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What Is Old Becomes New Again

Inflation, rising interest rates, war; the world seems very unsettled from a year ago. For investors fixated on near-term events while trying to discern their next move it must represent a nearly crippling dose of uncertainty, especially compared with the environment of the past ten years.

For long-term investors, however, this need not be the case. Inflation, rising interest rates, and wars are unfortunately relatively common variables in the span of market history, even in modern times. Investors grounded in reality and focused on long-term wealth creation should fully expect to confront these changing circumstances. Indeed, a more careful look shows that it was the absence of inflation, the continued presence of low-interest rates, and a comparatively sanguine geopolitical environment that was the anomaly.

Of course, this begs the question of how to successfully confront these changing circumstances. In our view, the simple answer comes from Ben Franklin's timeless quote, "An ounce of prevention, is worth a pound of cure;" or perhaps the indelicate amalgam from Berkshire Hathaway Vice Chairman Charlie Munger, "All I want to know is where I'm going to die, so I never go there."

From an investment perspective, knowing where you might die and what to avoid is not difficult. Heavily indebted firms, firms with weak competitive positioning, firms unable to generate cash flows, and firms whose shares are wildly overpriced represent some obvious examples. So, today it should come as no surprise that firms with little or no pricing power to combat inflation, firms with worrisome debt loads reliant upon external financing (in a rising interest rate environment), and firms that were wildly over-valued are the same ones coming under heightened selling pressure.

Since we know where we might die as an investor, let us flip the conversation instead to where we should go live. That part is also simple. We should choose places where we can stay relatively safe, grow, and thrive over time. In the investment world, these places are represented through a steady stream of compound interest.

Compound interest or interest on interest is most readily viewed in the context of fixed income where interest coupons are reinvested into new bond purchases that also produce interest (i.e., interest on interest), whose coupons are then reinvested (over and over), eventually building a foundation of wealth. Whenever discussions of compound interest arise, the very next question is often: how soon will my money double? The rule of 72 is a reliable shorthand (divide either the number of years or the interest rate

into 72 to estimate the other variable). For instance, at an interest rate of 7% it would take a little over 10 years for your money to double. If you want to know the interest rate needed to double your money in 7 years, it is approximately 10%. Problematically, the yields on fixed income have been stubbornly low for the past decade. For example, in July 2020, when the 10-year Treasury touched its low of 0.55%, it would have taken 130 years to double one's money at that rate.

The futility of investing at paltry interest rates led investors towards ethereal methods of wealth creation, including speculation across a wide spectrum of assets that went so far as to include crypto currencies, NFTs, and tech stocks trading at over 100x sales. Ironically, an investor choosing a tech stock trading at over 100x sales during late 2020-2021, was accepting a payback period not unlike the treasury investor at 0.55%--except at least the treasury investor was guaranteed their coupons and principal by the U.S. government. There are obviously no such guarantees with stocks. Not coincidentally, the wildest of those crypto-NFT-tech stock speculations are the same assets being dismantled in the current market environment of rising interest rates.

Even with their rise, current interest rates remain painfully low relative to the current rate of inflation, and fixed-income investors must settle for only losing less money than a few months ago, stated in real terms. This begs the question though, is there a happy medium lying between 10-year Treasuries at 2.7% (today) and tech stocks trading between 10x-100x sales? The simple answer is, yes, we believe so.

Echoing Charlie Munger's warning about places to go, we believe investors can and should seek habitats of compound interest but pursued through the materially higher rates (versus fixed income) offered by dividend-paying stocks. The appeal of dividends during periods of economic uncertainty is straightforward, the investor receives a bird in hand, often on a dependable quarterly timetable.

This fact, however appealing, belies the role of compound interest in the equation. The large majority of investors will focus on the size of the bird in hand (i.e., dividend yield), and hopefully its reliability in the future. However, we would argue that the main event and the most critical element for investor scrutiny should lie in the portion of earnings that are not paid out in dividends, i.e., the retained earnings.

The reason being is that retained earnings are the lifeblood of future dividends and create the conditions for sustainable compound interest over time within the corporation itself, which the investor has the opportunity to continue to own. Put differently, when retained earnings are reinvested successfully at the corporate level, the returns on that capital should contribute to both the growth in future dividend payments and future levels of reinvestment, thereby creating a compounding effect when successful. An investor in such a scenario can have the confidence that over

time, the dividend should increase on the back of reinvestment and, if needed, put pressure on the share price to rise alongside.

Most importantly, when the process described above is successful and the firm possesses a strong opportunity set for reinvestment, it allows shareholder capital to compound at a much higher rate than those available in fixed income markets (both current and historical). Moreover, when these dynamics are available in higher-margin firms possessing pricing power, the internal compounding mechanism can weather changing economic circumstances such as higher inflation and rising interest rates. In sum, firms with these characteristics can be durable wealth creators. Consider the simple observation that a reliable dividend payer such as Nestle was founded in 1866, surviving numerous wars, inflationary events, changing interest rates, depressions, etc.

In light of the above, it is important to note that we have been prioritizing holdings with these attributes dating back to March 2020, when stocks of all varieties went on sale. At the time, we believe we poured a healthy foundation of dividend growers that have consistently generated compound annual growth in dividends between 10-15%. More recently, during the past several months we have sought to take advantage of the market selling by purchasing additional dividend growers with historical growth rates between 15-20%, and what we believe is the opportunity to continue similarly strong growth rates into the future. In sum, we have been making purchases in this depressed market environment that we believe will increase the growth rates and prospective returns of the portfolio. In the table below we share the names of recent purchases and their respective historical dividend growth track records.

Dividend Growers	Annualized Growth Rate in Dividends			
	5 Yr CAGR	10 Yr CAGR	15 Yr CAGR	20 Yr CAGR
Adidas AG	17%	21%	19%	15%
Nintendo Co., Ltd.	71%	17%	12%	16%
Starbucks Corp.	19%	23%	NA	NA
Union Pacific Corp.	14%	16%	19%	17%
Visa Inc.	19%	24%	NA	NA
Tractor Supply Co.	18%	34%	NA	NA

Sources: Bloomberg, company reports, Templeton & Phillips Capital Management, LLC

Interestingly, and despite the nearly two-year wait, the markets finally appear to be warming to the fundamental appeal of dividend payers. For instance, on a trailing twelve-month basis, the MSCI Dividend Growth Factor ETF has returned 8.3%

compared with 2.9% in the MSCI Value Factor and 1.6% in the MSCI Growth Factor ETFs.

In conclusion, we believe the world's current level of uncertainty continues to benefit our investment approach, and it has been particularly interesting to watch investors today begin to favor the traditional value perspective and fundamental appeal of compound interest over time.

Thank you for allowing us to serve your investment needs, and please let us know if there is anything else we can do or provide.

Templeton and Phillips Capital Management, LLC

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