TRANSCRIPT: The Importance of High-Quality Stocks: A Conversation with Charles Rinehart, CFA, CAIA®, Managing Director and Portfolio Manager, and Scott Wyckoff, CFA, CFP®, Senior Portfolio Manager, Johnson Investment Counsel

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Scott Wyckoff: Hello and welcome to another audio update from Johnson Investment Counsel. My name is Scott Wyckoff and I'm a Portfolio Manager in our Wealth Management Division. And today, I'll be speaking with Charles Reinhart. Charles is a Managing Director and Portfolio Manager in our Family Office Services Division, and he's also a member of our portfolio strategy team. Charles also leads our equity strategy team and our equity income portfolio team. So, Charles, let's jump right in. At Johnson, our investment philosophy can basically be boiled down to a simple phrase, high quality securities all the time. So can you talk about what does that mean when we're looking at choosing stocks or stock funds and why is that approach a benefit to our clients?

Charles Rinehart: Sure. Well, I think what it means is that we're really laser focused on building portfolios that can withstand uncertain shocks. I think when investors are considering stock investments and trying to value stocks largely in the marketplace, it's a challenging exercise because what those investors are doing is they're buying the earnings stream for those companies from now until the indefinite future. And on a long enough timeframe, the only thing we really do know for certain is that there's going to be tough times and unexpected developments. And so the best way we can build portfolios to withstand those shocks in those uncertain times that are really impossible to forecast is to buy companies that we know are going to be able to make it through those recessions, corrections, bear markets, and be able to get to the other side, because the companies that are going to go out of business in the middle of those are the ones that put our clients' capital at the biggest risk for some sort of permanent loss. And that's something we want to avoid at all costs.

Scott Wyckoff: Okay, that makes sense. And certainly we're seeing some challenging times for many companies now. So what would you say in terms of everything you just described? How's that applied when you're actually looking for a stock or a fund to buy?

Charles Rinehart: Well, it's a little different from a stock and a fund. You know, we have a lot of research analysts and resources inside the firm that can help drive that process for an individual stock, particularly here in the United States. Those teams and research analysts are really focused on evaluating companies' quality through a checklist process that looks at things like the management team, balance sheets, how stable are their earnings, what's their competitive positioning like in the industry? So they're covering a lot of ground and it's really a mosaic approach. There's not one number that you can put on a stock to say whether it's quality or not. You have to consider a lot of different facets. But that's our starting point for every conversation. Now, does this stock deserve to be in the portfolio because it has those characteristics we're looking for?

When it comes to funds. Typically, we're talking about areas of the market where we don't have as much in-house expertise, maybe international stocks or some alternative segment of the marketplace. And then we're looking for investment management teams that have priorities and disciplines that are consistent and aligned with ours. So we want to be sure that they're doing the same sort of quality evaluations that we're doing, considering those same factors that we think are important. And we want to see, you know, that their teams are consistent. Their mindset is consistent, and their performance is consistent with those goals. Those are all really the ways that we can line up fund investing with what we do internally in terms of individual security selection and make sure that quality preference and mandate is expressed throughout the whole portfolio.

Scott Wyckoff: We talk a lot about being long term investors for the overall portfolio and then in the stock market as well. So could you talk about what that means in terms of how long we typically look to hold a stock or a fund?

Charles Rinehart: Yeah, well, I mentioned that when you buy a stock, you're looking at all of the future earnings close for the company, which would really mean you'd need foresight into the infinite future. That's obviously an impossible task. So we tend to focus on a three to five year time horizon when we're evaluating stocks. And that's our typical holding period. The reason for that is that there's a lot of participants in the markets that are very short term in their mindset. You can think of maybe some of the stereotypical or Hollywood portrayals of hedge fund managers trying to get the scoop on the next quarter's earnings and play one day's worth of trading in the markets. That's really not what we're doing. In fact, people that are focused on really short term events can create opportunities for folks like us that are going to look through a cycle. If there's a company has a bad quarter that may impact the near-term results. But in the scope of the next three to five years worth of earnings, it's likely to have less of an impact. So when the market gets excited and reacts really strongly to those short term moves, often it creates opportunities for us, if we're willing to have a three to five year mindset and we think that that's a behavioral edge that we can build into our portfolios by having that longer term focus.

Scott Wyckoff: I think you mentioned dividends and we talk a lot about dividends. So I think what would be interesting if you could just elaborate a little bit on why dividends are important and why we look at that when we're evaluating stocks.

Charles Rinehart: Well, you know, unfortunately, there's a lot of things that can be done to kind of manipulate some of the accounting measures that are out there in the market. But one thing that's hard to manipulate is the cash flow stream that the winds up in your bank account. And so dividends are a good indication of a company's overall financial health, because companies that pay strong and growing dividends are typically strong and growing companies. So first, we think it's an indicator of the quality of the overall firm and the overall stock investment – that there's a strong return of cash to shareholders. The other thing that's important about dividends is that it creates an income stream. Most of our clients are pulling something off their portfolios, living off of them or we're using them to fund organizational activities for our institutional investors and it's important that that cash flow can come in and can grow. And it's nice to know for doing our job and focusing on high quality companies and that cash flow can come in and even grow during these downturns.

So stock prices, while are volatile, they move with the market, but dividends are much less so. And we want to have that growing income stream for our clients to be able to spend and live off of and use to fund their goals.

Scott Wyckoff: OK. So we've talked a lot about reasons we would buy a stock and hold onto a stock. So let's just wrap this up by talking about why would you sell a stock from the portfolio?

Charles Rinehart: Yeah, one thing I maybe haven't mentioned yet is that we're pretty focused on valuation. So once we narrow our list of companies down to those that we deem to be high quality, really the timing of what goes into the portfolio and when is driven by, you know, how cheap or expensive the stock looks relative to what we think their earnings are going to be. And so the most common reason that we sell a stock is because that stock has appreciated to a point where we think that the expectations that other investors have for it exceed what we think the company is going to be able to deliver. So that's basically what we mean when we say it stock has gotten expensive is just that, you know, the market has really high expectations. And the hurdle rate for a company to meet those is now really a challenge. So that's the most common thing, is that a stock appreciates to or beyond the price target that we think is a realistic representation of what the company is likely to deliver. Other things that can happen, changes in management. Sometimes you have a management team leave to another opportunity and maybe we don't like the philosophy of the incoming management team as much. Or you can have acquisitions that change the landscape of an industry or change to leverage the debt profile of the company we've invested in to the point where we're not comfortable with it. So there's always going to be new information and when that new information comes in we have to evaluate it and sometimes change our view. But really, typically, it's either an appreciation in the price to where we think the value is not there anymore or some sort of change in the competitive dynamic of the industry or the management team or something specific with that company where our original thesis around the quality and cash flow generation is changed and we needed to change our view in accordance with that.

Scott Wyckoff: All right, Charles. Well, thanks for your insight and thanks to everyone for listening. And if you want more of our perspective, you can always visit our website. And of course, if you have any questions, feel free to reach out to your team at Johnson.