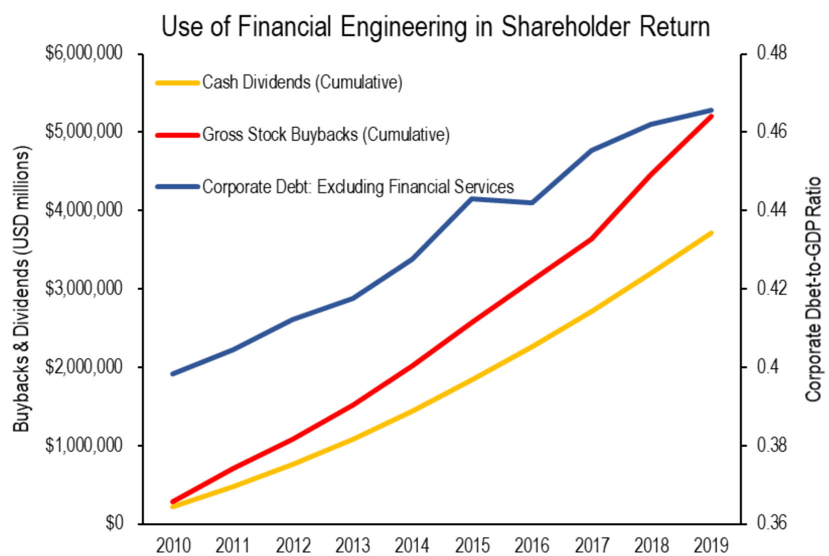
BROOKMONT
CAPITAL MANAGEMENT

Balance Sheet Strength Key to Success during Crisis

The COVID-19 pandemic has forced the world economy into a state of contraction. The current situation's impacts are more extreme than a typical cyclical downturn or even other crises, with worst case scenarios pointing to output declines twice as large as those in the 2007-08 financial crisis. Despite the differences in this crisis, the merits of our investment process hold as true as ever. When searching for "quality" long-term investments, some of the most important and easily quantified measurements are those relating to balance sheet health. Balance sheet health garners significant attention from investors looking to quickly de-risk portfolios prior to, or in conjunction with, market turmoil. As dividend-focused investors, balance sheet strength is a major factor in our portfolio companies' *capacity* to maintain dividends, and as such, it is one of the first factors we examine when initiating bottoms-up coverage of a company. Yet, it would be unwise to solely look at balance sheet strength to determine a company's ability to withstand an elongated business interruption or to grow their dividend in the future; it is an inefficient drag on any company to hold more than a few weeks' worth of cash on hand. What *really matters* is the durability of revenues, earnings and cash flow. This understanding is not easily or quickly attained and thus must be an ongoing endeavor of value-added active management to determine not only the *capacity* but the *quality* of dividends.

CHEAP DEBT Clouds Dividend Quality

One of the defining characteristics of the 2008-20 bull market was corporations using debt to manipulate and improve reported financial results through capital structure changes rather than improvements in their operations. Companies would use proceeds from debt in order to pay dividends (over $3.7 trillion) or buyback shares (over $4.5 trillion). Through this, certain companies, to varying degrees, were able to grow their dividend *capacity* via altering their capital structure (decreasing share count) rather than structural improvements in performance (Margin expansion, Sales Growth) or their dividend *quality*. Expanding the *capacity* to increase dividends through financial engineering, rather than structural improvements in the business, is the differentiator between *capacity* and *quality* of dividends.



This distinction is vital. Not all companies with great dividend *capacity* pay a *quality* dividend and the lowest quality dividends are not *sustainable*. Dividend payments supported by a business growing thru reinvestment (with proper reserves) can continue indefinitely and often grow overtime. Conversely a dividend that relies on debt (directly or via a lower share count)

can only be maintained for a certain period before the company is overleveraged. A company reaches the point of overleverage when either its credit rating declines and it can no longer borrow at a reasonable rate, or when its interest payments become too large for the company to continue investments in operations and maintain its dividend. When evaluating a company's dividend quality, a few factors that we look at are those relating to a firm's liquidity and solvency—the firm's ability to fulfill financial obligations in the short-term and long-term. These metrics are important because as equity investors, we are on the bottom of the list when it comes to who is entitled to the company's assets and cash flows in the event of liquidation, with senior debt, mezzanine debt, and preferred shares all having priority liens. This is significant because it means that if a company is unable to meet their other financial obligations, they will not be legally allowed to distribute a dividend to common shareholders. Thus, liquidity and solvency are prerequisites for further analysis as they provide the basis for dividend *capacity*. However, determining the *capacity* for--and *quality* of-- future dividend payment afforded by the underlying business necessarily involves comprehensive fundamental analysis and forecasting.

Quantitative Models Don't Tell the Full Story

Another, even more prolific trend of the newly minted bull market was/is the explosion of ETFs and passive investing. Across nearly every dimension—AUM, asset classes, styles, sizes breadth complexity etc. the growth has been astounding. In the third quarter of 2019 U.S. passive equity funds reached $4.271 trillion, for the first time exceeding actively managed equity funds. Of particular interest to us is the rise of factor-based ETF portfolio construction and implementation. Conceptually, such strategies are appealing to us, indeed we here at Brookmont employ similar tactics of using abstractions of company fundamentals to guide our investment when researching dividend *capacity,* (to the extent fundamentals can be expressed in numbers.) However, the limitations of such factor-based strategies relate to the qualitative assessments of a company that cannot be quantified and the portfolio level implications of maximizing a given factor, or group of factors, at the expense of a more holistic approach. We have found that a narrow factor focus at the company level, (yield maximization for example) can produce portfolios misaligned with principles of diversification and dividend *quality*, core aspects of our philosophy here at Brookmont.

Regarding dividend-focused ETF's, there are two common flaws that active management addresses. The first of these is companies who are using financial engineering in order to maintain or grow their dividend yield as described above. This can be avoided by inserting certain leverage requirements into the screen; however, the second flaw cannot be as easily avoided. Predefined screens available through ETF's do not account for the industry-level trends that a company is experiencing; our mosaic of understanding, as previously mentioned, is able to capture these trends and use the information in our investment decision and thesis. If a specific product or industry is in danger of becoming obsolete, the quantitative metrics used by the screens will not be able to capture this; the majority metrics used by these screens are inherently trailing indicators. In fact, the company or industry would become more attractive to the predefined, quantitative screens, with active managers selling the stock, driving the price down and therefore, increasing the dividend yield. All of these factors are just some of the reasons why active management can outperform predefined quantitative screens, which are criteria set by ETF's that will automatically trade on certain metrics, regardless of the underlying business.

In addition to the increase of long-term, upside potential from active management, it also greatly decreases downside risk. By applying fundamental, top-down analysis to a company's industry and overall sector, we identify industries with consistent demand, reducing the portfolio's exposure to major market contractions and reductions in demand.

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