Value & Income Portfolio: The Value in Being Contrarian

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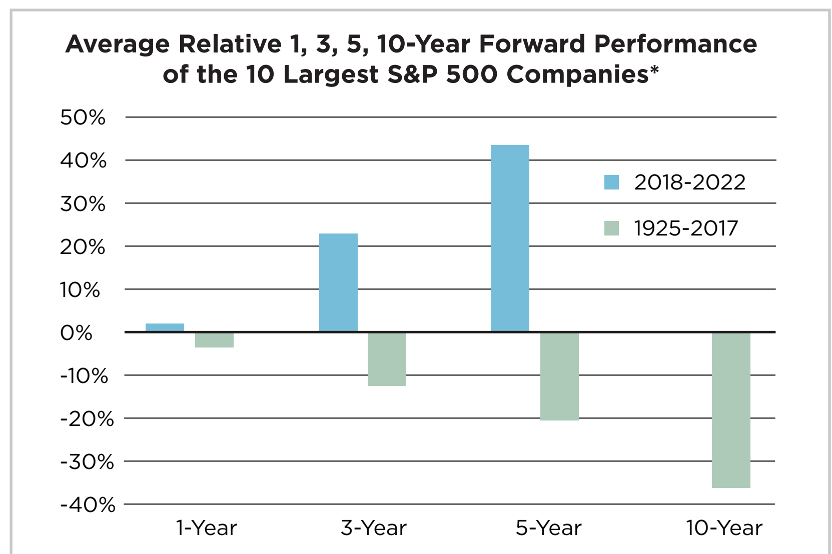
Significant ink and airtime has been devoted to the domination that a few high-growth technology stocks have exerted on US markets in the first half of 2023. Those stocks added significant value to investor portfolios during that time-frame. The question, in our minds, is: What next? In this piece, we seek to provide some context about where we see opportunities ahead.

Many market indices are "capitalization weighted" rather than "equal weighted." Said more plainly, the oft-quoted S&P 500® Index does NOT represent the simple average of how all 500 securities have performed. Instead, the largest companies represent out-sized weights, while the smallest companies are almost immaterial to the overall index. More specifically, just two stocks – Apple and Microsoft – comprise approximately 14% of the index. Each of the nine largest S&P 500 constituents represent high-growth technology companies of one variety or another (these include companies like Netflix, which S&P does NOT classify as a technology stock).

While we're not making predictions, the last five years have bucked the historical tendency — since 1926 the 10 largest companies have tended to underperform the S&P 500 over the ensuing 1, 3, 5, and 10 years. In 2010, the S&P's largest constituent was Exxon, in 2000, it was General Electric, in 1990 it was Exxon, and in 1980 it was IBM. Size (and the Law of Large Numbers) can be an impediment to future growth.



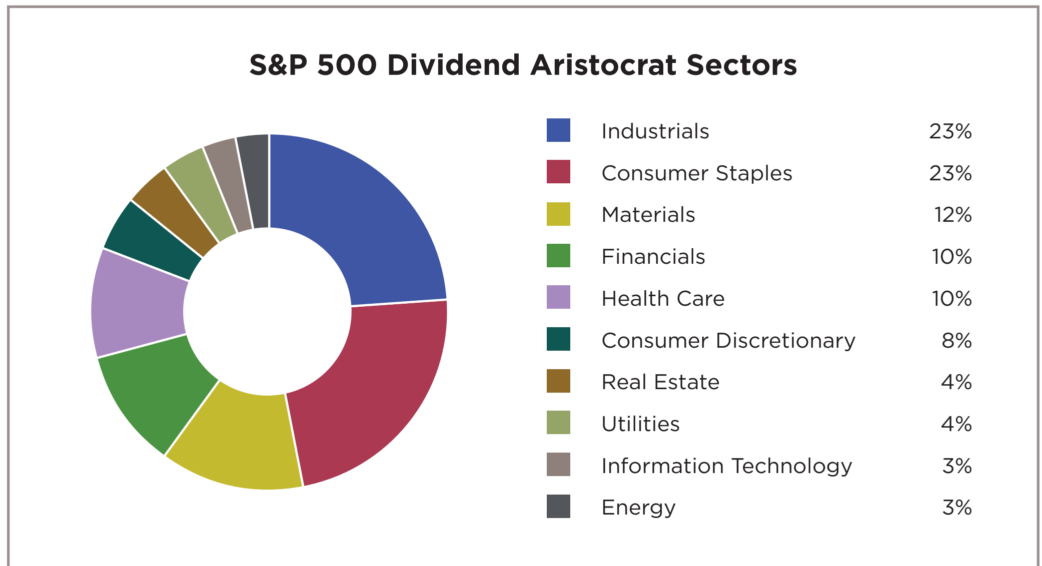
Source: Robert D. Amott, The Fundamental Index – A Better Way to Invest. John Wiley & Sons, Inc. 2008, Research Affiliates, LLC, Sanford C. Bernstein & Co., Pzena analysis *Equally-weighted returns of the 10 largest S&P 500 companies by market capitalization vs. the equal-weighted S&P 500 companies by market capitalization vs. the equal-weighted S&P 500 Index. Data as of December 31, 2022. Past performance is not indicative of future returns.

We mention this because we suspect most clients seek more diversification in their portfolios than what's provided by some of these top-heavy indexes; we certainly do. Broadly speaking, Davenport Asset Management portfolios are NOT capitalization weighted. And our portfolios tend to be more diversified vs. having all of our top holdings represented by a single market sector. Stated another way, in cap weighted indices, stocks that already have performed well become incrementally larger as a percent of the index. Channeling our inner Wayne Gretzky, while the index skates to where the puck just was, we try to skate to where the puck might be going.

None of this is intended as an indictment or endorsement of any single sector or stock. From our perspective, over the long term, the price an investor pays tends to matter. So a good company bought inexpensively can generate terrific returns (for example: Microsoft a decade ago at 12x earnings), while the same good company bought too expensively can generate mediocre returns (for example: Microsoft during the dot.com bubble at 40x earnings).

Turning to where we've been investing incrementally, we tend to favor companies that have the financial flexibility to achieve the rare combination of being able to "walk and chew gum" — demonstrated by self-financing their growth, paying a growing stream of dividends, and buying back shares or acquiring other businesses when it's opportunistic to do so.

So-called Dividend Aristocrats represent companies that have raised their dividends at least 25 consecutive years. This is a rare breed – with fewer than 70 such companies qualifying for that distinction. Today, only two of those are Technology companies (ADP and IBM).



Source: Davenport Asset Management and Simply Safe Dividends

In our Value & Income Portfolio, we own a dozen Aristocrats. Three of those holdings have achieved 50 or more years of higher dividends. Three others are not far behind at more than 45 years of higher dividends.

Source: FactSet financial data and analytics.

Our admiration for these companies is more than just philosophical; it's rooted in data, which shows that companies which regularly raise their dividends (as well as those that regularly buy back their shares) outperform the market.

As mentioned earlier, the price an investor pays for an asset matters. While Dividend Aristocrats have outperformed over long time periods, our interest in these businesses depends on their valuation. Over the past decade, these Aristocrats have averaged a slight P/E valuation premium vs. the S&P 500, but presently they trade at a discount. Therefore, we find this cohort particularly timely on a risk/reward basis. A number of recent purchases in the Value & Income portfolio include companies with long and distinguished track records of rising dividends, several of which have reached the threshold for Aristocracy

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