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Casual Friday: Portfolio Change + "5 Vs 495" – *August 7th 2020*

Portfolio Change: Increase Position in Leggett and Platt
Leggett & Platt is a US based manufacturer of engineered products, including: bedding components, residential and office furniture, store fixtures, displays, die castings, custom tooling, machining, drawn wire, welded steel tubing, specialty wire products, auto seating suspension, lumbar support, and control cable systems. Being the low-cost producer in these mundane markets allows LEG to be the first or second in market share for each of its products. The largest part of Leggett business is the bedding segment representing 47% of sales and 46% of operating income. The automotive segment is second largest, with 17% of sales and 26% of operating income. Year-to-date the stock is down approximately 27%, and in our opinion, provides us an opportunity to purchase a great company, a dividend aristocrat with 48 years of consecutive dividend increases, at a very reasonable price.

After the steep decline due to the pandemic, it appears LEG's businesses are rebounding sharply and are now almost back to last year's level. With consumer travel and entertainment affected by the pandemic, it looks like an estimated $1 trillion in annual spending is being partially reallocated to home improvements such as furniture and bedding. On the most recent earnings call, Karl Glassman, Leggett's CEO stated "I can sell every mattress I can get my hands on." He also indicated there is a two week wait for a new mattress. Further, with low cost financing, auto inventories are now at the low end of their historical range. With demand stabilizing, used car prices high, production is increasing.

We don't believe the market fully appreciates the swiftness and strength of the snapback in LEG two large money-making operations. We believe LEG can earn $3.00 per share in 2021, significantly better than analysts' expectations. Historically the stock trades on average, at about 18 times earnings. Applying an average multiple to our EPS estimate would value the company at $54.00 or 38% higher than today. Currently, the company carries a 4.2% current yield and we believe it is safe. We'll look for a token dividend increase from LEG this year.

Quick Chart on Growth / Value Gap:
We've featured numerous growth/value comments, but we think this chart alone summarizes 2020 market dynamics pretty clearly.

But it's not enough for dividend/value manager and advisors to state what's obvious. It is important to understand why the gap exists and what could potentially reverse it.

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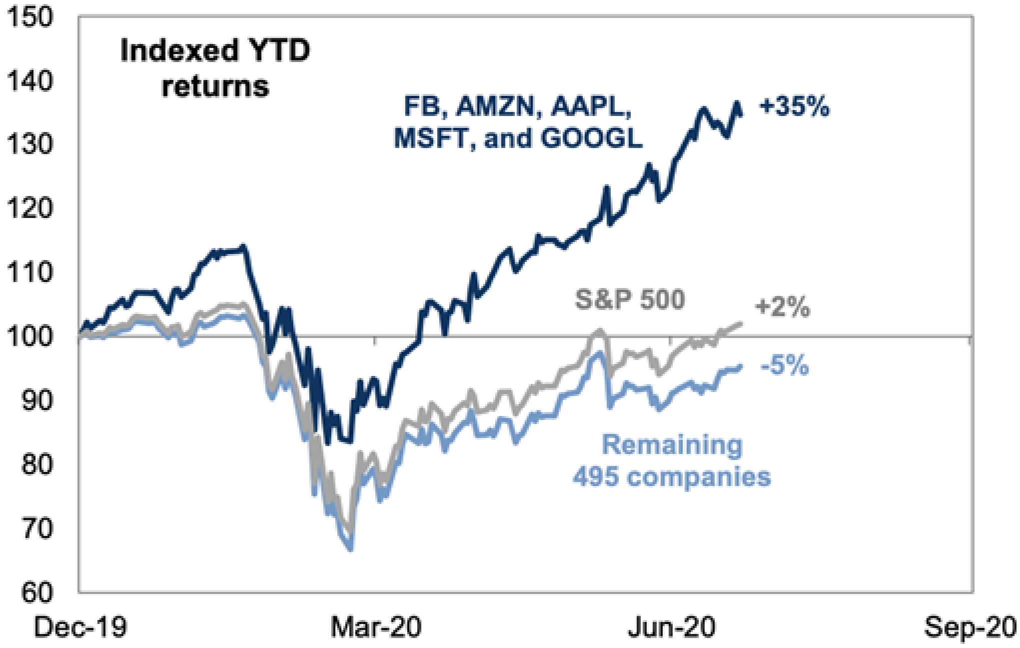
Dividend Highlights

- Dividend growth can often provide transparent insight into a company's fundamentals and vitality.
- Dividend growth can provide an attractive stream of increasing cash flow to satisfy many financial objectives.

Exhibit 1: The five largest stocks have returned 35% YTD; the other 495 stocks have declined by 5%.



Source: FactSet, Goldman Sachs Global Investment Research

Why does this gap exist in the first place?
We believe the reason for outsized performance of a handful of large cap growth stocks vs. the average stock can be explained by "scarcity of earnings growth." Since most believe the economy is in the doldrums, earnings growth is very hard to come by these days. So, paying up for companies with a unique secular growth that appear immune to the economic cycle makes sense. However, valuation gaps as measured by price to book are extremely large and, in some ways, not justified.

What market event or catalyst will help close it?
We believe even a modest economic turnaround will go a long way. If the economy can pick up, investors should realize a wider swath of companies are growing and have much lower valuations. This alone could cause a substantial shift in sentiment**.**

Client Perception Gap?
And speaking of gaps... filling in these "perception gaps" may be an advisor's top priority today.

We recently did a business building webinar. In it we cited a recent investor survey from Natixus which had some statistics that may shock advisors:

Gap 1: 57% of high net worth investors said they "don't have a financial plan" Yet, 80% of advisors say they prominently feature planning as a key offering in their practice.

Gap 2: Clients surveyed also said they expect returns of "11.2%." To make matters worse, 78% of these same people cite capital preservation as a top priority.

Gap 3: Clients believe "Passive is less risky than active and will protect me on the downside"

Source: https://www.im.natixis.com/us/resources/2020-financial-professionals-survey-executive-overview

Given this massive disconnect between expectations and reality, it is no wonder clients keep feeling disappointed and perhaps why Vanguard's latest AUM is over $6 trillion. It all adds up to one big gap that screams "We are either not delivering enough value or we are not articulating the value we can deliver." But you can't meet the value expectation if it's so far from reality. So, in the end, it's imperative we figure out how the client keeps score of the relationship and make sure we get clients expectations reasonable. And by the results of these surveys, it appears they keep score quite differently than we do.

During your next conversation, perhaps ask some of these questions to tease out expectations, perception gaps, and what clients really think:

"How satisfied are you with the completeness of your financial plan?"
"Are there any areas important to you this plan does not address?"
"What areas of the plan are low priorities?" – perhaps you are focusing on things they don't really care about!
"How do you define success in these areas?"

Then based on the response, you can lay out a set of action steps that will serve as something you CAN deliver.

"What return goal do you think is reasonable over time?"
"How do you define risk? Ie. Lack of income? Price fluctuations? Not keeping up with the market?"

Then, be at the ready with historical information: typical bear markets, annual corrections, you can't time the market etc.
"Do you think passive strategies have more risk or less risk than active strategies? If yes, you might ask "why do you think that is the case"

Another good strategy? Many of these types of questions might be in your original questionnaire, but perhaps with so many questions you did not have the time to ask probing questions about the responses – their responses just got lumped into the master document.

You could either address these with historical context now, OR you could schedule another meeting specifically dedicated to these agenda items. It will give good justification for future meetings.

In the end, it's imperative we figure out how the client keeps score of the relationship and by the results of these surveys, it may be quite different than how we do.

Thanks, and have a great weekend!

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