Featured Stock in December's Dividend Growth Model Portfolio

Four new stocks make our Dividend Growth Stocks Model Portfolio this month, which was made available to members on December 30, 2020.

Recap From November's Picks

On a price return basis, our Dividend Growth Stocks Model Portfolio (+0.1%) underperformed the S&P 500 (+2.5%) by 2.4% from November 24, 2020 through December 28, 2020. On a total return basis, the Model Portfolio (+0.3%) underperformed the S&P 500 (+2.9%) by 2.6% over the same time. The best performing stock was up 17%. Overall, nine out of the 30 Dividend Growth Stocks outperformed the S&P 500 from November 24, 2020 through December 28, 2020.

Learn more about the best fundamental research

The best fundamental data in the world, proven in The Journal of Financial Economics, drives our research. Our proprietary Robo-Analyst technology[1] scales our forensic accounting expertise (featured in Barron's) across thousands of stocks[2] to produce an unrivaled database of fundamental data.

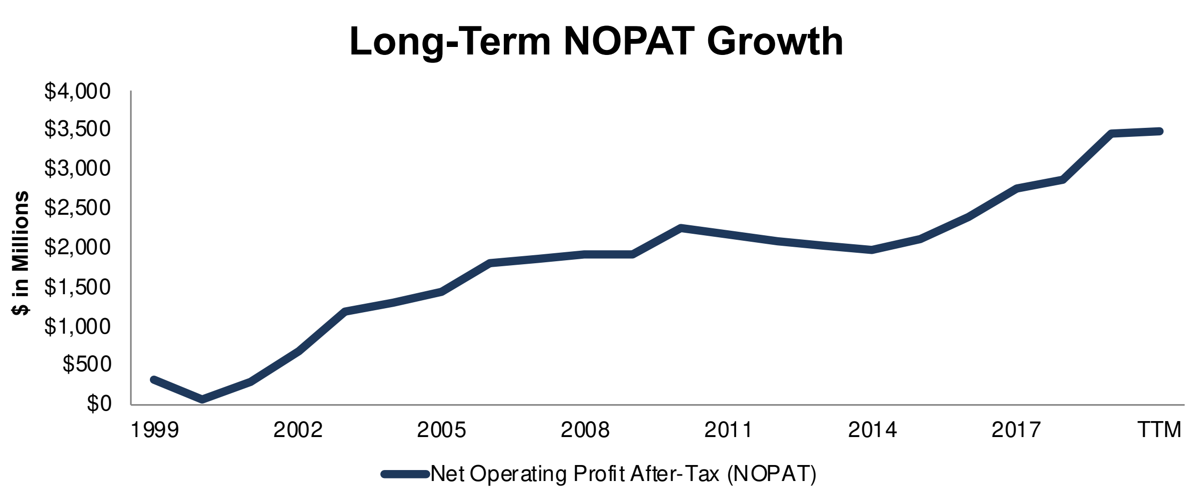
The methodology for this model portfolio mimics an All-Cap Blend style with a focus on dividend growth. Selected stocks earn an Attractive or Very Attractive rating, generate positive free cash flow (FCF) and economic earnings, offer a current dividend yield >1%, and have a 5+ year track record of consecutive 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 December: Northrop Grumman Corp (NOC: $297/share)

Northrop Grumman Corp (NOC) is the featured stock from December's Dividend Growth Stocks Model Portfolio.

Northrop Grumman has grown net operating profit after-tax (NOPAT) by 13% compounded annually and NOPAT margin from 3% to 10% over the past 20 years. The firm's return on invested capital (ROIC) has increased from 5% in 1999 to 10% over the trailing twelve months (TTM), while its economic earnings, or the true cash flows of the business, have grown from -$176 million to $2 billion over the same time.

Figure 1: Northrop Grumman NOPAT Since 1999



Sources: New Constructs, LLC and company filings

[1] Harvard Business School features our research automation technology in the case Disrupting Fundamental Analysis with Robo-Analysts.
[2] See how our models and financial ratios are superior to Bloomberg and Capital IQ's (SPGI) analytics in the detailed appendix of this paper.

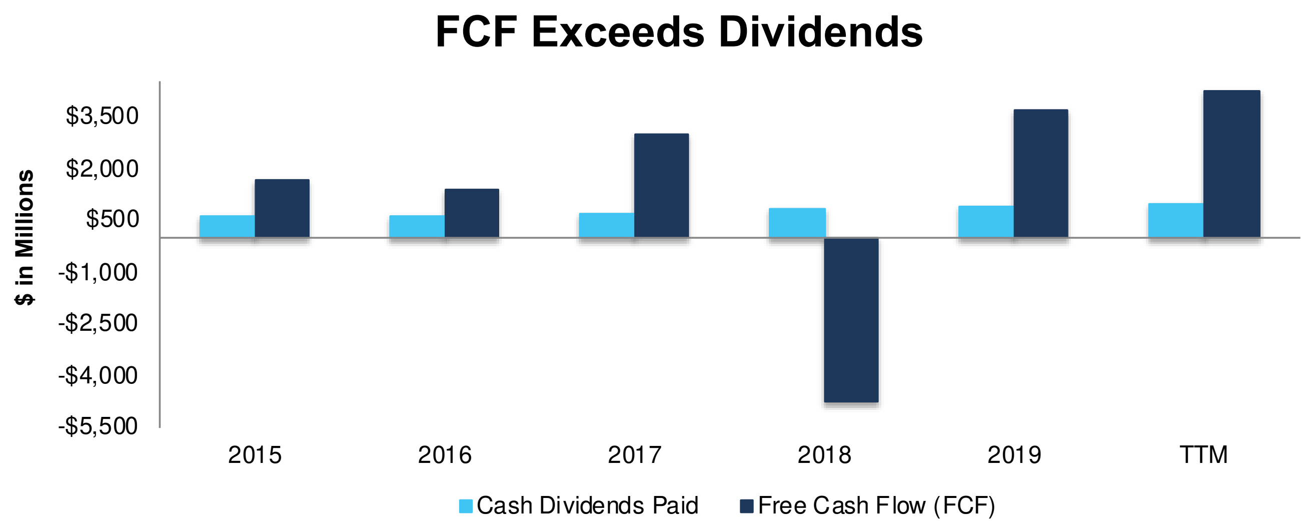
Important Disclosure Information is contained on the last page of this report.
The recipient of this report is directed to read these disclosures.

Steady Dividend Growth Supported by FCF

Northrop Grumman has increased its dividend for 17 consecutive years, and by 7% compounded annually from $1.60/share in 2003 to $5.16/share in 2019. The current quarterly dividend, when annualized, equals $5.80/share and provides a 2.0% dividend yield.

More importantly, Northrop Grumman's strong free cash flow (FCF) supports the firm's dividend payment. Northrop Grumman generated a cumulative $5 billion (10% of current market cap) in FCF while paying $3.6 billion in dividends from 2015 to 2019, per Figure 2. Over the TTM, Northrop Grumman generated $4.2 billion in free cash flow and paid $933 million in dividends.

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



Sources: New Constructs, LLC and company filings

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 maintain its dividend because of inadequate free cash flow.

NOC Has Upside Potential

At its current price of $297/share NOC has a price-to-economic book value (PEBV) ratio of 0.7. This ratio means the market expects Northrop Grumman's NOPAT to permanently decline by 30%. This expectation seems overly pessimistic for a firm that has grown NOPAT by 13% compounded annually over the past two decades and 12% compounded annually over the past five years.

Even if Northrop Grumman's NOPAT margin falls to 8% (vs. TTM margin of 10%), and the firm grows NOPAT by just 2% compounded annually for the next 10 years, the stock is worth $407/share today – a 37% upside. See the math behind this reverse DCF scenario. Add in Northrop Grumman's 2.0% dividend yield and history of dividend growth, and it's clear why this stock is in December's Dividend Growth Stocks Model Portfolio.

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

Fact: we provide superior fundamental data and earnings models – unrivaled in the world.
Proof: Core Earnings: New Data & Evidence, forthcoming in The Journal of Financial Economics.

Below are specifics on the adjustments we make based on Robo-Analyst findings in Northrop Grumman's 10-Qs and 10-K:

Income Statement: we made $3.6 billion of adjustments with a net effect of removing $1.2 billion in non-operating expenses (3% of revenue). See all adjustments made to Northrop Grumman's income statement here.

Balance Sheet: we made $7.2 billion of adjustments to calculate invested capital with a net increase of $3.4 billion. The most notable adjustment was $4 billion (13% of reported net assets) for asset write-downs. See all adjustments to Northrop Grumman's balance sheet here.

Valuation: we made $27.9 billion of adjustments with a net effect of decreasing shareholder value by $20.6 billion. Apart from total debt, one of the most notable adjustments to shareholder value was $6.9 billion in underfunded pensions. This adjustment represents 14% of Northrop Grumman's market value. See all adjustments to Northrop Grumman's valuation here.

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Disclosure: David Trainer, Kyle Guske II, Alex Sword, 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.

The Journal of Financial Economics 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.

Forthcoming in The Journal of Financial Economics, the HBS & MIT Sloan paper, Core Earnings: New Data and Evidence, proves 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 against Bloomberg & Capital IQ.

Learn more.

Quotes from HBS & MIT Sloan professors on our research:

Superior data:

"[New Constructs'] Total Adjustments differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in Total Adjustments is not explained by IBSPI Adjustments, OIADP Adjustments, or OPE Adjustments individually." — pp. 14, 1st para.

Pick better stocks:

"Trading strategies that exploit non-core earnings produce abnormal returns of 8% per year." – Abstract, 5th sentence

Risks of using legacy data providers:

"we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Build better models:

"… the machine [NC's Robo-Analyst technology] learned and replicated human analysts' judgements based on their prior decisions. It did so with greater speed and scale to produce a database covering a broad cross-section of firms." – pp. 9, 2nd para.

Exploit market inefficiencies:

"…analysts and other market participants are slow to impound the implications of the distinction between core and non-core earnings, especially those disclosed from the footnotes section of the 10-K" – pp. 35, 1st para.

Fulfill fiduciary duties:

"These costs [of analyzing footnotes] point to the potential for increasing inequities in the usefulness of financial statements for sophisticated versus unsophisticated investors who differ in their technological capabilities for processing 10-K information" – pp. 35, 2nd para.

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