STOCK PICKS AND PANS

7/3/18

Featured Stocks in June's Dividend Growth Model Portfolio

This report highlights last month's top performers and features a stock from the current portfolio. June's Dividend Growth Stocks Model Portfolio was made available to members on June 27, 2018.

Recap from May's Picks

Our Dividend Growth Stocks Model Portfolio outperformed the S&P 500 last month. The Model Portfolio rose 1.1% on a price return basis and 1.4% on a total return basis. The S&P 500 fell 0.6% on a price return basis and 0.1% on a total return basis. The portfolio's best performing stock was Best Buy (BBY), which was up 8%. Overall, 18 out of the 30 Dividend Growth Stocks outperformed the S&P last month.

The long-term success of our model portfolio strategies highlights the value of our Robo-Analyst technology[1], which scales our forensic accounting expertise (featured in Barron's) across thousands of stocks[2].

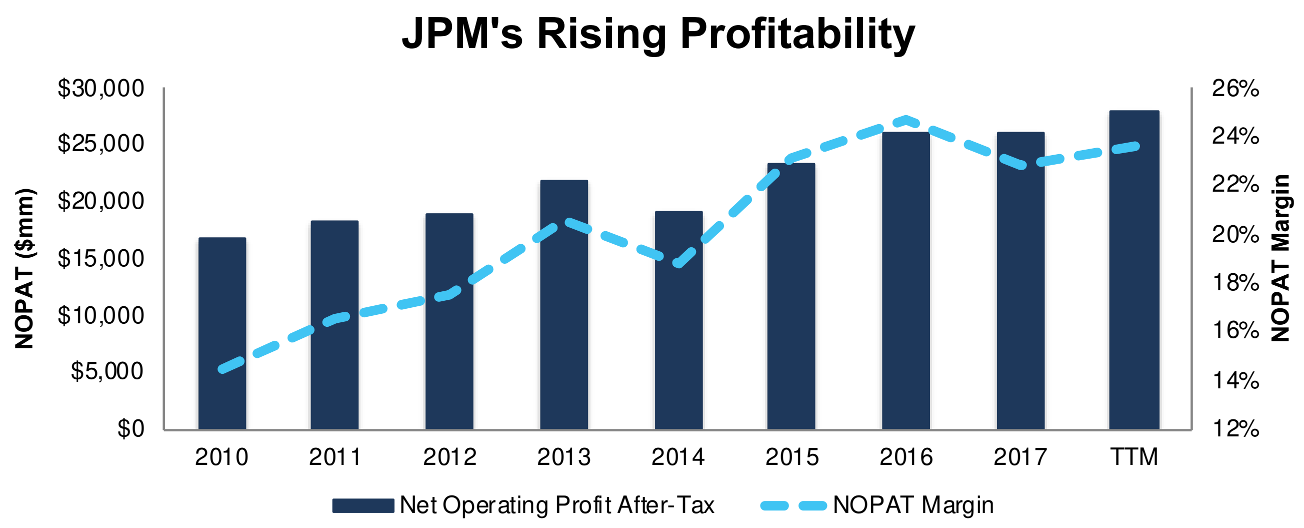
The methodology for this model portfolio mimics an All-Cap Blend style with a focus on dividend growth. Selected stocks earn an Attractive or Very Attractive rating, generate positive free cash flow (FCF) and economic earnings, offer a current dividend yield >1%, and have a 5+ year track record of consecutive dividend growth. This model portfolio is designed for investors who are more focused on long-term capital appreciation than current income, but still appreciate the power of dividends, especially growing dividends.

Featured Stock from June: JPMorgan Chase & Company (JPM: $104/share)

JPMorgan Chase & Company (JPM), a global financial services company, is the featured stock from June's Dividend Growth Stocks Model Portfolio.

Since 2010, JPM has grown after-tax profit (NOPAT) by 6% compounded annually to $26 billion in 2017. NOPAT has increased further, to $28 billion over the last twelve months (TTM). JPM's NOPAT margin has increased from 15% in 2010 to 24% TTM while its return on invested capital (ROIC) has improved from 7% to 10%.

Figure 1: JPM's NOPAT and Margin Since 2010



Sources: New Constructs, LLC and company filings

[1] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

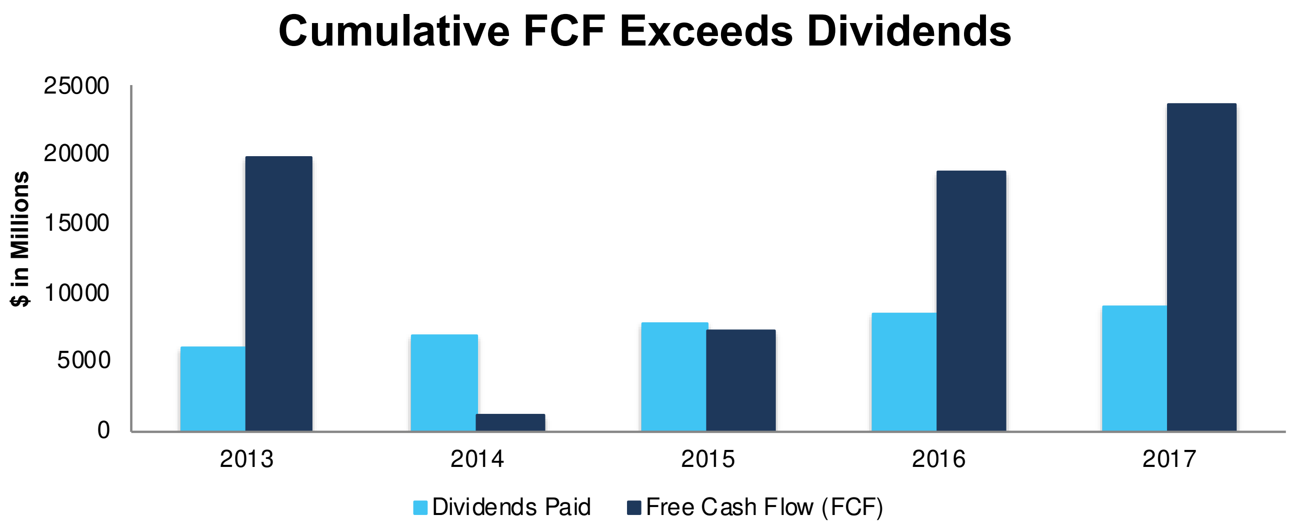
[2] Ernst & Young's recent white paper "Getting ROIC Right" proves the superiority of our holdings research and analytics.

Steady Dividend Growth Supported by FCF

JPM has increased its annual dividend in each of the past seven years. The current annualized dividend has grown from $1.44/share in 2013 to $2.12/share in 2017, or 10% compounded annually. Positive FCF has fueled dividend growth in the past and should continue to do so in the future. From 2013-2017, JPM generated cumulative FCF of $70.7 billion (20% of market cap), which is well above the $38.4 billion in dividends paid over the same time.

Companies with FCF well in excess of dividend payments provide higher quality dividend growth opportunities because we know the firm generates the cash to support the current dividend as well as a higher dividend. On the flip side, the dividend growth trajectory of a company where FCF falls short of the dividend payment over time cannot be trusted to grow or sustain its dividend because of inadequate free cash flow.

Figure 2: Free Cash Flow (FCF) vs. Regular Dividend Payments



Sources: New Constructs, LLC and company filings

JPM Presents Quality Risk/Reward

At its current price of $104/share, JPM has a price-to-economic book value (PEBV) ratio of 1.2. This ratio means the market expects JPM's NOPAT to grow by no more than 20% over its remaining corporate life. This expectation seems overly pessimistic for a firm that has grown NOPAT by 10% compounded annually since 1998.

If JPM can maintain current pre-tax margins (32% TTM), benefit from lower tax rates, and grow NOPAT by 6% compounded annually over the next decade, the stock is worth $127/share today – a 22% upside. See the math behind this dynamic DCF scenario. Add in JPM's 2.1% dividend yield and history of dividend growth, and it's clear why this stock is in the Dividend Growth Stocks Model Portfolio.

Critical Details Found in Financial Filings By Our Robo-Analyst Technology

As investors focus more on fundamental research, research automation technology is needed to analyze all the critical financial details in financial filings. Below are specifics on the adjustments we make based on Robo-Analyst findings in JPMorgan Chase & Company's 2017 10-K:

Income Statement: we made $7.2 billion of adjustments with a net effect of removing $3.4 billion in non-operating expense (3% of revenue). We removed $5.3 billion related to non-operating expenses and $1.9 billion related to non-operating income. See all adjustments made to JPM's income statement here.

Balance Sheet: we made $52.8 billion of adjustments to calculate invested capital with a net increase of $36 billion. The most notable adjustment was $16 billion (6% of reported net assets) related to goodwill. See all adjustments to JPM's balance sheet here.

Valuation: we made $43.8 billion of adjustments with a net effect of decreasing shareholder value by $33.8 billion. The largest adjustment to shareholder value was $26.1 billion in preferred stock. This adjustment represents 7% of JPM's market value. Despite the decrease in shareholder value, JPM remains undervalued.

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Disclosure: David Trainer, Kyle Guske II, and Sam McBride receive no compensation to write about any specific stock, style, or theme.

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To fulfill the Duty of Care, research should be:

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3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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