Featured Stock in May's Dividend Growth Model Portfolio

Thirteen stocks were added to our Dividend Growth Stocks Model Portfolio this month, which was made available to members on May 27, 2022.

Recap From April's Picks

On a price return basis our Dividend Growth Stocks Model Portfolio (-4.2%) outperformed the S&P 500 (-7.1%) by 2.9%, and on a total return basis the Model Portfolio (-4.0%) outperformed the S&P 500 (-7.1%) by 3.1%. The best performing stock was up 6%. Overall, 22 out of the 30 Dividend Growth Stocks outperformed the S&P 500 from April 28, 2022 through May 25, 2022.

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.

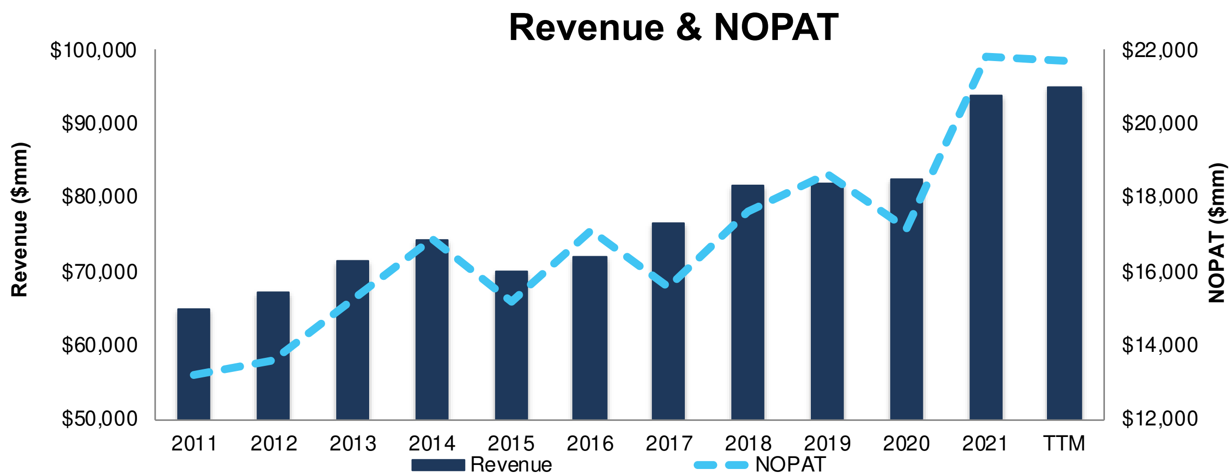
This report leverages our cutting-edge Robo-Analyst technology to deliver proven-superior[1] fundamental research and support more cost-effective fulfillment of the fiduciary duty of care.

Featured Stock From May: Johnson & Johnson (JNJ: $178/share)

Johnson & Johnson (JNJ) is the featured stock from May's Dividend Growth Stocks Model Portfolio. We made Johnson & Johnson a Long Idea in February 2020 and the stock is up 24% compared to a 32% gain for the S&P 500 since then. JNJ still offers excellent risk/reward, as detailed in our April 2022 update here.

Johnson & Johnson grew revenue by 4% compounded annually and net operating profit after-tax (NOPAT) by 5% compounded annually over the past decade. Johnson & Johnson's NOPAT margin improved from 20% in 2011 to 23% over the trailing twelve months (TTM). Though the company's return on invested capital (ROIC) fell from 16% in 2011 to 15% over the TTM, its economic earnings, the true cash flows of the business, rose from $9.9 billion to $16.1 billion over the same time.

Figure 1: Johnson & Johnson's NOPAT & Revenue Since 2011



Sources: New Constructs, LLC and company filings

[1] Our research utilizes our Core Earnings, a more reliable measure of profits, as proven in Core Earnings: New Data & Evidence, written by professors at Harvard Business School (HBS) & MIT Sloan and published in The Journal of Financial Economics.

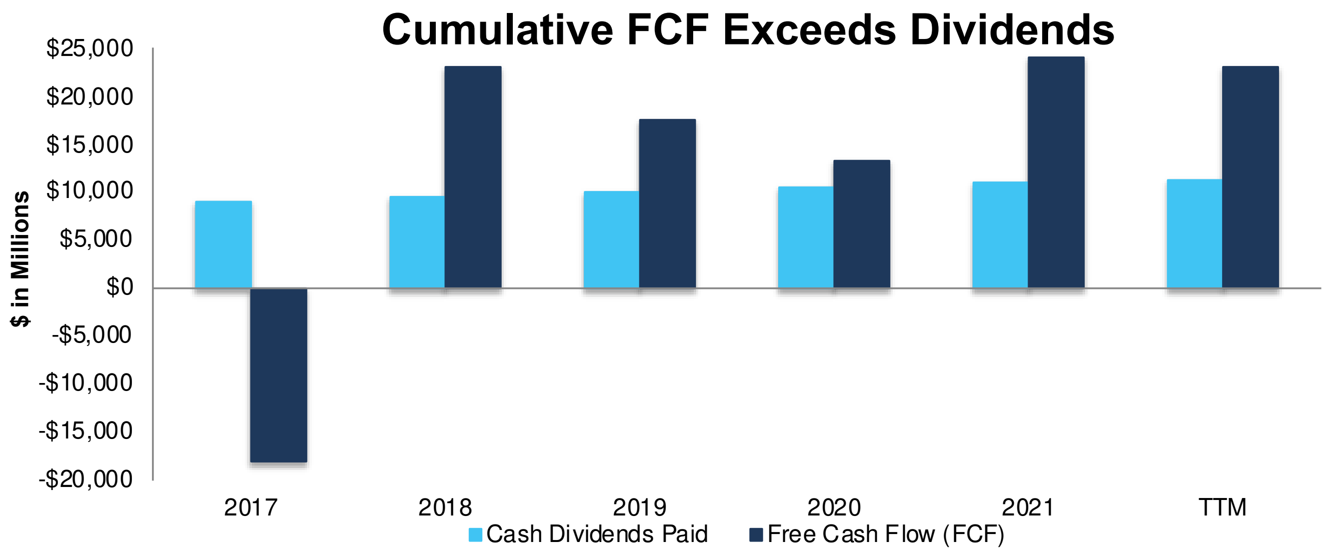
FCF Exceeds Dividends by Wide Margin

Johnson & Johnson has increased its dividend in each of the past 60 years. The company increased its regular dividend from $3.32/share in 2017 to $4.19/share in 2021, or 6% compounded annually. The current quarterly dividend, when annualized, equals $4.52/share and provides a 2.5% dividend yield.

More importantly, Johnson & Johnson's strong free cash flow (FCF) easily exceeds the company's growing dividend payments. From 2017 – 2021, Johnson & Johnson's cumulative $59.6 billion (13% of current market cap) in FCF is 1.2x the $49.9 billion in dividends paid out, per Figure 2. Over the TTM, the company generated $23.1 billion in FCF and paid out $11.2 billion in dividends.

Figure 2 also shows that Johnson & Johnson's FCF significantly exceeded its dividend payments in four of the past five years. The company's $30 billion acquisition of Actelion was the primary driver of its negative FCF in 2017.

Figure 2: Free Cash Flow vs. Regular Dividend Payments



Sources: New Constructs, LLC and company filings

Companies with FCF well above dividend payments provide higher quality dividend growth opportunities because we know the company 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.

Johnson & Johnson Has Upside Potential

At its current price of $178/share, JNJ has a price-to-economic book value (PEBV) ratio of 0.9. This ratio means the market expects Johnson & Johnson's NOPAT to permanently decline by 10%. This expectation seems overly pessimistic for a company that has grown NOPAT by 7% compounded annually over the past two decades.

If Johnson & Johnson's NOPAT margin falls to 22% (three-year average) and the company grows NOPAT by just 3% compounded annually for the next decade, the stock is worth $244/share today – a 37% upside. See the math behind the reverse DCF scenario.

Should the company grow NOPAT more in line with historical growth rates, the stock has even more upside. Add in Johnson & Johnson's 2.5% dividend yield and history of dividend growth, and it's clear why this stock is in May's Dividend Growth Stocks Model Portfolio.

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

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

Income Statement: We made $4.7 billion in adjustments with a net effect of removing $922 million in non-operating expenses (1% of revenue). Clients can see all adjustments made to Johnson & Johnson's income statement on the GAAP Reconciliation tab on the Ratings page on our website.

Balance Sheet: We made $90.5 billion in adjustments to calculate invested capital with a net increase of $6.8 billion. The most notable adjustment was $15.6 billion (11% of reported net assets) in asset write-downs. Clients can see all adjustments made to Johnson & Johnson's balance sheet on the GAAP Reconciliation tab on the Ratings page on our website.

Valuation: We made $71.1 billion in adjustments with a net effect of decreasing shareholder value by $14.1 billion. The most notable adjustment to shareholder value was $28.5 billion in excess cash. This adjustment represents 6% of Johnson & Johnson's market value. Clients can see all adjustments to Johnson & Johnson's valuation on the GAAP Reconciliation tab on the Ratings page on our website.

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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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It's Official: We Offer the Best Fundamental Data in the World

Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" can overcome these flaws and provides materially superior fundamental data.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[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 *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

Our mission is to provide the best fundamental analysis of public and private businesses in the world and make it affordable for all investors, not just Wall Street insiders.

We believe every investor deserves to know the whole truth about the profitability and valuation of any company they consider for investment. More details on our cutting-edge technology and how we use it are here.

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