Featured Stock in June's Safest Dividend Yields Model Portfolio

Seven new stocks make our Safest Dividend Yields Model Portfolio this month, which was made available to members on June 23, 2020.

Recap from May's Picks

On a price return basis, our Safest Dividend Yields Model Portfolio (+7.7%) outperformed the S&P 500 (+3.9%) by 3.8% from May 20, 2020 through June 19, 2020. On a total return basis, the Model Portfolio (+8.1%) outperformed the S&P 500 (+4.4%) by 3.7% over the same time. The best performing large cap stock was up 19%, and the best performing small cap stock was up 39%. Overall, eleven out of the 20 Safest Dividend Yield stocks outperformed their respective benchmarks (S&P 500 and Russell 2000) from May 20, 2020 through June 19, 2020.

Learn more about the best fundamental research

Only our research utilizes the superior data and earnings adjustments featured by the HBS & MIT Sloan paper, "Core Earnings: New Data and Evidence." This Model Portfolio leverages our Robo-Analyst technology[1], which scales our forensic accounting expertise (featured in Barron's) across thousands of stocks.[2]

This Model Portfolio only includes stocks that earn an Attractive or Very Attractive rating, have positive free cash flow and economic earnings, and offer a dividend yield greater than 3%. Companies with strong free cash flow provide higher quality and safer dividend yields because we know they have the cash to support the dividend. We think this portfolio provides a uniquely well-screened group of stocks that can help clients outperform.

Featured Stock for June: NetApp Inc. (NTAP: $44/share)

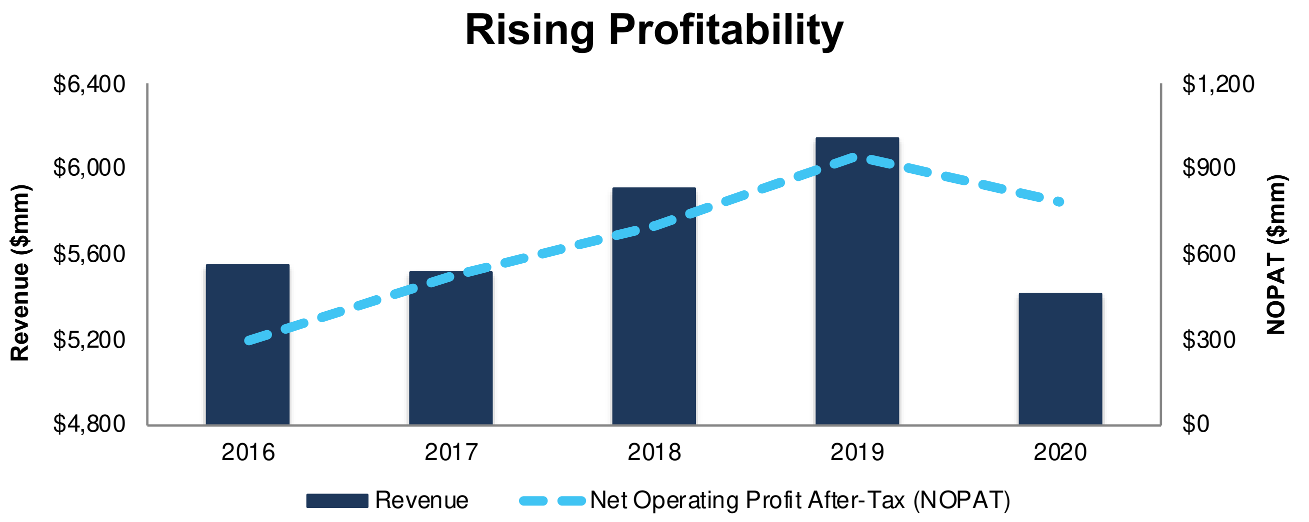
NetApp Inc. (NTAP) is the featured stock in June's Safest Dividend Yields Model Portfolio.

NetApp has grown revenue by 3% compounded annually and net operating profit after-tax (NOPAT) by 6% compounded annually over the past decade. More recently, NetApp grew NOPAT from by 28% compounded annually since 2016. The firm's NOPAT margin increased from 11% in 2010 to 14% in 2020, while its return on invested capital (ROIC) improved from 30% to 42% 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 Compare our analytics on a mega cap company to Bloomberg and Capital IQ's (SPGI) analytics in the detailed appendix of this paper.

Important Disclosure Information is contained on the last page of this report.
The recipient of this report is directed to read these disclosures.

Figure 1: NetApp's Revenue & NOPAT Since 2016



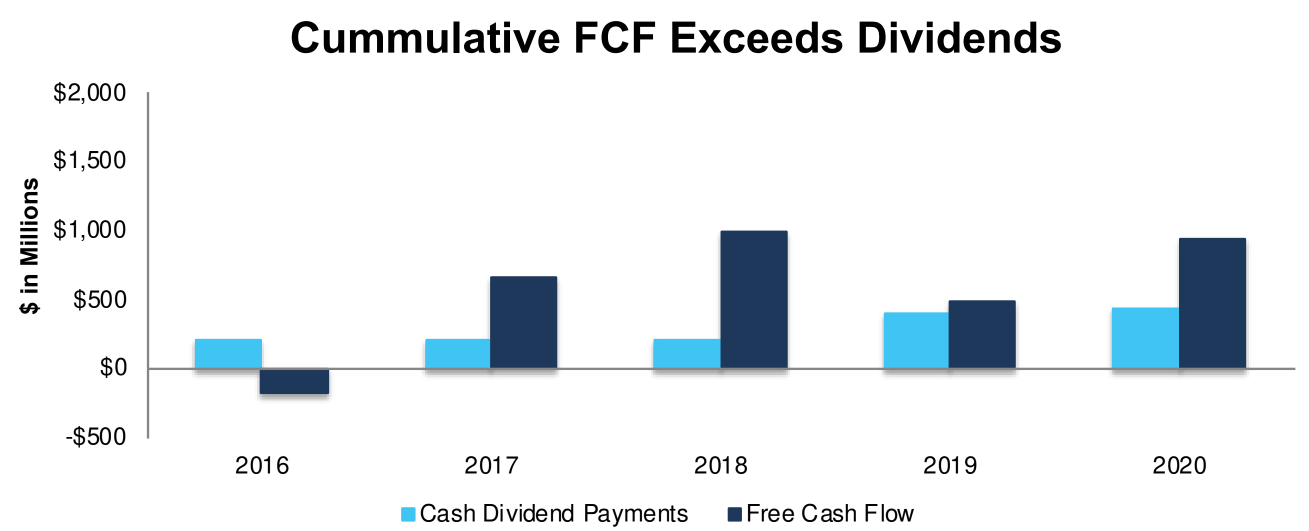
Sources: New Constructs, LLC and company filings

Cash Flow Supports Dividend Payments

NetApp has paid a dividend in each of the past six years and stated in its 1Q20 earnings call that it was "going to stay with the dividend." The firm increased its dividend payments from $0.72/share in 2016 to $1.92/share in 2020, or 28% compounded annually. The current quarterly dividend, when annualized provides a 4.4% dividend yield.

NetApp's dividend payment is supported by the firm's strong free cash flow (FCF). NetApp generated $2.9 billion (31% of current market cap) in FCF while paying $1.5 billion in dividends from 2016 to 2020, per Figure 2. Last year, NetApp generated $937 million in FCF and paid out $439 million in dividends.

Figure 2: NetApp's FCF vs. Dividends Since 2016



Sources: New Constructs, LLC and company filings

Companies with strong FCF provide higher quality dividend yields because we know the firm has the cash to support its dividend. On the other hand, dividends from companies with low or negative FCF cannot be trusted as much because the company may not be able to sustain paying dividends.

NTAP Is Undervalued

At its current price of $44/share, NTAP has a price-to-economic book value (PEBV) ratio of 0.7. This ratio means the market expects NetApp's NOPAT to permanently decline by 30%. This expectation seems overly pessimistic given that NetApp has grown NOPAT by 6% compounded annually over the past decade.

Even if NetApp's NOPAT margin falls to 11% (10-year average vs. 14% in 2020), and the firm grows revenue by just 2% compounded annually, which results in NOPAT falling by less than 1% compounded annually over the next decade, the stock is worth $57/share today – a 30% upside. See the math behind this reverse DCF scenario.

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 NetApp's 2020 10-K:

Income Statement: we made $209 million of adjustments with a net effect of removing $123 million in non-operating income (2% of revenue). See all adjustments made to NetApp's income statement here.

Balance Sheet: we made $3.7 billion of adjustments to calculate invested capital with a net decrease of $2.1 billion. The most notable adjustment was $220 million (6% of reported net assets) in deferred tax assets. See all adjustments to NetApp's balance sheet here.

Valuation: we made $4.5 billion of adjustments with a net effect of increasing shareholder value by $786 million. Apart from total debt, one of the most notable adjustments to shareholder value was $2.6 billion in excess cash. This adjustment represents 28% of NetApp's market value. See all adjustments to NetApp's valuation here.

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Disclosure: David Trainer, Kyle Guske II, and Matt Shuler 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.**
- **Corporate managers hide gains/losses in footnotes to manage earnings.**
- **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.

Learn more.

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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