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STOCK PICKS AND PANS
11/24/20

Featured Stock in November's Safest Dividend Yields Model Portfolio

Eight new stocks make our Safest Dividend Yields Model Portfolio this month, which was made available to members on November 19, 2020.

Recap from October's Picks

On a price return basis, our Safest Dividend Yields Model Portfolio (+8.9%) outperformed the S&P 500 (+5.2%) by 3.7% from October 21, 2020 through November 17, 2020. On a total return basis, the Model Portfolio (+9.2%) outperformed the S&P 500 (+5.2%) by 4.0% over the same time. The best performing large cap stock was up 20%, and the best performing small cap stock was up 26%. Overall, 11 out of the 20 Safest Dividend Yield stocks outperformed their respective benchmarks (S&P 500 and Russell 2000) from October 21, 2020 through November 17, 2020.

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 November: Kellogg Company (K: $64/share)

Kellogg Company (K) is the featured stock in November's Safest Dividend Yields Model Portfolio.

While revenue has been stagnant, Kellogg has grown core earnings[3] by 5% compounded annually since 2015. Kellogg's core earnings margin increased from 8% in 2015 to 10% TTM.

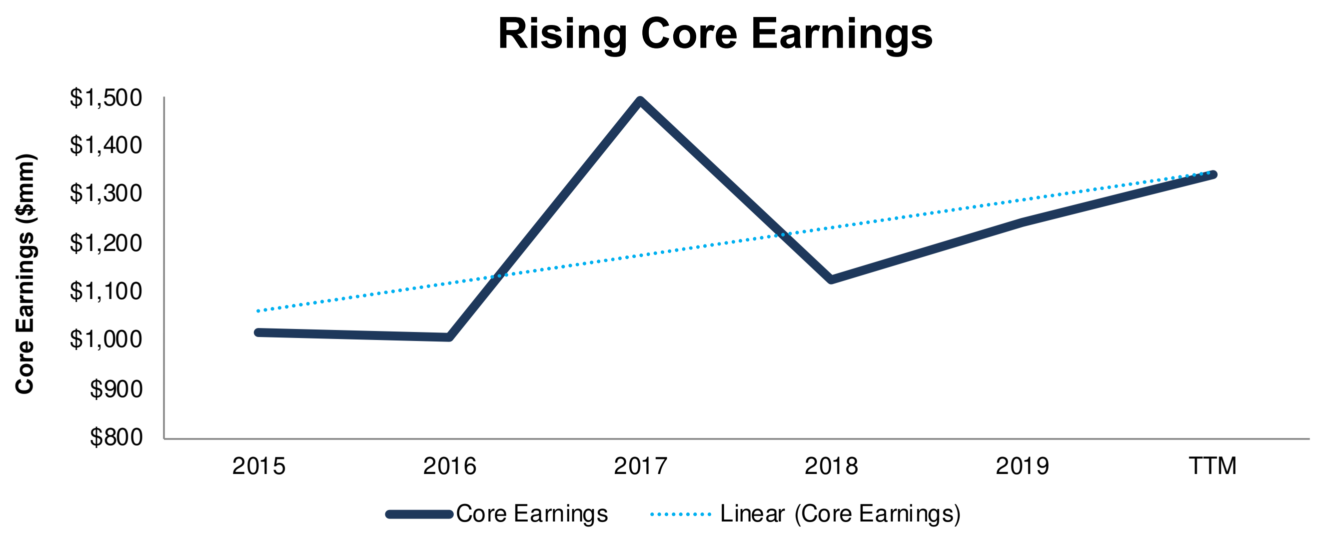
Kellogg's return on invested capital (ROIC) of 9% is unchanged from 2015, but the firm's economic earnings, or the true cash flows of the business, have grown from $811 million in 2015 to $954 million TTM.

[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.

[3] Our core earnings are a superior measure of profits, as demonstrated in Core Earnings: New Data & Evidence a paper by professors at Harvard Business School (HBS) & MIT Sloan. The paper empirically shows that our data is superior to "Operating Income After Depreciation" and "Income Before Special Items" from Compustat, owned by S&P Global (SPGI).

Figure 1: Core Earnings Since 2014



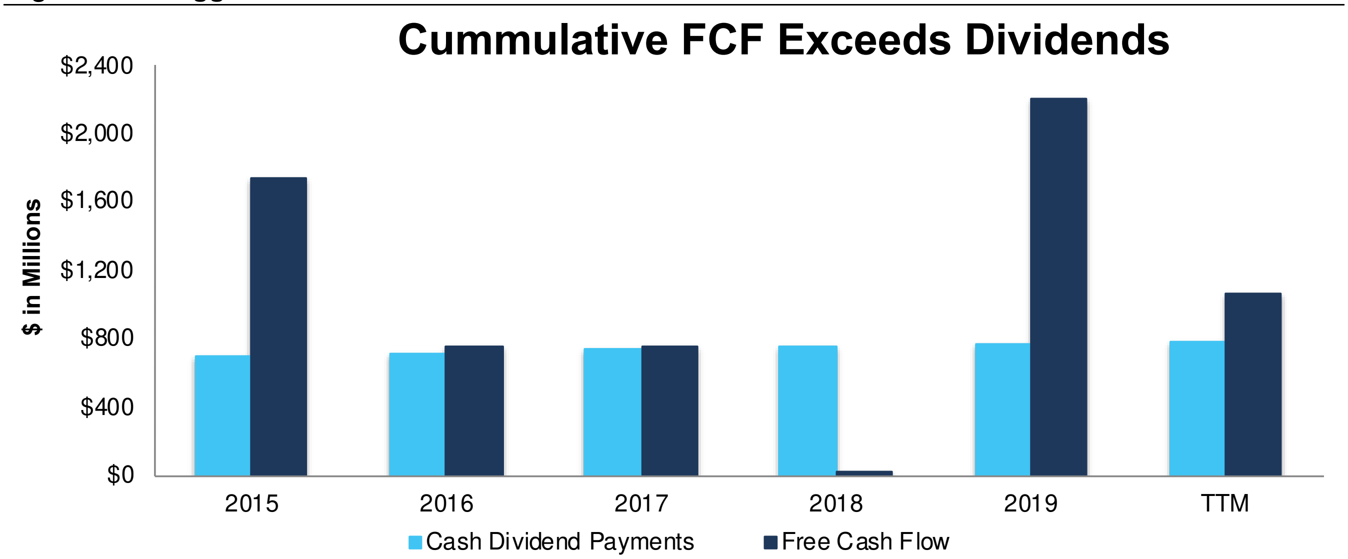
Sources: New Constructs, LLC and company filings

Cash Flow Supports Dividend Payments

Kellogg has paid a dividend every year since 1952. The firm increased its dividend payments from $1.98/share in 2015 to $2.26/share in 2019, or 3% compounded annually. The current quarterly dividend, when annualized provides a 3.5% dividend yield.

Kellogg's dividend payment is supported by the firm's strong free cash flow (FCF). Kellogg generated $5.5 billion (25% of current market cap) in FCF while paying $3.7 billion in dividends from 2015 to 2019, per Figure 2. Over the TTM, Kellogg has generated $1.1 billion in FCF and paid out $781 million in dividends.

Figure 2: Kellogg's FCF vs. Dividends Since 2015



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.

K Is Undervalued

At its current price of $64/share, K has a price-to-economic book value (PEBV) ratio of 0.6. This ratio means the market expects Kellogg's NOPAT to permanently decline by 40%. This expectation seems overly pessimistic given that Kellogg has grown NOPAT by 4% compounded annually over the past two decades.

Even if Kellogg's margin falls to 9% (ten-year low) and the firm grows revenue by 1% compounded annually over the next decade, which results in NOPAT falling by less than 1% compounded annually over the same time, the stock is worth $105/share today – a 64% 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 Kellogg's 10-Q's and 10-K:

Income Statement: we made $1 billion of adjustments with a net effect of removing $444 million in non-operating income (3% of revenue). See all adjustments made to Kellogg's income statement here.

Balance Sheet: we made $3.8 billion of adjustments to calculate invested capital with a net increase of $3.3 billion. The most notable adjustment was $1.5 billion (11% of reported net assets) in other comprehensive income. See all adjustments to Kellogg's balance sheet here.

Valuation: we made $11.2 billion of adjustments with a net effect of decreasing shareholder value by $9.4 billion. Apart from total debt, one of the most notable adjustments to shareholder value was $903 million in excess cash. This adjustment represents 4% of Kellogg's market value. See all adjustments to Kellogg'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.

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

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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