CONSUELO MACK | WEALTHTRACK

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An exclusive interview with award winning value investor Hersh Cohen on the compounding power of increasing dividends.

Hersh Cohen
Co-Manager
ClearBridge Dividend Strategy

CONSUELO MACK: This week in a WEALTHTRACK exclusive: Fifty years of market and investment perspective from Great Investor Hersh Cohen is next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack.
Investing is complicated. There are so many choices available and so many decisions to make it can be absolutely overwhelming. Sometimes a simple approach is the best one.

One tried and true strategy over the years has been to invest in companies that increase their dividends every year and reinvest those dividends back in the companies' stocks, letting the power of compounding go to work.

Historically it's been a performance winner. An analysis by Ned Davis Research of Russell 3000 companies over the last 30 years found that investing in dividend growers has done substantially better than in dividend paying companies that don't grow their dividends, and significantly outpaced stocks of non-dividend paying companies. The stocks of the dividend growers were also less volatile than the dividend non-changers and non-payers.

These results are no surprise to this week's guest who has spent half a century finding high quality dividend growers and has beaten the S&P over the years doing it.

He is great investor Hersh Cohen, Co-Chief Investment Officer of Clearbridge Investments, a Legg Mason affiliate, where he oversees nearly $18 billion in assets. He is also Co-Manager of the firm's Dividend Strategy Portfolios including the Clearbridge Dividend Strategy Fund which he has co-managed since 2009. Cohen made his reputation with the Clearbridge Appreciation Fund which he left in 2010 after a thirty year run, in which he edged out the S&P 500 with much less risk and volatility than the market. Cohen is stepping down from management of the fund at the end of 2017 but will continue to run portfolios for clients. He will also stay on as Co-Chief Investment Officer with Scott Glasser.

I began the interview by asking Cohen why dividends have always played a key role in his investment strategy?

HERSH COHEN: Because I think, A, they provide some measure of down side protection. When markets go down, there is some point at which people will say the yield on this stock is enough that I'd rather own this than money funds or bonds or something. That went out of favor in the 1990s, but it came back into favor over the past decade. Great companies can give you a rising stream of income, and especially in this environment. Now my love of dividends goes way back, but in this environment who's getting raises of five, six, seven, eight, 12 percent a couple years ago? So, that rising stream of income is terrific. The power of compounding, people forget about. They don't think about it, and it makes for a better future. If you start when you're young and let the great companies work for you and take that money and either reinvest it.

The best part is reinvesting it, and then somewhere down the road in the future stop reinvesting it and get the dividends directing and use them for whatever, for living expenses, charities, whatever it is, and I just think it makes for kind of a better life to be thinking about rising streams of income.

CONSUELO MACK: It's important, so the rising streams of income, and again long before there was anything called the "Dividend Aristocrats" list, you at ClearBridge and predecessor firms were basically looking at companies that were growing their dividends. You weren't looking for necessarily high-yield companies. You were looking for growing dividend streams consistently over time.

HERSH COHEN: I've owned companies like Johnson & Johnson, 3M to name a couple that their dividends have gone up every year for 50 years. Don't quote me on the exact number but decades, many, many decades. PPG, an industrial company. It's always a nice thing to see that announcement every year of those dividends going up, and my team and I like to look for companies that could be the dividend aristocrats of the future. So, Microsoft for example was a stock that had never ... technology in general had kind of ...

CONSUELO MACK: Didn't pay dividends.

HERSH COHEN: It was an anathema to them to pay dividends, but when they became more mature and started to have all this excess cash and pressure from shareholders within the past decade to pay dividends and raise dividends ... they don't qualify as have paid 25 years of consecutive growth, but they might in the future, and meanwhile Texas Instruments, Micro, they've become very good dividend growers.

CONSUELO MACK: How do you make that decision to stick with a company, let's say one of the companies that has a history of growing dividends, when it's appreciate a lot or when it's declined a lot. I mean how do you make those decisions?

HERSH COHEN: Gee, those are such easy questions.

CONSUELO MACK: Bull markets and bear markets.

HERSH COHEN: It's an art. It's not a science, but our tendency is to kind of leave companies alone and let them do their thing for you. You had asked me to think about investing principles for people in our pre-interview, and I'll tell you. One of my principles is traders, you don't meet too many rich traders, but you do meet very well-to-do long-term investors. So, if you get shaken out, every time there's a ten percent down move in one of these great companies, you'll never get the power of the compounding. You'll never get the full benefits. Who can time it that well?
But the answer to your question is, as long as a company is making the right kinds of decisions in terms of capital allocation, that is how much they put into research and

development and how much they pay out in dividends, how much they do stock buyback, as long as the company's doing the right thing in terms of capital allocation and as long as their business model is good, you have to pay attention to outside forces.
I mean one of the mistakes I made was not understanding ... probably the worst stock I've had in the last decade was Gannett. I didn't understand how quickly newspaper readership was going down. Why? I like to read the newspapers, but I didn't realize how quickly ...

CONSUELO MACK: You and Warren Buffett incidentally.

HERSH COHEN: I didn't realize how quickly individuals were giving up. Young people were not reading the newspaper and so you have to pay attention, and they've cut their dividend. To me a dividend cut, you basically want to get out of a stock if it's a dividend cut, but that fortunately doesn't happen very often. I don't want to see great management straying too far from what they do. When companies start making mega mergers that you're kind of scratching your head, why are they doing that, that's a pretty good time to examine your underlying belief in a stock. That doesn't happen all the time. Tuck in acquisitions. We like those for companies as long as they fit. There are just signs you kind of look for over the years. You get signs. One is just getting outside their field of expertise. I mean I think Microsoft did that many years ago. They bought Skype. They bought Nokia and it's like, what the heck are they doing?

CONSUELO MACK: So, when they do something like that, you reduce. That's the signal just to ...

HERSH COHEN: That's a signal. You want to yell at management and hope they do something about it, which in that case they did.

CONSUELO MACK: So, the capital allocation piece which you had just mentioned, would you equate a stock buyback with a dividend payment?

HERSH COHEN: I do not equate them. No. We much prefer dividends. Dividends we have in hand. It's real money. It's spendable money. Companies are loath to stop paying them or to cut them. Stock buybacks, unless it's a Dutch tender offer or a tender offer for stock, you don't know for sure that the companies are actually going to execute them, and a lot of the buybacks are done when the stocks are way too expensive anyhow. When do I like buybacks? When the markets are getting killed and stocks are selling at below fair value. Then you want buybacks. Sure.

CONSUELO MACK: One of your long-term holdings has been Berkshire Hathaway which doesn't pay a dividend. But you talked about the power of compounding and that's an example ...

HERSH COHEN: Well, there's no better compounder and no better capital allocator in my opinion.

CONSUELO MACK: So, that fits in because of again management decisions of what they're doing with their capital.

HERSH COHEN: It's rare that you'll get that kind of company with such incredibly good compounding abilities that doesn't pay a dividend.

CONSUELO MACK: I've interviewed you many times over the years, and you came to help us on WEALTHTRACK understand what was going on during the Great Recession. So, I looked back at some of our shows, one of the ones you did in 2008, and at that time in the midst of this panic, your one investment recommendation was to buy a basket of high quality dividend-paying stocks, we'll put it on WEALTHTRACK again, the list of companies that you have that have been long-term payers. How did you keep your cool and make a rationale decision like that which paid off big time in 2008?

HERSH COHEN: Well, I don't know if I kept my cool, because inside I gained weight. Inside it's turmoil, but here's the thing. I urge people to study stock market history, and I love the markets and so I know that in 1929 to 1932, if you look at graphs of the market, it had a certain pattern. The market had declined, declined, declined. Waterfall panic, rally, back down to a level that it found a bottom at. The leading stocks, the RCAs of the world, the new things in the world went down 80 to 90 percent. Okay, that was number one. Number two, 1973, '74 you had a similar situation. The so-called Nifty Fifty stocks ...

CONSUELO MACK: Nifty Fifty.

HERSH COHEN: ... which people would pay any price for, they went down 80 or 90 percent and the market had the waterfall decline in October of '74. Look at the state the country was in then. I mean who could think about stocks? But you had the same pattern. Waterfall decline in the summer, rally, decline back to the levels in December and, bing, that was it. The same thing happened in 2000 and 2002. The Internet stocks, the ones that had so-called new metrics of measurement, bam. Ninety percent and the same thing, waterfall decline. Rally took a little longer because the level of speculation had been so great. It took about six months to form that bottom. If you look at a graph, it looked the same.
Guess what. 2007 and 2008 the same thing, waterfall decline, and the world feels like it's coming to an end. People get scared. I said you're physically sick. The difference is I recognized that when you feel that way, you're probably better off buying stocks than selling them.

CONSUELO MACK: But what's hard I think for most individuals, number one, is maybe they ride down the first leg, and then they think then there's that little dip up, but then it's the second leg that just ... that's the washout leg. That's the capitulation leg. But in the meantime, you've lost paper money on the way down.

HERSH COHEN: Hopefully you've done something to protect yourself against the most speculative items in the beginning.

CONSUELO MACK: So that's the question.

HERSH COHEN: That goes back to your question. How do you know when to sell? I mean there's no formula. There's no formula. Sometimes things are just crazy.

CONSUELO MACK: One of the key characteristics that you are applauded for is that your performance in down markets is so much better than the market and that basically you're able to protect your shareholders in down markets. How did you do that?

HERSH COHEN: What I think is important is what Morningstar said years ago. Certain funds help people stay in the market. I believe in trying to keep the volatility lower than the general market. So, if I can give market or maybe market-beating returns over a cycle but with 75 or 80 percent of the volatility, maybe people will stay aboard, and you go back to 1974. We talked about this. I use this in speeches all the time to people about you think back to 1974. The world felt like it was coming to an end. The country was torn apart by the war. The president and vice president resigned in disgrace. New York City was effectively bankrupt. Oil prices were tripling. You couldn't get gasoline. The country was a mess.

CONSUELO MACK: Was a mess.

HERSH COHEN: I'll ask people, "Where do you think the Dow Jones average was?" If they don't know, they'll say, "Ah, 5,000, 6,000." No, 600, and look where we've come. Look how far we've come since then, and it hasn't been easy, and look at all the things that have happened. Now the Dow is, what, 22,000, something like that. Plus, dividends along the way and some pretty scary things have happened, 20 percent interest rates, the World Trade Center, emerging markets collapsing, et cetera, et cetera. A ten-year war in Iraq.

CONSUELO MACK: It's been endless.

HERSH COHEN: Here we are at all-time highs. Why? Because this country's resilient. Corporate America does a great job. So I love great companies. I love dividend-paying companies. One of my greatest strengths is also my greatest weaknesses. I don't like paying up for stocks, and so in markets that are extended bull markets ...

CONSUELO MACK: Like now.

HERSH COHEN: ... like now, I'll miss some stocks or I'll see them too early. I sold Microsoft and Intel way too early in 1998 because we had bought them at eight and 12 times earnings. I sold them at 30 times earnings on the way to 50 times earnings. So I felt stupid, but it kind of comes back. It worked out. For Scott and me it worked out well in 2000 to 2003.

CONSUELO MACK: So, protecting ...

HERSH COHEN: So as an active manager, what I want to do is keep people on the train and, by the way, if I can't do better than passive funds in a down market, then I shouldn't be managing money.

CONSUELO MACK: When you look at the active versus passive debate, I realize that if you are in an index fund, when the index fund declines, you are going to feel the full brunt of the market decline. We haven't really seen a market decline, a significant one, in eight and a half years.

HERSH COHEN: Exactly, exactly.

CONSUELO MACK: And it's during this period of time when index funds have absolutely taken off.

HERSH COHEN: Yes, and it's ...

CONSUELO MACK: So, it's feeling like ...

HERSH COHEN: It's easy for people to get in.

CONSUELO MACK: ... a crowd play.

HERSH COHEN: But I don't want to see people trading the market. I tell you. I go back to what I said before. I don't think you get rich trading, and what you wind up doing is missing the big moves. You don't make money that way and so ...

CONSUELO MACK: No, as an individual…

HERSH COHEN: ETFs make it too easy to get in. You get in and out during the day.

CONSUELO MACK: With ETFs.

HERSH COHEN: Now you know we have ETFs. We started some. I don't know. Are they good? They not good? I mean I'll use them for specialty things. Everybody can have a use for them, but I like picking great companies. That's one of the things that we try to do.

CONSUELO MACK: So, the argument that the market is so efficient now because there are so many smart people on Wall Street, and 99 percent of the trading is driven by machines that have all of this meta data in it, and they're picking up every possible tidbit about every single company that you're investing in. So how can you possibly do better than the average? So, that's the argument. What's your response? Is it ...

HERSH COHEN: Because what happens, there aren't that many of those companies and so what happens is it tends to get concentrated in those, and it does leave some things that are kind of out of favor that if you're patient enough you'll find them and hold them. I mean that's one answer. The other answer is sometimes you just can't beat it. Sometimes you can, and we won't know until the next bear market. So, we won't know. I want people to survive, and if you survive you can do very well.

CONSUELO MACK: So as an active manager, what are you doing to help people survive? What is it that enables your portfolios not to go down as much as the market? That you have much better risk-adjusted returns. What is it that you're doing?

HERSH COHEN: Well, I think the underlying dividends do help. The popularity of dividend funds I think is well-justified, and I think that helps. I think I've always been willing to use cash as a tool. We don't have an enormous amount now but kind of a little more than what I would call frictional cash. So, that's not a bad way, and if I felt really nervous about things, then my team would probably go more to cash, and that's a dangerous thing for money managers to do, because if you're wrong you lose your job, but I've been able to survive that, and so cash has helped. The quality of the companies I think makes a big difference and to me the biggest thing is avoiding the areas with kind of the greatest ... to say the greatest risk is one way of putting it, but kind of things that have been sort of in bubble territory before and start to break. I won't name those stocks now, and more money has been lost shorting "bubble stocks" as they're on their way up, but when they break they can really break hard, and in bear markets they go down much more than people think. You want to be out of the way of those things. It's not always possible, but since we don't buy a lot of those in the first place, we don't have them in the second place.

CONSUELO MACK: One of the things that you said when you were on WEALTHTRACK… The market is determined by three things: earnings, interest rates and psychology.

HERSH COHEN: Correct.

CONSUELO MACK: So what are those three things telling you now?

HERSH COHEN: Well, earnings have picked up. That's good.

CONSUELO MACK: That's good.

HERSH COHEN: But again, here's the thing. That's a good thing except this bull market started when earnings were a disaster.

CONSUELO MACK: A disaster.

HERSH COHEN: And the economy was a disaster. So, I'm going to call that as a positive, but it's not the only factor. Interest rates and low interest rates, huge positive. In 2009 we had the first time since the mid 1950s stocks yielding more upfront than bonds did. My gosh, there was stuff being thrown out the window, and the Fed was keeping rates down. All the rates are artificially low. It turns out, maybe they're not artificially low. This is where there's no inflation, no headline inflation, and for most things the CPI is modest, and so rates are deservedly low. So, interest rates are a positive, and psychology is interesting. The worst psychology is when people are manic. We don't have that. The best psychology is when people are depressed for buying stocks. We don't have that either. There's sort of a complacency, so I'll call that a neutral. So, on balance this is a market that is kind of probably where it ought to be, where it ought to be. I think underpinning this market and why I don't think we have a bear market coming is because interest rates, that's a pretty good ballast underneath the market. That's why, again, you come back to dividends. Would you rather have really good companies paying three to four percent, or a ten-year Treasury paying 2.1? Now some people would rather have the ten-year Treasury, but that's a choice people make, but dividends give it some support. Right now, on balance earnings and interest rates point to being a market that's in pretty good shape. Psychology, neutral.

CONSUELO MACK: Hersh, what do we do?

HERSH COHEN: But that doesn't mean we're launching a new bull market. It's just in support of what's kind of been going on. These are in fact things that are in support of the current bull market which has been a wonderful bull market.

CONSUELO MACK: It's going to correct at some point.

HERSH COHEN: Of course.

CONSUELO MACK: We just don't know when.

HERSH COHEN: It might have started already. Who knows.

CONSUELO MACK: Your advice to investors when the market, which has had this incredible bull run, does correct. What do we do when that's happening? What do you do?

HERSH COHEN: I mean I've had stocks I've held since the 1970s. What do I do? I mean I pretty much close my eyes. I hold. I hold.

CONSUELO MACK: Collecting the dividends.

HERSH COHEN: This sounds stupid. I'm sorry, but when the market was collapsing in 2009, people would go ... I say, "You know it's amazing. Not one of our companies cut their dividends today." So in other words, the income. I try to convince people don't look, and especially in the dividends, but don't look at what the asset values. We all like the wealth effect of the market. Listen. When you go home counting your money, that's when you have to be careful how rich. Oh, I made so much money. Be careful. People aren't doing that now and so the answer to your question is when things turn bad and there's that correction, you don't know how low it's going to go unless you've had a mania first or unless there's been a bubble. You have to ride it through. You have to stay on the train, and again that's what I like to think a good active manager will help people do. Does that mean I'm not going to go down? Of course not. Of course, you're going to go down. The market goes down. You're going to go down. Hope to go down less. Hope to keep people from feeling that the bottom's falling out of their lives. It's hard. One of the hardest things for people in the financial business to do in markets is to understand that markets can fluctuate. I know it's an old stupid saying.

CONSUELO MACK: Yes, no, but they do and they will.

HERSH COHEN: I have a quote on my wall. I think it's from one of the Rockefellers about there's nothing I like better than getting my dividend checks. It was one of those daily sayings that popped up on Bloomberg a while ago, and I printed it out and put it up there.

CONSUELO MACK: You printed it out. It's so perfect for you. One last question.
One investment for a long-term diversified portfolio. What should we all own some of?

HERSH COHEN: When I was on in 2009 was it, you said one idea. I said, "Consuelo, I'm not going to give you one idea, but I'm going to give you a list of 20 dividend payers/growers," and there have been a couple changes to the list maybe.

CONSUELO MACK: We have that list, Hersh.

HERSH COHEN: I'm guessing it's still a pretty good list.

CONSUELO MACK: It is. It is.

HERSH COHEN: There have been some changes.

CONSUELO MACK: So, we'll stick with that, the basket of ...

HERSH COHEN: We've added some things.

CONSUELO MACK: Basket of high quality dividend-paying stocks.

HERSH COHEN: A basket of high quality dividend payers. I love it. Why not?

CONSUELO MACK: We've got the list. It'll be on our website.

HERSH COHEN: Why not?

CONSUELO MACK: Hersh Cohen. So great to see you. Thanks so much.

HERSH COHEN: Consuelo, thank you for having me.

CONSUELO MACK: At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term.
This week's Action Point reiterates Hersh Cohen's emphasis on the power of compounding dividends and is a core principal of investing that we have discussed many times on WEALTHTRACK. It is: Put the power of compounding dividends to work for you.
Cohen has invested for years in companies that have a long history of paying and growing dividends year after year. Many of them are called "Dividend Aristocrats", S&P 500 companies that have increased dividends for at least 25 consecutive years.

Many of them have "DRIPs," or Dividend Reinvestment Plans that automatically reinvest their dividends in new shares. There are also ETFs that invest in companies with long track records of growing dividends every year. Two of the most popular are the SPDR S&P dividend ETF, symbol SDY and the Vanguard Dividend Appreciation ETF symbol VIG.

The combination of a growing stream of reliable income and the potential of compounding is a powerful force.

Next week, with passive index funds beating the vast majority of active managers a few more WEALTHTRACK guests who have bucked the trend give their views on the stampede to passive. In the meantime to get Hersh Cohen's list of dividend growers go to our website wealthtrack.com and click on our EXTRA feature. You will also hear an additional interview with Cohen about his other investment passion: American prints.

Thank you for watching.Have a great weekend and make the week ahead a profitable and a productive one.