How To protect Your Dividend Growth Portfolio from the Pending Market Crash

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Introduction

Ever since I first entered the investment industry circa 1970, I have been confronted with a constant and persistent admonition about the next pending market crash. In those early days I contributed much of the negativity toward stocks to a lingering overhang from the Great Depression. Many of the people I was talking with had been literally traumatized by stern warnings from their parents or grandparents about the risk of investing in the stock market. They were told that stocks were too risky for prudent people to invest in and serious money should never be invested there.

Fast forward to today, and once again I am receiving many questions from investors regarding what they should do to protect their portfolios (their money) from the pending and some even say imminent market crash. Many investors, especially those in retirement, are asking if they should go to cash with either a portion or all their money. This is usually followed with a statement suggesting that they no longer have the time to wait several years to get their money back.

With that said, logical thinking investors certainly have some rational justification to worry about the possibility of a looming market crash. After all, we are now in what is surely the late stages of one of the longest running bull markets in history. Therefore, common sense and history tell us that all bull markets end with a bear market – and vice versa. As a result, it can only be a matter of time before this bull market comes to an end. Consequently, many investors feel the need to take action to protect themselves. However, I personally agree with legendary investor Warren Buffett when he said: “inactivity strikes us as intelligent behavior.”

Not All Stock Price Drops Are the Same

The beauty of dividend growth investing is that when done correctly you don’t have to worry about bear markets or market crashes. There are several reasons for this. First, bear markets tend to be short-lived whereas bull markets tend to last a lot longer. Consequently, if you’re a long-term focused dividend growth stock investor and your portfolio is positioned properly, you can easily weather the storm. Dividends are paid on the number of shares you own and not affected by the price volatility of those shares. Therefore, even in a bear market when prices are dropping, your dividend income can still be rising.

Additionally, not all stock price drops are the same. This is precisely why I believe it is extremely important that investors focus on the value of what they own more than they do on the day-to-day machinations of price volatility. However, I also believe, and even recognize, that very few investors can ignore volatile stock price movements. When the price of a stock that they own is rising or falling, especially when the swings are large and/or violent, it is very difficult for people to maintain a steady head and hand. Instead, emotions take over reason which often cause otherwise rational investors to make irrational decisions.

Furthermore, and more to the point of this article, not all stock price drops are the same. I intend to illustrate later in the video with several examples that there is a significant difference between the devastation from the price drop of an overvalued stock versus the more benign price drop from a fairly valued – or better yet – undervalued stock. With the former, the recovery can be unacceptably long and in rare cases it might never occur. With inexpensive stocks, the recovery will usually occur much sooner, and if fundamentals remain intact, recovery is inevitable.

What “The Great Recession” Taught Me About Dividend Growth Investing

As I previously suggested, most investors take their lead from stock prices. If they buy a stock and it goes up, they consider it a good stock. If they buy a stock and it goes down, it’s a bad stock. In all fairness, for most investors, stock prices are all they have available to judge their decisions by. However, there is a primary reason why I start this section out by discussing stock prices. Investors whose focus is solely on stock prices are not investors under my strictest definition of an investor. Instead, from my perspective, they are speculators in the stock market. Personally, I do not speculate in the stock market – never have and never will.

As it relates to common stocks, I consider someone a true investor when they are focused on becoming an owner/partner in a good business. Therefore, to my way of thinking, the true investor is primarily focused on the business they own. Consequently, they are positioning themselves to be owners of the business they invested in for a long time to come. Therefore, it logically follows that their primary attention is best placed on the operating results that their business generates on their behalf as owners.

Most importantly, the true investor that buys their investment from the stock market understands going in that it is an auction. As such, they understand that prices will fluctuate as other people place bid and ask orders continuously. However, since they have no intention of selling their business ownership, at least in the near future, the daily, weekly, monthly or even yearly fluctuations in price are of little to no interest or concern to them. They are primarily interested in and concerned about how the business is doing, because from their perspective they own the business, not the stock.

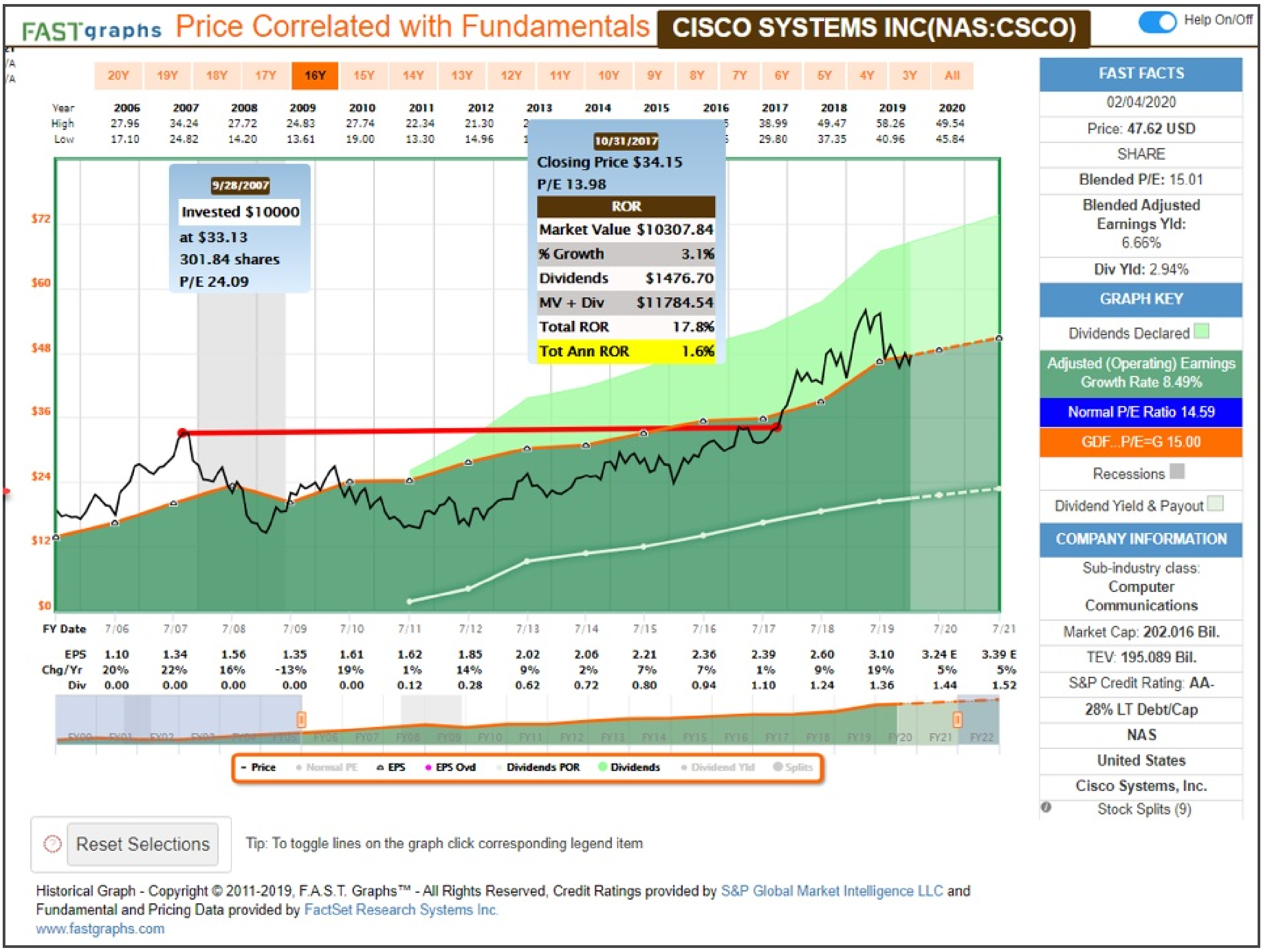
At this point, I would like to turn our attention to the Great Recession and the lessons it taught about dividend growth investing. First, I believe that most everyone would agree that the Great Recession of 2008 was severe. In fact, it was one of the worst recessions our country ever experienced, except for the Great Depression of 1929. Consequently, I don't want any reader to think that I do not recognize and acknowledge just how bad those economic times were.

On the other hand, as it relates to high-quality blue-chip dividend growth stocks, I intend to demonstrate that the Great Recession was not as devastating, at least to the true investor, as many people believe. On the other hand, I will also demonstrate that the Great Recession was traumatic and, in many cases, catastrophic to those speculators that took their lead solely from stock price movement.

But most importantly, I will also demonstrate the role that valuation played relative to whether the recession was a simple short-term interruption or a permanent devastation. In addition to the forthcoming video and in order to support my point, I offer the following FAST Graphs earnings, dividends and price correlated graphs with real-life examples.

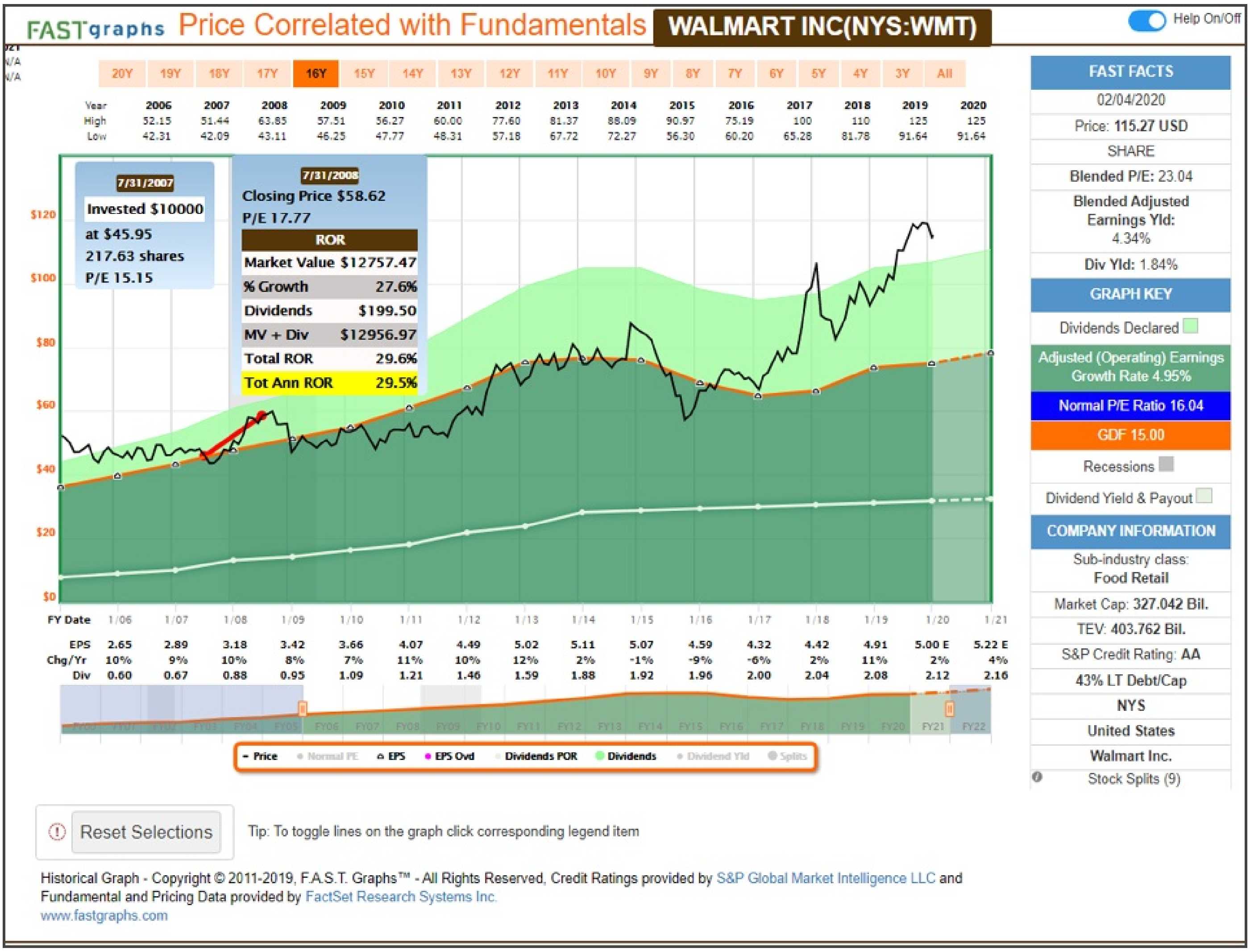
Cisco Systems: The Great Recession and the Lost Decade

As you can see from the following screenshot Cisco's (CSCO) stock price was significantly overvalued (the price was way above the orange earnings justified valuation line) entering the Great Recession. As a result, it took 10 years before the stock price recovered to its previous high. This is a clear example of the risk of overvaluation and how it resulted in an unacceptably long time before recovery occurred. (Note: Cisco was not a dividend paying stock at that time.)



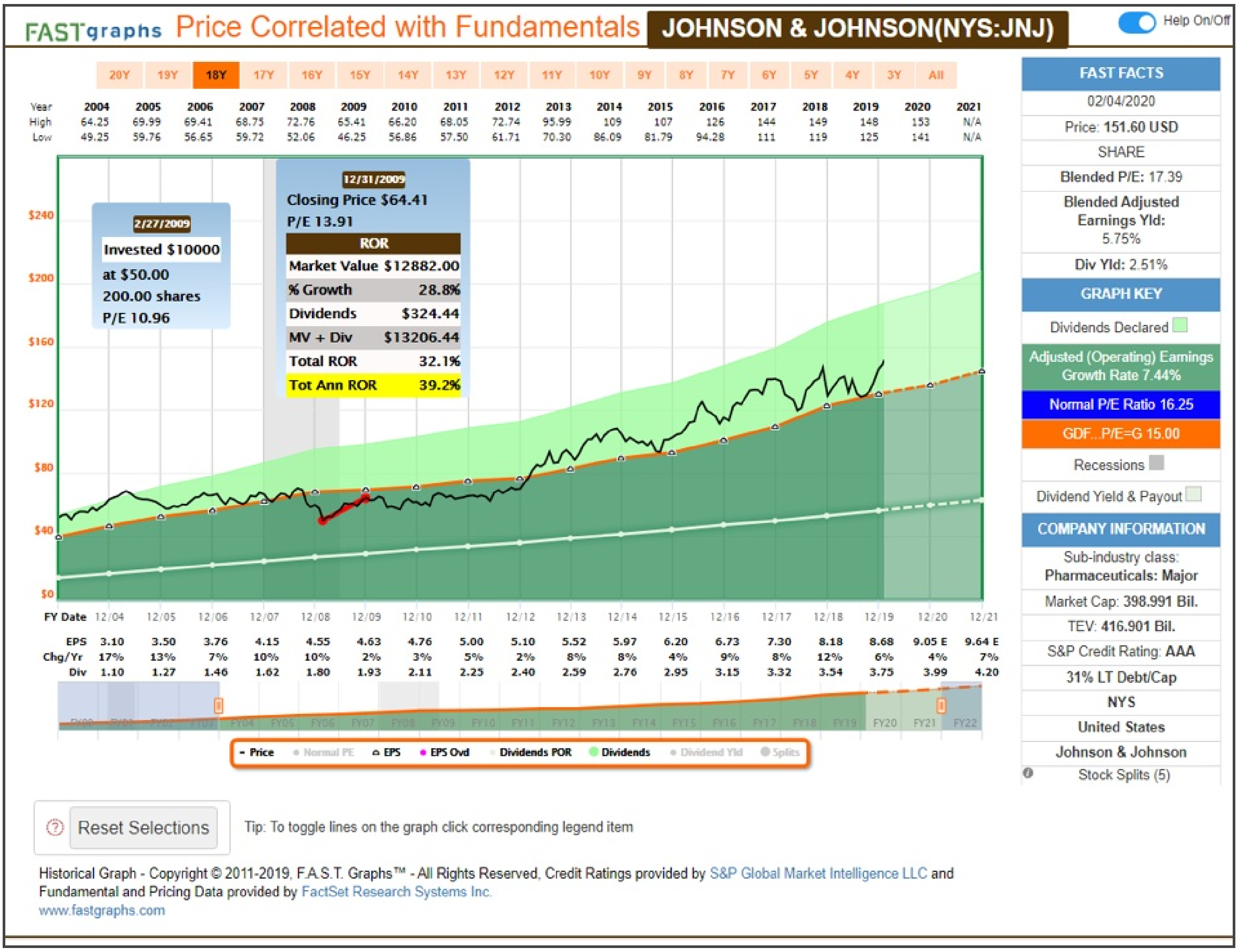
Walmart: What Recession?

In contrast to what we saw with Cisco, which entered the Great Recession when it was overvalued, Walmart (WMT) entered the Great Recession when it was fairly valued. Consequently, there was no recession for owners of Walmart. There was never a material drop in the stock price, the fundamentals remained intact and the company increased its dividend the year before the recession, during the recession and every year thereafter. It's a market of stocks not a stock market.



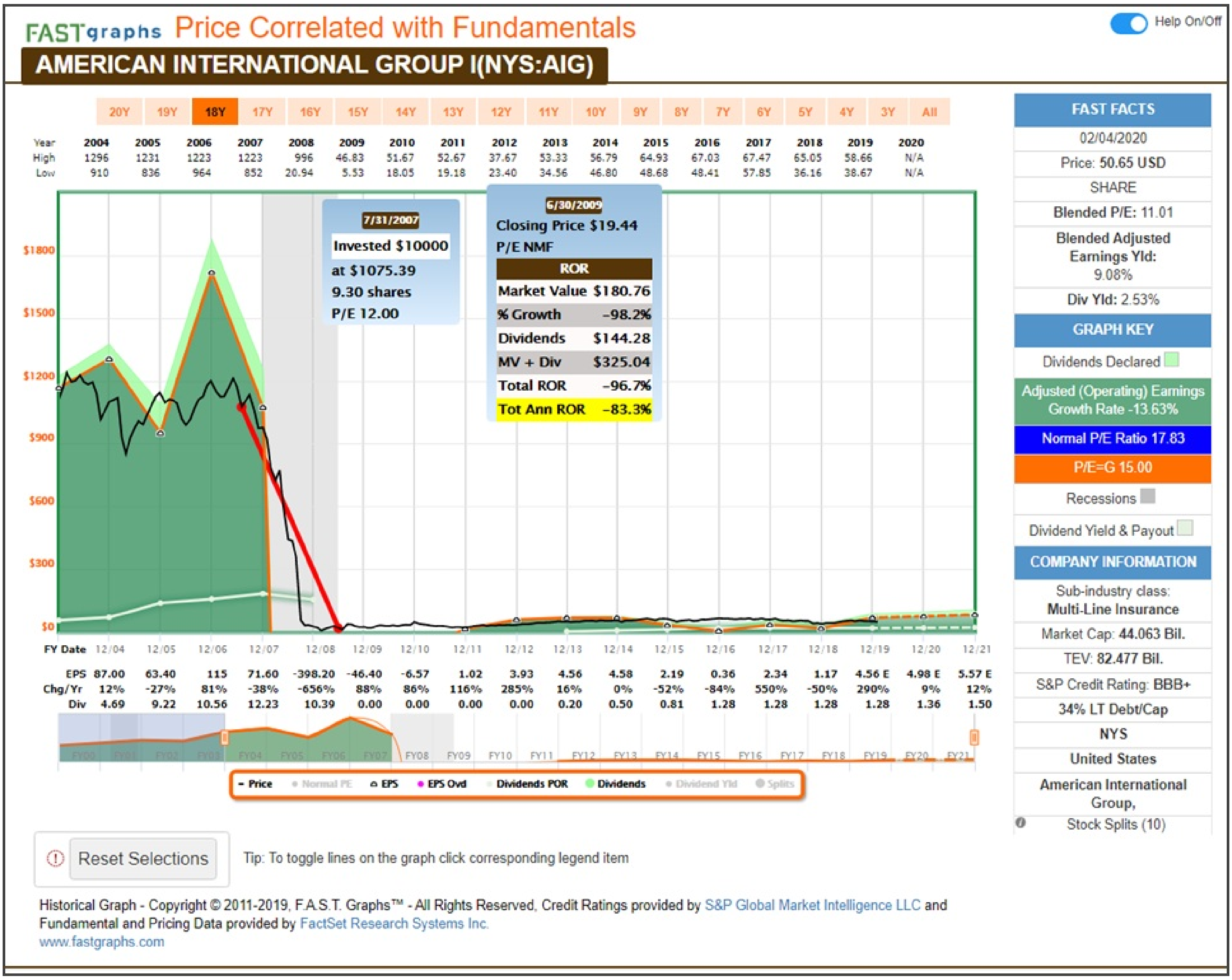
Johnson & Johnson: No Lost Decade Short Recovery

In a similar fashion to Walmart, Johnson & Johnson (JNJ) was fairly valued entering the recession, and even when there eventually was a price drop, it was short-lived. Like Walmart, Johnson & Johnson grew their earnings and their dividend prior to, during, and after the recession. Although the stock price did eventually drop by February 27th, 2009, it fell significantly less than the market, and the price was up 39% off its lows even before 2009 ended. Obviously, no lost decade and a very quick recovery.



American International Group: Fundamentals Collapsed, Dividend Eliminated Still No Recovery

Although American International Group (AIG) was technically attractively valued entering the Great Recession, their fundamentals did not remain intact. Consequently, shareholders were literally wiped out and the stock price is still nowhere near its previous highs. Not all price drops are the same.



FAST Graph Analyze Out Loud Video Showing Not All Price Drops Are the Same

I am on record many times stating that it is a market of stocks not a stock market. To me this means quit worrying about the general market – and as I also stated in the past "mind your owned businesses." If the individual companies you own are properly valued and their fundamentals strong, recessions and bear markets are really nothing to fear.

On the other hand, if you own a portfolio of significantly overvalued stocks, then recessions and bear markets are something you should be concerned about. Likewise, if you own companies that are fundamentally weak, you should also worry. However, if you own low-quality weak companies, you probably should re-examine your investment strategies in the first place.

In the following video, I will provide examples of dividend growth stocks that fared well during the Great Recession and some that did not. Additionally, I will provide examples of high-quality dividend growth stocks that I feel are dangerously overvalued currently, as well as examples of high-quality dividend growth stocks that I consider attractively valued. The real meat of this article will be found in the video, therefore, I hope you take the time to watch it.

Summary and Conclusions

With this article, I demonstrated that a high-quality, fairly valued dividend growth stock portfolio offers the best protection against a bear market for two primary reasons: Dividends are paid on the number of shares you own and not the stock price. Second, fairly valued stocks are likely to recover very quickly – assuming that fundamentals remain intact.

On the other hand, I hope the reader also recognizes the important lesson of why overvaluation can be dangerous. When a significantly overvalued stock returns to fair value, it is simply going where it belongs. Therefore, it is illogical and highly unlikely that it will return to significant overvaluation where it doesn't belong.

My primary point is that a prudent dividend growth investor is best served to focus on the financial strength and quality of the companies they own. Additionally, we need also pay attention to the valuation that the market is currently applying. I am not suggesting that high-quality overvalued stocks should immediately be sold. On the other hand, I am suggesting that investors need to be aware of the amount and level of valuation risk they are assuming. Therefore, when the inevitable bear market does eventually come, whether it happens tomorrow or years from now, they can be prepared to take appropriate action.

To me this means being poised to quickly move out of overvalued stocks if the occasion requires, and/or having the intelligent patience to stay the course if their stocks are in alignment with fair value. Not all price drops are the same, and not all stocks are susceptible to the same dangers. Although it is true that all stocks will likely fall when the bear market comes. The attractively valued stocks will usually recover quickly, and in most cases their dividends will continue to increase just like they did during the Great Recession.

Disclosure: Long JNJ,CSCO

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