a substantial portion of the fund's holdings are in U.S.-domiciled companies and are priced in U.S. dollars. The companies that are held outside of the U.S. are typically larger-cap, multinational companies that have meaningful exposure to the U.S. dollar. In many cases they sell their products in the U.S. and other dollar-based regions. They are also selling their products in a multitude of different countries and currencies around the world. Given the nature of these large, multinational businesses, we believe that they are naturally hedged to some degree. For this reason, attempting to reduce currency risk through hedging currency exposure in these companies appears to be of little apparent benefit.

Can an unhedged portfolio be more volatile? Yes, possibly. That said, Tweedy, Browne Worldwide High Dividend Yield Value seems to have volatility, as measured by standard deviation, that is in line with our other funds during the past three years, based on Morningstar Principia Pro data. In our traditional global value strategies, our hedged portfolios have experienced slightly less volatility than our unhedged portfolios during the past 10 years as measured by standard deviation. During this same time period, our analysis indicates that our unhedged, high-dividend portfolios have been even less volatile than our traditional value portfolios (both hedged and unhedged).

A Lehman Brothers study of U.S. stocks from 1970-2005 points to higher-dividend-yielding stocks having higher returns and lower standard deviations**.

Although equity returns in general are often lumpy, we think low volatility is good because it will keep shareholders in our fund. However, we do not attempt to manage levels of volatility. Rather, it is a byproduct of our value investment process. Big return swings, both up and down, sometimes can cause investors to behave less than rationally, increasing transaction activity. We have seen time and time again that investors are often making those trades at just the wrong time. We believe that most of the time, the best thing for an investor to do is sit and do nothing.

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* Stocks and bonds are subject to different risks. In general, stocks are subject to greater price fluctuations and volatility than bonds and can decline significantly in value in response to adverse issuer, political, regulatory, market, or economic developments. Bonds, unlike stocks, if held to maturity, generally offer to pay both a fixed rate of return and a fixed principal value. Bonds are subject to interest-rate risk (as interest rates rise, bond prices generally fall), the risk of issuer default, issuer credit risk, and inflation risk, though U.S. Treasuries are backed by the full faith and credit of the U.S. government.

** (See study, "The High Dividend Yield Advantage" at www.tweedy.com).



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As of December 31, 2011, Tweedy, Browne Global Value Fund, Tweedy, Browne Global Value Fund II – Currency Unhedged, Tweedy, Browne Value Fund, and Tweedy, Browne Worldwide High Dividend Yield Value had invested the following percentages of its net assets, respectively, in the following portfolio holdings: Sysco (0.0%, 0.0%, 0.0%, 1.5%); British American Tobacco (2.1%, 0.9%, 2.0%, 2.5%); and Reynolds American (0.0%, 0.0%, 0.0%, 0.0%). Portfolio characteristics mentioned above reflect the Funds' investments on the date indicated and may not be representative of the Funds' current or future holdings.

Current and future portfolio holdings are subject to risk. The securities of small, less well-known companies may be more volatile than those of larger companies. In addition, investing in foreign securities involves additional risks beyond the risks of investing in securities of U.S. markets. These risks include economic and political considerations not typically found in US markets, including currency fluctuation, political uncertainty and different financial standards, regulatory environments, and overall market and economic factors in the countries. Value investing involves the risk that the market will not recognize a security's intrinsic value for a long time, or that a security thought to be undervalued may actually be appropriately priced when purchased. Investors should refer to the prospectus for a description of risk factors associated with investments in securities held by the Fund.

Although the practice of hedging against currency exchange rate changes utilized by the Tweedy, Browne Global Value Fund and Tweedy, Browne Value Fund reduces the risk of loss from exchange rate movements, it also reduces the ability of the Funds to gain from favorable exchange rate movements when the U.S. dollar declines against the currencies in which the Funds' investments are denominated and in some interest rate environments may impose out-of-pocket costs on the Funds.

Tweedy, Browne Global Value Fund, Tweedy, Browne Global Value Fund II – Currency Unhedged, Tweedy, Browne Value Fund, and Tweedy, Browne Worldwide High Dividend Yield Value Fund are distributed by Tweedy, Browne Company LLC.

This material must be preceded or accompanied by a prospectus for Tweedy, Browne Fund Inc.