Prufrock ponders Total Return

(with earnest apologies to T.S. Eliot)

And indeed there will be time
To wonder, "Do I dare?" and, "Do I dare?"
Time to turn back and descend the stair,
With a bald spot in the middle of my hair—
(They will say: "How his hair is growing thin!")
My morning coat, my collar mounting firmly to the chin,
My necktie rich and modest, but asserted by a simple pin—
(They will say: "But how his arms and legs are thin!"”
Do I dare disturb the universe?
In a minute there is time
For decisions and revisions which a minute will reverse.

And should I then presume?
And how should I begin?

And would it have been worth it, after all,
After the cups, the marmalade, the tea,
Among the porcelain, among some talk of you and me,
Would it have been worth while,
To have bitten off the matter with a smile,
To have squeezed the universe into a ball
To roll it towards some overwhelming question,
To say: "I am Lazarus, come from the dead,
Come back to tell you all, I shall tell you all"---

I want to question total return as the exclusive foundation of equity analysis and measurement. That will not be easy to do. Maximizing total return is built deeply into the legal framework of stock-market investing (SEC rules, fiduciary practices[1], case law, etc), not to mention in the every-day sales and measurement of equity products. How to maximize total return in short, intermediate and longer-term periods is the central proposition in the finance portion of MBA curricula and in the industry's credentialing programs. My pay package, not surprisingly, has a total return component. So out of respect for the weight of that reality, I solemnly affirm that I do seek maximum total return within the framework of my specific style mandate.

Let me then frame this exercise AS SIMPLY ASKING A QUESTION about how we all do our jobs in the investment industry. Yes, for asking such a question, I run the risk of being burned at the Seeking Alpha stake, a pillory will be reinstalled on Wall Street for the first time in 200 years, and I will lose my handful of Twitter and LinkedIn followers, but so be it. (*The questions and views expressed herein are most certainly not those of my employer. They are mine and mine alone.*)

Rather than receiving this question as a dangerous affront, defenders of the current regime—pretty much everyone in the industry—should welcome the opportunity to take a step back,

[1] The distinction between income beneficiaries and principal recipients—remaindermen—is still on the books in trust law, but it is almost quaint at this point—a sepia photograph from a simpler time.

and assert with perspective, why it is the best possible or at least the most practical approach. By asking this seemingly crazy question, I am giving them—you—that opportunity to confirm that the industry remains on the right path and that the choices made in the past are still the right ones for the future.

And let me also be clear that I have no opposition whatsoever to capital appreciation—to stocks going up. Most business enterprises and sensible people involved in them are keen on capital appreciation, whether that appreciation is in regard to a house, a personal business, a financial asset or a portfolio of them. I am no different.

The concern I have is different: it is that the quest for near-term capital appreciation (daily, monthly, quarterly, twelve-month) has become the singular measure of success in the stock market. This narrow approach comes at the exclusion of at least several other potential yardsticks, particularly cash distributions. That does not sit well with me. Let me explain.

The calculation of total return in the stock market naturally includes the cash payment component—the dividend—but in a US stock market that yields 2% and has a nominal annual total return of 8-10%, that cash payment is necessarily treated as a minor player on the stage. The share price calculation can and is made daily, while dividends are generally paid only four times per year. As a result, almost all the total return math is reserved for share price changes. Managers are praised if they "outperform" the market or benchmark in any given period, and subject to disappointment if they do not.

Keeping score is a good thing. Indeed, until the 1960s and 1970s, there actually wasn't much comparison of returns for trust accounts and institutional accounts versus benchmarks or peers, because the former were only just coming into existence at the time, as was the technology permitting the second.[2] Fast forward 50 years, and boy, are we keeping score. Every day, every week, every month, every quarter. Investor obsession with near-term relative total return has made it difficult to be a business investor in the stock market, and much easier to be a speculator. The perverse outcomes resulting from this by-the-minute measurement culture are detailed in, among other places, this author's *Strategic Dividend Investor* (2011) and in *Getting Back to Business* (2018). Or you can watch any cable tv shows about the market. They are about today, and that's it.

In short, measuring long-term business success with a figure that comes out daily isn't really measuring success at all. It is measuring speculation. As all good businesspeople know, successful investments usually take time. And as most attentive stock market participants know, the price of a share can change for reasons that have absolutely nothing to do with that asset. To make matters worse, stock market risk is defined in Modern Portfolio Theory (MPT) as the standard deviation and other statistical tortures of total return. That is, it is focused

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[2] Among many possible references, Robert G. Kirby, "Portfolio Management: Lesson's Learned and Never Learned," *JPM*, vol. 6, no. 1, (Fall, 1979), 53. See also Charles D. Ellis, "The Rise and Fall of Performance Investing," *Financial Analyst Journal*, vol. 70, no. 4, (Summer, 2014), 14-23.

mostly on changes in share price.[3] So the same problem holds: the standard deviation of short-term changes in an asset price is *nobody's* real-world definition of risk. Yet, in a near-term total return world, it enjoys pride of place.

Some might wonder whether I am doubting the role of markets more generally. Certainly not. I am not calling into question the liquidity that markets provide. I am not calling into question the long-term price discovery that markets generally offer. It would be almost unpatriotic in this day and age to do so. And the University of Chicago does not permit such challenges. They argue that the market price (and by derivation, anything based off of that market price) is a great virtue and pretty much the only necessary measure of anything one needs to know. Not withstanding the long list Nobel Prizes in Hyde Park, Chicago's stranglehold on finance curricula and the CFA program, I want to suggest otherwise.

Near-term total return—the market's daily judgment of success and failure—need not have a monopoly on truth. This is an instance in which one size does not fit all. There should be a more balanced approach to measuring investment success. And high on that list of additional measures should be cash distributions made to business owners. Such distributions are the primary (albeit not the only) measure of success in the private business world. Why not measure and track the trajectory of dividends distributed by stocks?

There are many practical reasons to broaden the measurement of performance in stock portfolios to include cash payments. And then there is one big-picture, philosophical case to be made. Let's contrast a share price gain with a dividend payment. Everyone loves when the price of their favorite stock (or a collection of them) is in the green. But what does that really mean? Simply that the market price for that security has changed in the investor's favor. His or her *nominal* wealth has increased. That's great, but it does not mean that a check is in the mail. In order to realize that nominal increase in value, the investor has to go out and conduct a transaction in the marketplace. That involves activity, counterparties, a process, etc. In the case of smaller or less liquid securities, realizing those gains in a transaction can mean that they disappear or are reduced. And recall that while the long-term trend of the market is up, it isn't always that way. If one needs cash during a market downturn, or an individual security's retreat, the sale price can be below the purchase price, easily. That is, stock returns can be negative. It's been ten full years since we've had just such a period, but they do occur periodically.

In contrast, a dividend payment is a dividend payment is a dividend payment. It is simple to understand and even simpler to consume. Its "return" is always positive. Nowadays with electronic deposit, you don't even have to cash the check. The money—cash on the barrel—shows up in your account. In short, it is real and tangible; share price gains are theoretical until realized with a transaction.

[3] When MPT was created in the 1950s and 1960s, the percentage of total return coming from the dividend was much greater than it is now.

As a practical matter, incorporating cash returns into portfolio measurement means counting the distributions, the current yield, the yield at cost for an individual investment, and (most importantly) the growth rate of the income stream. You would think that would be easy, right? Wrong. The investment management industry is very focused on calculating and parsing total returns down to the second. Rest assured, there are armies of people making sure that that calculation is correct on a daily basis. (They use daily returns that are then geometrically linked over longer periods. It is a complicated but well-developed methodology.)

But what about the cash you actually receive from your investments? That gets somewhat less attention in part because it requires making some choices. In theory, an investment's annual yield is simple: the annual distribution you receive divided by the price you pay for it. In practice, it is a little trickier. Dividend payments from equities can vary, so you can either use the trailing twelve-month payments, or annualize the most recent quarterly payment. Both can be spot on for an annual yield, or way off. For securities that are about to raise their dividend, or just paid a special dividend, it is a very misleading measure of yield. The SEC has its own calculation for the yield of "40 Act companies" (mutual funds) which tries—cheers and thank you—to level the playing field. But it is complex and not at all transparent for most investors. Nevertheless, yield is and can be tracked. That is the first step. While not considered part of performance measurement, the yield of a security or a portfolio is generally available on the internet and third-party sites such as Morningstar.com or Bloomberg.com.

The second is the growth of the income stream. This would be a great addition to performance measurement, and where it is almost entirely absent. It too can require some choices. Dividend growth is a second derivative function, by which I mean that is a function of something (1) that is a function of something else (2). That makes it very sensitive to small input changes. Let me give you an example. You have $1,000 invested at a 4% yield. In year one, the cash payment is $40. Next year, you are expected a 5% increase in the dividends. Assuming you have taken the cash from the first year, in the second year you would expect a payment of $42. If it turns out to be just a 4% increase, your payment is $41.60. If it turns out to be a 6% increase, your payment is $42.40. Between a 4% and 6% increase is just $0.80. Out of capital invested of $1000, an $0.80 difference will seem like small potatoes to most investors. But as a second derivative outcome, it matters a lot. Then there is the issue of special dividends, returns of capital, and other forms of distributions. Despite these challenges, however, dividend growth can and should be calculated as part of portfolio measurement. Outside of a handful of dedicated dividend managers, it rarely is. My investment team calculates growth of the dividend in our portfolios and communicates that to clients, but that reporting has no canonical status. It is extra color, but does not count towards the formal measurement of performance by the industry's gatekeepers.

Why put in the time and effort to track dividend growth? Well, it is actually an excellent measure of long-term share price appreciation, of the capital gains that all investors seek. In the world of private business, the trajectory of a company's sustainable cash distributions will track its ultimate market value closely. (Businesses that have high and rising cash distributions can generally be sold for more than businesses that have small or declining distributions.) Even in the stock market, that is true over long measurement periods. In short, applying this business measure to the stock market, one concludes that share prices follow the dividends. The share price change is not the driver of the analysis—as is the case in today's low-yielding, dividend indifferent market—but an outcome of dividend growth. This point is elaborated in *The Dividend Imperative* (2013), in stock market analysis provided by the alternative strategy team at Société Générale, and by a variety of out-of-sync voices in the investment community.[4]

Is suggesting using more than one measure—change in market price—so heretical? Imagine measuring the success of baseball players strictly in terms of their pay packages in the free agency market. That would be silly. Many other measures are used, and as most sports fans know, the amount paid for free agents rarely corresponds to the ultimate value realized at the team (portfolio) level. It is a strained analogy, I grant you, but the basic idea holds: Price is not always value and change in price is not always change in value.

A few caveats. Defenders of the current system will point out that share price changes can contain important information about future distributable cash flows. That is no doubt certainly true, and one of many reasons why share price changes, even for dividend-paying stocks, should be closely monitored. The question is one of weight and emphasis. Share prices change daily; dividends change infrequently. As a consequence, most share price changes have no information content about future dividends. This needs to be acknowledged.

Second, tracking cash distributions does not add much to the analysis of stocks that don't pay dividends. Performance measurement of those stocks is all about changes in the market price. There is not much more to say about them. Within a cash-based approach to portfolio construction, management and measurement, they do not fit in. How they might be seen is addressed in Chapter 5 of *Getting Back to Business* (2018).

How likely is a move in the direction of incorporating cash distributions into the formal measurement of stock portfolios? After a decade of very strong price gains led by non-or low-dividend securities, I will admit that there is little chance of this notion being adopted by most investors. But there are glimmers of hope. In addition to the communications of dividend-focused managers, I am delighted to see early signs of the return of the concept of duration to the equity world, mostly in the form of articles from English academics. Why? Because it shifts our gaze, if ever so slightly, from share prices to cashflows...

But what else can I do? What else should I do?

Do I dare to eat a peach?

No! I am not Prince Hamlet, nor was meant to be;
Am an attendant lord, one that will do

[4] For example, most recently, David Bahnsen, *The Case for Dividend Growth* (2019).

To swell a progress, start a scene or two,
Advise the prince; no doubt, an easy tool,
Deferential, glad to be of use,
Politic, cautious, and meticulous;
Full of high sentence, but a bit obtuse;
At times, indeed, almost ridiculous---
Almost, at times, the Fool.

Excerpt from the T.S. Eliot, “The Love Song of J. Alfred Prufrock,” *Prufrock and Other Observations*, 1920.

Please note: Views expressed here are mine, not those of my employer. Nothing here should be construed as investment advice.

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