# Featured Stock in October's Dividend Growth Model Portfolio

Six new stocks make our Dividend Growth Stocks Model Portfolio this month, which was made available to members on October 30, 2019.

**Recap from September's Picks**

Our Dividend Growth Stocks Model Portfolio outperformed the S&P 500 from September 26, 2019 through October 28, 2019. The Model Portfolio rose 5.1% on a price return basis and 5.2% on a total return basis. The S&P 500 rose 2.1% on a price return and total return basis. The portfolio's best performing stock was up 16%. Overall, 19 out of the 30 Dividend Growth Stocks outperformed the S&P from September 26, 2019 through October 28, 2019, and 23 had positive returns.



Only our research utilizes the superior data and earnings adjustments featured by the HBS & MIT Sloan paper, "Core Earnings: New Data and Evidence." 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.

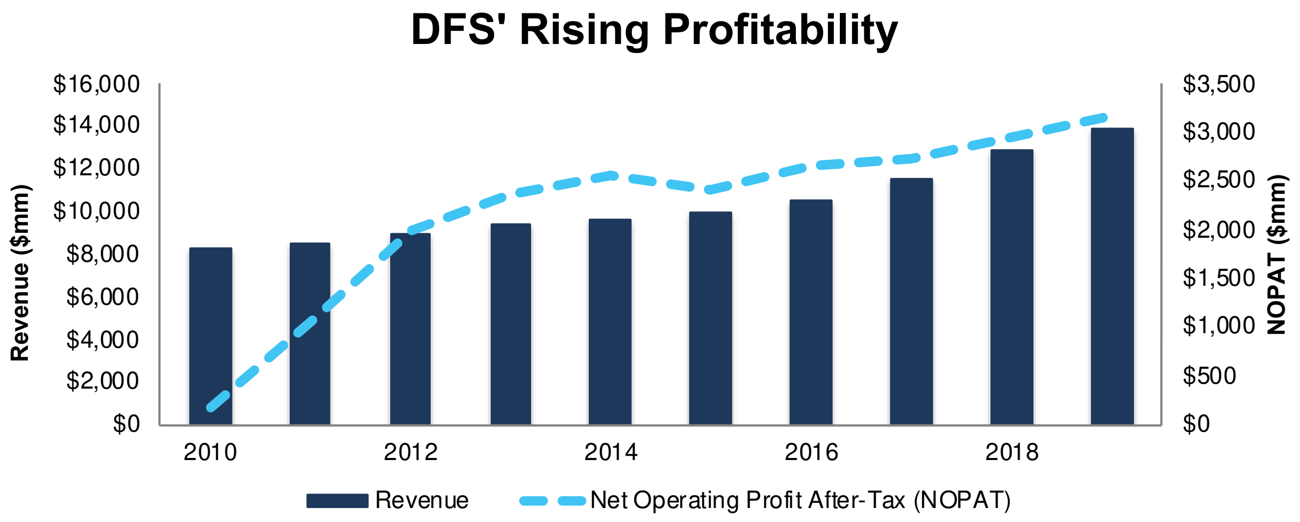
**Featured Stock from October: Discover Financial Services (DFS: $82/share)**

Discover Financial Services (DFS) is the featured stock from October's Dividend Growth Stocks Model Portfolio. We recently made DFS a Long Idea in October 2019 and, despite outperforming (+8% vs. S&P +5%), the stock remains undervalued.

Since 2010, DFS has grown revenue by 6% compounded annually and after-tax operating profit (NOPAT) by 16% compounded annually. DFS' trailing twelve months (TTM) NOPAT of $3.2 billion is up 11% over the prior TTM period. DFS' NOPAT margin is up from 12% in 2011 to 23% TTM and its return on invested capital (ROIC) has also improved from 11% to 22% over the same time.

[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] This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

**Figure 1: DFS Revenue & NOPAT Since 2010**



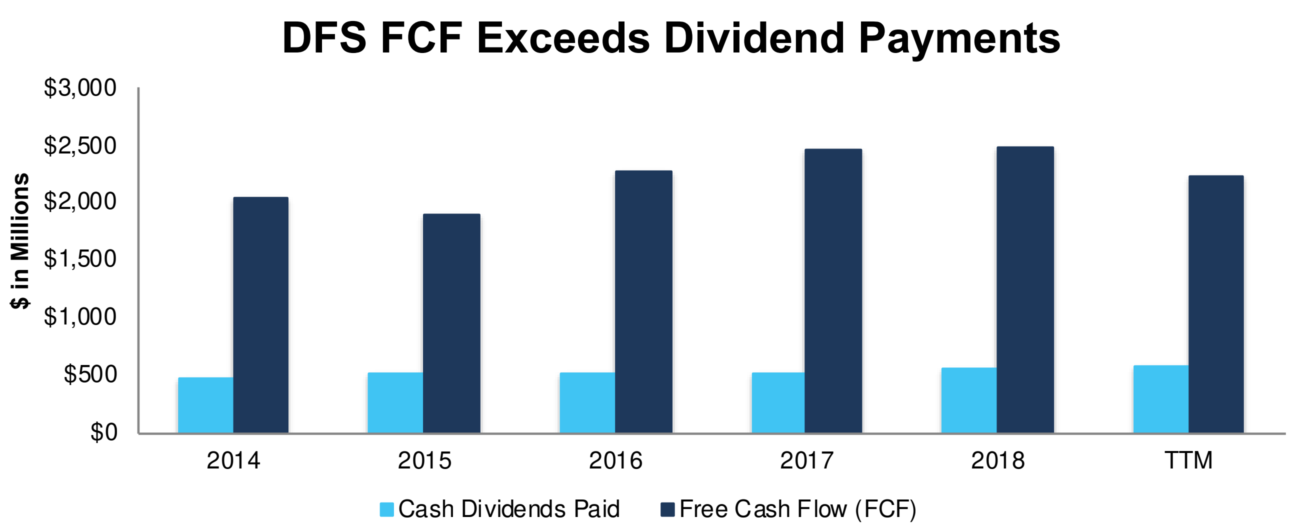

Sources: New Constructs, LLC and company filings

### Steady Dividend Growth Supported by FCF

Discover Financial Services has increased its annual dividend in each year since 2011. The regular annual dividend has grown from $0.92/share in 2014 to $1.64/share TTM, or 12% compounded annually. DFS easily generates the cash flow needed to continue paying and growing its dividend. Since 2014, DFS has generated cumulative FCF of $11.2 billion (44% of market cap) while paying $2.6 billion in dividends.

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 a higher dividend. On the other hand, the dividend of a company where FCF falls short of the dividend payment over time cannot be trusted to grow or even stay the same because of inadequate free cash flow.

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




Sources: New Constructs, LLC and company filings

### DFS Holds Significant Upside Potential

At its current price of $82/share, DFS has a price-to-economic book value (PEBV) ratio of 0.7. This ratio means the market expects DFS' NOPAT to permanently decline by 30%. This expectation seems rather pessimistic for a firm that has grown NOPAT by 16% compounded annually since 2010 and 11% compounded annually since 2007.

If DFS can maintain a 22% NOPAT margin (slightly down from 23% in 2018) and grow NOPAT by 5% compounded annually over the next decade, the stock is worth $150/share today, an 83% upside to the current stock price. See the math behind this reverse DCF scenario. Add in DFS' 2.2% dividend yield and history of dividend growth, and it's clear why this stock is in October's 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 as shown in the Harvard Business School and MIT Sloan paper, "Core Earnings: New Data and Evidence".

Below are specifics on the adjustments we make based on Robo-Analyst findings in Discover Financial Service's 2018 10-K:

Income Statement: we made $737 million of adjustments, with a net effect of removing $269 million in non-operating expense (2% of revenue). You can see all the adjustments made to DFS' income statement here.

Balance Sheet: we made $4.5 billion of adjustments to calculate invested capital with a net increase of $3.1 billion. The most notable adjustment was $3.0 billion (27% of reported net assets) related to total reserves. See all adjustments to DFS' balance sheet here.

Valuation: we made $724 million of adjustments with a net effect of decreasing shareholder value by $724 million. There were no adjustments that increased shareholder value. The largest adjustment to shareholder value was $563 million in preferred stock. This adjustment represents 2% of DFS' market value. See all adjustments to DFS' valuation here.

*This article originally published on November 6, 2019.*

*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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## *Footnotes adjustments matter. We are the ONLY source.*

We provide ratings, models, reports & screeners on U.S. 3,000 stocks, 700 ETFs and 7,000 mutual funds.

**HBS & MIT Sloan research reveals that:**

- **Markets are inefficiently assessing earnings because no one reads the footnotes.**
- **Our technology brings the material footnotes data to market for the first time ever.**

Combining human expertise with NLP/ML/AI technologies (featured by Harvard Business School), we shine a light in the dark corners (e.g. footnotes) of hundreds of thousands of financial filings to unearth critical details.

The HBS & MIT Sloan paper, Core Earnings: New Data and Evidence, shows how our superior data drives uniquely comprehensive and independent debt and equity research.

This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Quotes from HBS & MIT Sloan professors on our research:

### *Get better research:*

*"…the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications."* – page 20

### *Pick better stocks:*

*"Trading strategies that exploit cross-sectional differences in firms' transitory earnings produce abnormal returns of 7-to-10% per year." – Abstract*

### *Avoid losses from using other firms' data:*

*"…many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat…" – page 14*

### *Build better models:*

*"Core Earnings [calculated using New Constructs' novel dataset] provides predictive power for various measures of one-year-ahead performance…that is incremental to their current-period counterparts." – page 4*

### *Exploit market inefficiencies:*

*"These results … suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures." – page 26*

### *Fulfill fiduciary duties:*

*"An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A." – page 33-34*

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