Federated®

Strategic Value Dividend Strategy Newsletter

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May you live in interesting times…..
Strategic Value Dividend in the Age of Trump

Our first and primary answer to the client question of what one can expect from investment in a Strategic Value Dividend product is the opportunity for a high and rising income stream from high-quality business assets. For our more stockmarket-oriented clients, our answer is that we have historically delivered broad market returns, plus or minus, depending on the measurement period, but with a notably lower standard deviation.   Both of those propositions were in effect prior to the US Presidential election; both remain in effect today.

That being said, the world is now quite different than it was on November 8. How has this reality affected our companies? In short, not much, but let's review some of the possible "talking points" involving the new administration's policies. Keep in mind that all of these proposals are, for now, just media speculation and Sunday talk-show fodder.   But let's tally up the potential pros and cons. They are listed in positive-negative rank order.

Corporate tax reform

At first glance, the new administration's explicit goal of lowering US corporate tax rates to around 20% or so is clearly a positive. Nominal US corporate tax rates are among the highest in the developed world, and this measure is seen as a way to boost US investment spending, as well as get some of that cash stored abroad by US corporations back into the US. That's all good, and the SVD portfolios do own a number of companies with tax rates in the 30s, including some of the nation's largest telcos and utilities.   Were their tax rates to decline materially, that would free up a great deal of cash for further investment and shareholder payments.

Ahh, but there's a rub. To offset the lower flows coming into the US Treasury, administration officials are apparently considering getting rid of or significantly lowering the tax deductibility of interest payments. (For over a century, the US tax code has encouraged companies to take on debt by making payments to bond holders tax deductible. In contrast, profits distributed to equity holders (dividends) are only made after taxes have been paid. The consequence has been to structurally disadvantage dividend collectors. But that is a topic for another newsletter….)

Those very same SVD companies that have high corporate tax rates—the telcos and utilities—are also "old economy" enterprises that have debt in the capital stack. So what the administration giveth with one hand, it may well take away, at least a portion, with the other. We can't do the precise analysis until the proposals are specified, but we currently estimate that the net benefit would be substantial for some of the companies in the portfolio, with a lesser benefit for the global companies that already have relatively low tax rates. We also have a small sleeve of REITs which do not pay a Federal income tax but pass that responsibility on to investors.   So let's call possible corporate tax reform a **Modest Positive**

Deregulation

The new administration, and the Republican-controlled congress, are on record intending to reduce business regulation, and in general to create a more business-friendly climate than existed under the previous administration. Whether those intentions actually translate into greater business activity remains to be seen. The stated goal, however, certainly counts as a tailwind, albeit one that cannot easily be translated into specific incremental dividend growth. Rather than a quantitative benefit, less regulation could have a different but equally welcome impact on the portfolio: a greater opportunity set. As many SVD clients know, we have not had any major US commercial banks in the portfolio since the Financial Crisis. Yet, the basic business models of the regional commercial banks have historically been consistent with the SVD approach to business ownership. Time will tell whether the US commercial banks will once again enter our orbit. For now, the prospect of regulatory relief counts as a **Modest Positive**

Border Adjustment Tax (BAT)

Like Corporate Tax Reform, the Border Adjustment Tax is at an early stage. Its goal is to advantage, or at least to not disadvantage, exporters and Made-in-America manufacturers. Here too, the devil in the details, but it seems likely that such a tax will have minimal if any impact on our operating companies. The vast majority of the goods and services that we produce are small-ticket items that are already made, sold and delivered locally. Think of your monthly statement from Verizon or the utility bill or that flat of Coke Zeros. Yes, some items in our portfolio, such as diapers and toothpaste and shampoo, may be manufactured in Canada or Mexico and would be subject to the proposed new arrangements, but the impact has already been partially priced in (by the stronger dollar). So while it is too early to say for certain, it is hard to see a major impact from the BAT on our companies. Now it is true that the commodities that go into many of our final goods are produced and shipped globally, but it doesn't look like the BAT is designed to address or disrupt those flows. It is more a matter of large-ticket finished goods—think automobiles and machinery—not ketchup and potato chips or the tomatoes and potatoes that go into them. This one is a **Minimal Impact**

Immigration Reform

For the type of companies that we own, it is simply hard to see that changes to US immigration policy will have a material impact on the results of our operating companies. For some businesses that use migrant labor—for instance, the farming that supports the food manufacturers in the portfolio—there may be some near-term disruption to operations. But the main driver for those companies is GDP, or more specifically, consumer spending. To the extent that the policy would lead to lower in-migration to the US, that would necessarily and unfortunately diminish already anemic medium and long-term GDP prospects. In that case, our companies would face a marginal headwind, but one that would be hard to measure and separate from the other contributors to GDP and consumer spending over the next several years. **Minimal Impact**

Trade Agreement Renegotiation

For the past year, the global media has been full of discussion of how difficult it *might* be for England if it pulls out of the EU. (I have my doubts about that.) Closer to home, the new administration has pulled out of the TransPacificPartnership talks (TPP). These trade relations are viewed as significant, but there is some question as to how significant, as lots of trade occurs between entities—such as the US and China—that don't have formal trade structures. The exception here is NAFTA—an existing comprehensive trade framework involving the United States, Canada, and Mexico. Revising NAFTA is apparently on the administration's agenda, and Canada is also seeking a review, as it considers some current terms to be unfavorable. As many of the small ticket items that our companies sell are manufactured, distributed and sold pretty much seamlessly in North America, any significant disruption to the trade framework could have some near-term impact. Still, the administration's proposed "tweaks" (according to President Trump on February 13) are simply unlikely to have a major impact on those small-ticket items and monthly services that constitute the vast majority of our companies' sales in the region. It's very early days here, but for now I'm going with **Minimal Impact.**

Negotiated Federal Government Drug Pricing

We do our best to shy away from politics in the portfolio. That is not always possible to do, however, and over the past 15 years, tobacco has garnered the lion's share of the political (or regulatory or litigation) limelight. That space is now occupied by the pharmaceutical industry. Since the mid 1990s and the first Clinton administration, drug pricing has been in and out of the political spotlight. It is currently back in and we do have a high teens exposure throughout the product suite. But it is worth noting that our holdings are exclusively in the large, research-based, global pharma businesses. These companies generally do not buy the rights to narrow, off-patent or non-research-based compounds and then raise the price by a 1000% or 10,000% because there are few if any competitors. That has been the purview of smaller, specialty pharma companies. They have names, but I will not name them. A quick Internet search involving specialty drug companies and Canonsburg or Toronto will clue you in to several of them.

In contrast, our companies have a different business model: developing research-based, novel compounds that enjoy a certain period of patent exclusivity. These compounds seek to address the biggest medical challenges faced by our aging population: cancer, diabetes, heart and lung disease, among others. During their period of patent protection, the companies do charge a high price to cover the cost of research for the few treatments that do succeed and the many that do not. That business model is not without its flaws, but it should hold up well when government authorities ask how much research went into such and such a product. Our companies can answer that question, and it is a big number.

While our portfolios have little exposure to the current "bad apples" issue in pharma, we do have exposure to the second major current challenge, and that is negotiated Medicare pricing. Medicare, as the largest government purchaser of pharmaceutical compounds, does not currently negotiate a bulk discount. That's unusual and may not last through this administration. But from our perspective, the math is simple. Sales to Medicare represent less than 10% of revenue for our companies. (Private insurance and sales outside the US are far more significant.) Our best current estimate is that a big haircut to Medicare pricing would hit the earnings of our companies by no more than 5%, and in most cases, by much less. A 5% hit is one year's worth of projected growth, but it is not the end of the world. In short, negotiated Medicare drug pricing would not have a huge impact on us, but it could quite possibly end up being a **Modest Negative**.

Net, net….keep an eye on GDP and inflation

If we tally up the current proposals, we come up with two modest positives, one modest negative, and several minimal impacts. That doesn't mean that the actual proposals, when they are detailed and make their way through the political process, won't come out quite differently, but for now, it's more good than bad.

Rather than obsess over the latest news coming from Washington or Palm Beach, my advice to our co-business owners is to keep an eye on consumer spending, both here and abroad. That's where our cash streams, and their trajectory, will be determined. Federated's house view is for a pick up in nominal GDP—a result of both real economic improvement and a modest gain in inflation. Should those forecasts come to pass, our companies will clearly benefit, and investors will see a higher rate of growth in dividends. If the mix is in favor of real GDP growth, it is all for the good. If it is more on the inflation side, the stock market may take a darker view of our assets. As we have noted on many occasions, our businesses are not sensitive to interest rate movements (partially a reflection of inflation), but the share prices often have reacted to big swings in interest rates.

Daniel Peris
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Past performance is no guarantee of future results.

There is no guarantee that dividend paying stocks will continue to pay dividends. In addition, dividend paying stocks may not experience the same capital appreciation potential as non-dividend paying stocks.

International investing involves special risks including currency risk, increased volatility, political risks, and differences in auditing and other financial standards.

Diversification does not assure a profit nor protect against loss.

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