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Q&A

7 Dividend-Paying Stocks to Play a Value Comeback

Jim Cullen of the Cullen High Dividend Equity fund expects value to outperform for a "very long" time.

By CRYSTAL KIM

Stock investors searching for income need to be much choosier.

Payouts among companies in the Standard & Poor's 500 surged 13% a year on average between 2012 and 2015. However, the era of supercharged dividend growth appears to be ending. As such, the indiscriminate buying of baskets of dividend-paying stocks simply won't cut it anymore.

Moreover, in turbulent markets, such as the current one, dividend-paying stocks provide ballast to portfolios and often outperform growth stocks.

Veteran stockpicker Jim Cullen has achieved long-term success managing the $1.8 billion Cullen High Dividend Equity fund (ticker: CHDEX), which yields 2.4%. Cullen, 77, adheres to the value investing philosophy espoused by noted investor and economist Benjamin Graham.

Cullen looks for stocks trading at a discount to the broader market and maintains a long time-horizon for his investments, preferring names with healthy dividend yields. Cullen's patience and investing discipline are apparent in the 36-stock fund's 10% annual turnover and average price-to-earnings ratio of 15 for his holdings.

The fund, which Cullen has managed since its inception in 2003, has produced annualized returns of 6.9%, edging out its benchmark the Russell 1000 Value's 6.8%. During that time, the S&P 500 has gained 7.2%.

In the context of what Cullen calls the "melt-up market,"—when the S&P 500 becomes inflated by inflows into the most popular, high-multiple stocks—those returns are pretty impressive. With the melt-up period possibly – if not likely – over, Cullen expects "a very long and dramatic period of outperformance by value."

Barrons.com caught up with Cullen to discuss the case for value stocks including Chubb (CB), Boeing (BA) and Cisco Systems (CSCO).

***Barrons.com:* Are we heading into a bear market?**

Cullen: It tends to happen in five-year increments. The next one should happen by 2017. You are going to get a recession there, but the good news, is that the really bad recessions in bear markets seem to come every 30 years when there is a major crisis.

Over the last five years, the biotechnology index was up the same amount as Nasdaq before the top. They built up 500% over a five-year period and of course, the FANG stocks [Facebook, Amazon.com, Netflix and Google], are up over 100% and averaged at around 100 times earnings, which is reminiscent of bubble-ish markets.

Q: That has certainly made it difficult for value investors to put up good returns.

Value investors started to drift, because the only way to get good performance was to buy some of the FANG stocks. I mean CNBC had a hard time finding somebody, when it looked like value was going to do a little bit better, so they dusted off Bill Miller and brought him back. Right after the correction [last year], they had him on the show and he talked about Amazon and Facebook—not value stocks, the way we look at it. Of course, you can call anything "value," but as far as a discipline value approach goes you wouldn't have been in Amazon or Facebook. I think value is starting to work again.

Manager's Bio

Name: Jim Cullen
Age: 77
Title: Chairman and CEO, Schafer Cullen Capital Management
Education: B.S. in finance, Seton Hall University
Hobbies: Reading Raymond Chandler novels and nonfiction

What makes you think that?

(over please)

Fund Facts
(as of Feb. 22, 2016)

Cullen High Dividend Equity	(CHDEX)
Assets:	$1.8 billion
Expense Ratio:	1.00%
Front Load:	None
Annual Portfolio Turnover:	10%
Yield:	2.38%

Top 10 Holdings
(as of Dec. 31, 2015)

Microsoft	(MSFT)
Johnson & Johnson	(JNJ)
Raytheon	(RTN)
Kimberly-Clark	(KMB)
NextEra Energy	(NEE)
3M	(MMM)
General Electric	(GE)
Cisco Systems	(CSCO)
JPMorgan Chase	(JPM)
AT&T	(T)

Source: Cullen Funds

Once you get a market which goes up with, say, no more than a 10% correction over a long period of time, a confidence gradually builds up, risk/fear of the market gradually declines, and you get a more speculative market. After 500 days without a correction that is classified as a "melt up market," and so we hit this most recent market, which is one of the three worst in history. It's surprising, because it's not as big or as speculative a buildup as the tech bubble, which is what we all remember. People forget about risk-adjusted returns and focus strictly on performance, but once that ends you get a period where value comes back for quite a while. From 2000 to 2008, as measured by the Russell 1000 Growth and Value indexes, value did better. Since then growth has done better. If history is any guide, it should be a better time for value.

How do you ensure you're not buying companies that can't afford their dividends?
Management is always key, but you want companies that are paying out no more than half of their earnings in dividends. Some companies are more dividend-orientated and they don't have the demand for capital, so it's a little different in that case. Some stocks are in the portfolio for absolute yield. In general, we're looking for payout ratios that aren't too high, and we're looking for debt that's not too high. Debt-to-equity ratios should be around 30% or better.

What are some pitfalls of dividend funds?
We are sort of anti-exchange-traded fund, because I think the danger of ETFs is if people go into something just for yield, one winds up with a bunch of stocks that may have good dividends, but also could have extended P/Es. There are three parts to the high-dividend strategy. No. 1 is valuation; No. 2 is absolute high yield and No. 3, dividend growth. We are trying to get all three of those things right. You can screen for the second two, the first is a little bit more subjective, and depends on which direction earnings are going.

Most equity income funds are loaded with utility stocks. In the early 1990s, utility stocks were trading at 10 times earnings with a 6% yield. They were slow growth. Now they've got a 3% dividend yield, and they are trading between 15 and 16 times earnings. Much of it is a result of loading up these [stocks] in ETFs, because people feel that it's a place to get yield. It is dangerous to overpay for utilities that naturally have a hard time growing. We used to own Arizona Public Service, now called Pinnacle West Capital (PNW). We did some research on it not too long ago, and the stock hadn't had a price increase in six years. It's tough. You have to get politicians to give you a price increase.

The fund does hold NextEra Energy (NEE), a holding company for electric utilities.
We bought [NextEra] mainly for their alternative business, which is what has really driven the stock. I think they are actually going to spin that business off, but we've doubled our money in that stock over the last four to five years. Yield bonus is now 2.8%. We are underweight utilities.

Have you found more value in other sectors or industries?
Cisco, which is our heaviest weighting in technology, trades at 10-11 times earnings, and they recently said they would increase the dividend by 20%. We started buying some of the old tech stocks a few years ago, and they've been showing good dividend increases. Financials have had pretty good increases. MetLife (MET), also recently raised its dividend by 20%. We're trying to find stocks that are selling at 10 times earnings, where we can get a dividend, and the payout ratios are low.

Though we try not to get too distracted by the possibility of recession, a recession is the ideal time to buy most cyclical stocks. One shocking thing to me: Every time we had a recession in the U.S. for the last 60-70 years, earnings have gone down 25%-50% depending on the recession; stock prices also go down that much. Yet dividends of stocks have basically gone up during all the recessionary periods. The only exception was in 2008 and 2009 when the banks had to make cuts. In the 1960s, when I got started in the business, dividends were important and these days, dividends are increasingly a secondary consideration, pretty much across the board on the part of corporate management. They were all doing buybacks for many reasons, which weren't necessarily in the best interest of the shareholder.

Q: Why do you think there has been that shift away from dividends and into buybacks?
Everybody is focused on short-term performance. Buybacks make your earnings look better even if you are producing the same amount of earnings, and the same amount of sales. You'll get a company that cuts their guidance five or six times in a row, and then they make a big announcement, "we beat the estimate by a penny," and the stock goes up. The fact that they've lowered their guidance five times should be a factor.

What have you bought recently?
We bought Chubb, which was the old ACE insurance. We owned Chubb before in our value portfolios, so we went to analyze whether the new company would make sense in the Dividend fund. People at Chubb were not too crazy about the CEO Evan Greenberg. Greenberg did a phenomenal job, and he answered questions well as far as integrating the two companies. The stock was trading at 10-11 times earnings. But the key thing that got us excited is that someone asked about buybacks, and Greenberg said, "I have no interest in doing buybacks. We're going to focus on paying down debt and increasing the dividend." I said to the analyst I had with me at the meeting, "He's going to win us over on that one." Companies are starting to realize that having a dividend policy adds to the stock price, because it sends a message to investors that there is a discipline; companies have made mistakes doing too much investment banking, and too many acquisitions that wind up not making any sense.

Q: What other names do you like?
In industrials, we have Boeing and Raytheon (RTN), which we've had for a while. The story on Raytheon was that the U.S. business and defense business is low margin, but its international business is very high margin. Raytheon, three or four years ago, was 90%-95% U.S.; now about 15%-20% of the business is international and that business is a lot more profitable. The way things are going in the Middle East and now Asia, defense technology is going to continue to be an important area. But the most cyclical [businesses] are most

intriguing. In fact, I have a screen on my desk right in front of me showing me that the global consumer discretionary stocks are selling under 15 times earnings.

Q: What do you like about Kimberly-Clark?

Kimberly-Clark (KMB) was a great stock for us. We're up a lot in the stock. The stock is still on the higher end on a multiple basis for us. It has been a play on diapers in China to a certain extent. When we bought Kimberly-Clark originally, the stock was 10% international, and now it is 40% international. Global growth will be in the emerging markets; that's where the consumer is. Though there is a hiccup now in some of these markets, the potential of growth in demand for those products is staggering. When we bought this stock, it was trading at 10 times earnings, and had a 4% to 5% dividend yield. Now at around 18 times forward earnings, it is slightly more expensive than the market. We've got the dividend yield of roughly 3%, and dividend growth of around 7%, so we like the long-term aspect of it. We were 25% consumer staples a year and a half to two years ago. We're down to about 14%, so we cut it in half, and we're still basically trimming these stocks.

The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 877.485.8586, or by visiting www.cullenfunds.com. Read it carefully before investing.

Mutual fund investing involves risk. Principal loss is possible. The Funds invest in foreign securities, which involve political, economic, and currency risks, greater volatility, and differences in accounting methods. The Funds invest in medium and small capitalization companies, which involve additional risks such as limited liquidity and greater volatility than large capitalization companies. References to other mutual funds should not be interpreted as an offer of these securities.

The subsidized SEC 30-day yield is 2.38%. This is a compounded and annualized figure calculated according to a formula set by the SEC. The formula requires use of a specific methodology for calculating dividends and interest earned, and expenses accrued during the period, and reflects the maximum offering price per fund share. The standardized computation is designed to facilitate yield comparisons among different funds. In the absence of temporary expense waivers or reimbursements by the Adviser, the 30-day yield would have been 2.06%.

All current holdings are subject to change.

The S&P 500 is an index of 500 stocks chosen, among other factors, for market size, liquidity and industry grouping. The Russell 1000 Value and Russell 1000 Growth are segments of the Russell 1000, which is a market capitalization-weighted index, meaning that the largest companies constitute the largest percentages in the index and will affect performance more than the smallest index members. The NASDAQ is a global electronic marketplace for buying and selling securities, as well as the benchmark index for U.S. technology stocks. An individual cannot invest directly in an index. P/E, or price-to-earnings, refers to the price of a stock divided by its estimated forward 12-month earnings per share.

An ETF, or exchange traded fund, is a marketable security that tracks an index, a commodity, bonds, or a basket of assets like an index fund.

The Cullen Funds are distributed by ALPS Distributors, Inc. The Gross Expense Ratio of CHDEX is 1.32%. The Fund imposes a 2% redemption fee on shares held less than seven days. Performance data does not reflect the redemption fee. If reflected, total returns would be reduced.

Average Annual Total Returns as of December 31, 2015:

	Q4 2015	YTD	1 Year	3 Year	5 Year	10 Year
CHDEX	9.00	0.06	0.06	11.27	10.82	6.56
S&P 500 Index	7.04	1.38	1.38	15.13	12.57	7.31
Russell 1000 Value	5.64	-3.83	-3.83	13.08	11.27	6.16

Past performance does not guarantee future results. The investment return and principle value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. Current performance may be lower or higher than the performance data quoted. You can obtain performance data current to the most recent month end by calling 1.877.485.8586 or by visiting our website: www.cullenfunds.com.