Beware the Large Cap Dividend Trap
Passive Money Flows Creating Opportunity for Value Driven Income Investors
(Part One as of June 2016)

One effect of low to negative global interest rates is investors are driven farther out on the risk curve. When investment grade fixed income yields become insufficient even for the most risk-averse investor, there is a search for alternative sources of income. One avenue has been large-cap dividend paying stocks.

We can understand the thought process to a degree. A 3.5% dividend from a blue chip multinational company compares well when its own 5-year maturity debt may be yielding less than 2%. As security agnostic investors at CCMNX, we as portfolio managers are constantly evaluating such relative yields between securities and asset classes. Given this experience, we can say with confidence that higher yields are not a free lunch.

While many dividend index component shares might have higher dividend yields than what can be found in bond land, those shares also now trade at severely elevated valuations relative to historic measures.[1] These elevated valuations contrast with deep-cyclical or structural head winds in some cases. Unlike investment grade bonds that mature at par barring fairly rare instances of default, paying stretched earnings multiples for stocks in search of yield can result in significant lost capital should multiples normalize without a commensurate increase in earnings.

Additionally, in some cases, management of these blue chip companies are keeping or increasing dividends to please investors at the expense of the current balance sheet and future growth. Paying dividends in excess of earnings and/or free cash flow can be dangerous and ultimately an unsustainable strategy. Owning such stocks purely for their yield can endanger investors in two ways:

- A future dividend cut (voluntary or involuntary) may not only result in reduced cash flow, but share prices frequently decline following dividend cuts.
- A reversion to historic or comparable mean earnings multiples even if dividends are maintained could result in large losses.

Investing involves risk including possible loss of principal. Bonds and bond funds will decrease in value as interest rates rise. High yield bonds involve greater risks of default or downgrade and are more volatile than investment grade securities, due to the speculative nature of their investments. The Fund uses investment techniques that are different from the risks ordinarily associated with equity investments. Such techniques and strategies include hedging risk, merger arbitrage risks, derivatives risks, short sale risks, leverage risks, commodities risk, and foreign investment risks, which may increase volatility and may increase costs and lower performance. Commodities can be highly volatile and the use of leverage may accelerate the velocity of potential losses. A security may reduce or eliminate its dividend, causing losses to the fund.

[1] Based on S&P 500 Dividend Aristocrats Index, measuring performance S&P 500 companies that have increased dividends every year for the last 25 consecutive years. The Index equally weights each constituent.

The irony of the matter is that investors are putting money into these situations while lesser-known, better performing companies trade at very attractive valuations and yields. Certainly there is risk with any investment class. However, we believe these companies can offer significant potential price appreciation in addition to possibly having more sustainable dividends that can be supported by sound fundamentals.

Below you will find two situations that illustrate this lopsided risk dynamic. They are both investment grade companies with some degree of overlap; however we don't look at them as a paired trade. Our goal is to educate people that size, credit ratings and dividends can be useful investment yardsticks but are still surface measures. We believe valuation, management and fundamentals in the end will rule the day and the current rush of passive, valuation agnostic flows will have created great opportunities on both the long and short side.

To avoid any biases, we will not name them until later. We'll introduce them with a quick table:

	Company A	**Company B**
Credit Rating (S&P)[2]	AA+ Neg	BBB- Stable
Market Cap	$371bln	$5.5bln
Free Cash Flow % of Market Cap[3]	1.75%	8.1%
Dividend Yield	3.28%	6.62%
Dividend Payout Ratio[4]	186%	76.5%

Source: Bloomberg as of May 10, 2016

Company A

Company A is perhaps the poster child for dividend chasing investors. The company came into 2016 having raised its dividend every year for 33 years and until last month had a AAA credit rating from S&P and Moody's. A closer look reveals an uglier truth.

Dividend Sustainability

Company A's cash flow is very dependent on the price of oil. High prices mean high cash flows, which allow the company to pay its dividend and invest in its business without incurring debt. Low oil prices, like now, do not allow the company to do all three. Even with 25% reductions in capital expenditures, the company's cash flow did not cover its dividend in 2015. Lower capital investment goes beyond cost-cutting as well. This past quarter Company A's production exceeded its reserve growth for the first time since 1993. Reserve growth below production means there should be less production in the future.

[2] Ratings are on a scale from AAA(best) to D (lowest)
[3] Free Cash Flow" numbers are provided separately by each. Please note company definitions of free cash flows can vary.
[4] Defined as current dividends as a percentage of free cash flow for 2015.

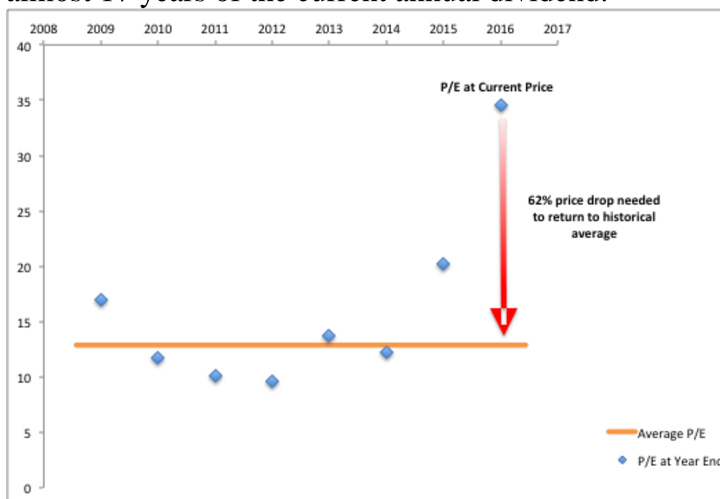
In essence, the company is risking future profits and incurring leverage to maintain their dividend record. To cover its dividend without further cuts to new oil finds or adding leverage, our analysis and projections suggest that WTI (West Texas Intermediate) oil would have to average $70/barrel.

Share Price Sustainability

Company A's earnings multiple averaged around 12.88x since 2009 with few anomalies preceding that. Prior to now, the previous high watermark for the multiple occurred in 2009 and was 17x. This 2009 multiple was achieved while oil averaged $62 and their earnings bottomed at $4.01 per share.

To justify today's share price of $87[5] with the historical multiple of 12.88x, earnings per share (EPS) would have to increase from $3.85 to $6.75. The last time Company A's earnings exceeded $6.75 was 2014 when WTI averaged almost $93/barrel—nearly double the current price. Essentially a valuation based on historical multiples necessitates EPS and ultimately crude oil increasing two fold from current levels.

Worse yet, the company's cash flow and earnings have continued to deteriorate in 2016, yet its stock remains elevated. Consensus estimates for 2016 earnings are around $2.50 per share, leaving the company share price at almost 35x earnings. As the chart below shows, shares could drop substantially should they revert to the 7 year average earnings multiple. At 35x earnings, each 1x of earnings represents a 2.85% move in the stock price. Therefore, should the earnings multiple contract 1x, an investor would suffer capital losses equal to 87% of the current annual dividend. Should the multiple contract back to 12.88, a loss of almost 22 multiples of earnings, capital losses would be equal to almost 17 years of the current annual dividend.



2016 is based on estimated earnings
Source: Bloomberg as of May 10, 2016[6]

[5] As of May 10, 2016 sourced from Bloomberg
[6] Average P/E is for the period from 2009 through May 10, 2016. P/E is based on share price at the end of the year divided by that that previous years earnings per share. Source Bloomberg.

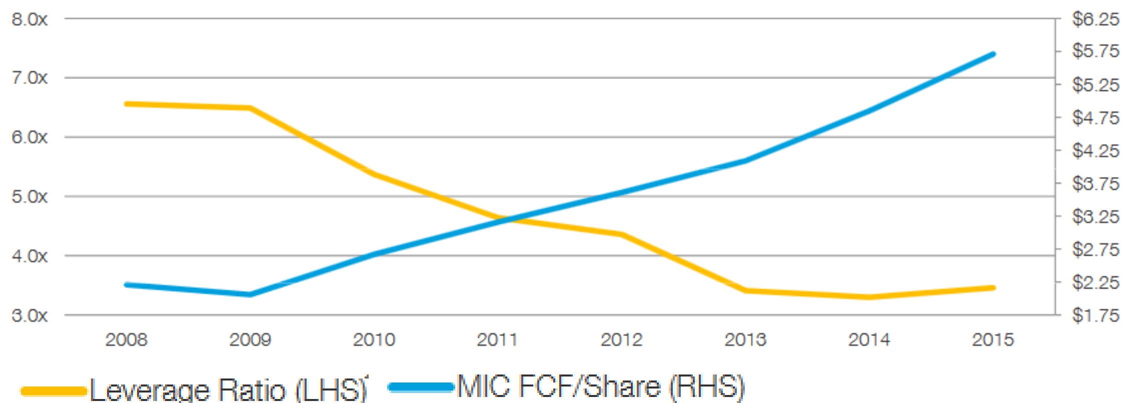
Company B

In contrast to Company A, Company B is not a household name. It has only been around since 2004 and none of its assets bear its name. Also unlike Company A, its businesses have few direct impacts from the price of oil or natural gas or any commodity for that matter. The company owns various businesses that:

- Contract solar generated power to utilities
- Provide gas generated peak hour electricity to southern Manhattan
- Service jets at private airports
- Supply regulated natural gas to Hawaii
- Own tanker storage for a wide range of materials from vegetable to oil to asphalt.

Dividend Sustainability
All businesses have had excellent returns on capital and throw off a lot of cash. Company B has increased its operating cash flow per share at an 11.4% compound annual rate over the eleven years it has been publicly traded. Its dividend has increased at an 8.25% compound annual rate since over the past ten years. These trends have gotten better. The company has guided to around 20% higher cash flows and 14% higher dividends in 2016.

Share Price Sustainability
The accomplishments have occurred while management has continuously invested in its business, acquired assets at accretive prices and reduced debt from junk levels to an investment grade rating. The chart below shows the company's progress in deleveraging while simultaneously growing its free cash flow per share. It leaves little wonder how the company has been able to grow its dividend so impressively. What one might wonder is why Company B's stock is down 20% from its high last spring while Company A is up slightly.



Source: Macquarie Infrastructure Corporation 1Q2016 Earnings Presentation
The left hand side of the chart above represents Company B's leverage ratio as defined by debt divided by EBITDA (earnings before interest, taxes, depreciation and amortization). A lower leverage ratio implies lower leverage. The right hand side of the chart above represents Company B's free cash flow per share, which is defined as free cash flow divided by total number of shares.

As far as we can tell, hedge fund deleveraging has played a role in the share price performance gap between the two companies. Hedge fund ownership of Company B has declined from 40% to 20% over the past twelve months. Company A has never had a major hedge fund presence. Perhaps as important, Company A is a large component of many dividend indices, whereas Company B is in very few. Many of these indices are valuation agnostic. When ETFs that mirror these indices get inflows (like many have), Company A gets bought, while Company B does not. As a result, Company A currently trades at a stretched valuation, while Company B trades at a comparatively cheap one.

Looking Forward

Company A is obviously Exxon and its history and macro challenges are broadly known. When just looking at the current management team, it appears they are more concerned with the dividend and are leveraging the balance sheet and selling their future via reduced capital expenditure to maintain it. From a risk/reward perspective we believe there are limited reasons to invest beyond “it’s Exxon”.

Company B is Macquarie Infrastructure (MIC). Understanding Macquarie requires a little time examining its assets, but it would be time well spent. We consider MIC’s assets to have moats so wide as to be virtually irreplaceable. But MIC’s management are far from the types to just sit back and milk good assets. They continuously seek to improve efficiency of their various businesses, improve margins and seek pockets of growth. Moreover, they are proven terrific capital allocators. Not only have they been shrewd buyers of assets, they are willing to part with businesses at high multiples and willing to walk away from projects when yields get too skinny.

Conclusion

Inflows into long only and passive income funds are driving P/E multiples on some blue chip companies to levels that we feel can’t be justified barring a massive change to their operating environments. At the same time, highly-performing companies that float under the radar are being ignored yet are at attractive relative and absolute yields.

As of 4/30/16, Macquarie Infrastructure (MIC) represented 0.03% of the Fund’s net assets and Exxon represented -0.02% of the Fund’s net assets. Holdings are subject to change. With short sales, you risk paying more for a security than you receive from its sale. Short sales losses are potentially unlimited and the expenses involved with the shorting strategy may negatively impact the performance of the Fund. There is no guarantee these holdings will have the intended effect on the Fund’s performance.

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