New Stocks on Safest Dividend Yields Model Portfolio: February 2017

Twelve new stocks make our Safest Dividend Yields Model Portfolio this month, which was made available to members on 2/22/17.

Recap from January's Picks

Our Safest Dividend Yields Model Portfolio (+1.9%) underperformed the S&P 500 (+4.1%) last month. The best performing stocks in the portfolio were large cap stock Cisco Systems (CSCO), which was up 13%, and small cap stock, Highway Holdings (HIHO), which was up 9%. Overall, eight out of the 20 Safest Dividend Yields stocks outperformed the S&P in January and 14 had positive returns.

The success of the Safest Dividend Yields Model Portfolio highlights the value of our forensic accounting research (featured in Barron's). Companies with strong free cash flow provide higher quality and safer dividend yields because we know they have the cash to support the dividend. By analyzing footnotes in SEC filings, we are able to calculate cash flow more accurately and diligently.

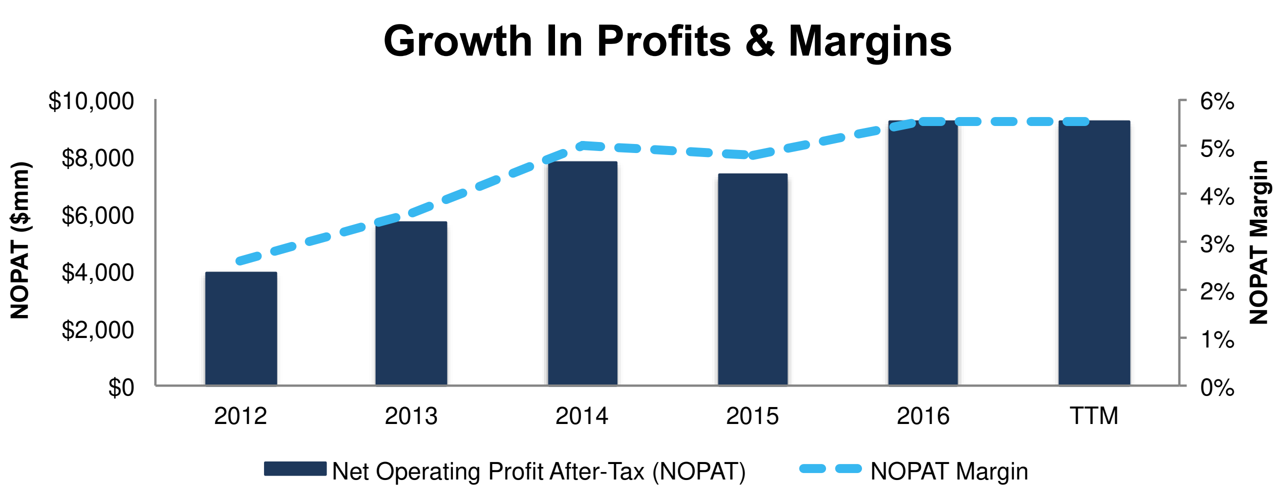
This Model Portfolio only includes stocks that earn an Attractive or Very Attractive rating, have positive free cash flow and economic earnings, and offer a dividend yield greater than 3%. We think this combination provides a uniquely well-screened group of stocks that can deliver returns greater than the market.

New Stock Feature for February: General Motors (GM: $37/share)

General Motors (GM) is one of the additions to our Safest Dividend Yields Model Portfolio in February. We featured General Motors in September 2015 when we highlighted its impressive profit growth and undervalued stock price. Since then, GM has traded in line with the S&P 500 (both are up 20%), and it remains undervalued.

Since 2012, General Motors has grown after tax profit (NOPAT) by 23% compounded annually. NOPAT margins have improved from 3% in 2012 to 5% in 2016, per Figure 1. General Motors' return on invested capital (ROIC) has improved from 6% in 2012 to 13% in 2016. Such strong fundamentals and a 4% dividend yield earn GM a spot on this month's Safest Dividend Yields Model Portfolio.

Figure 1: General Motors' Improving Profitability



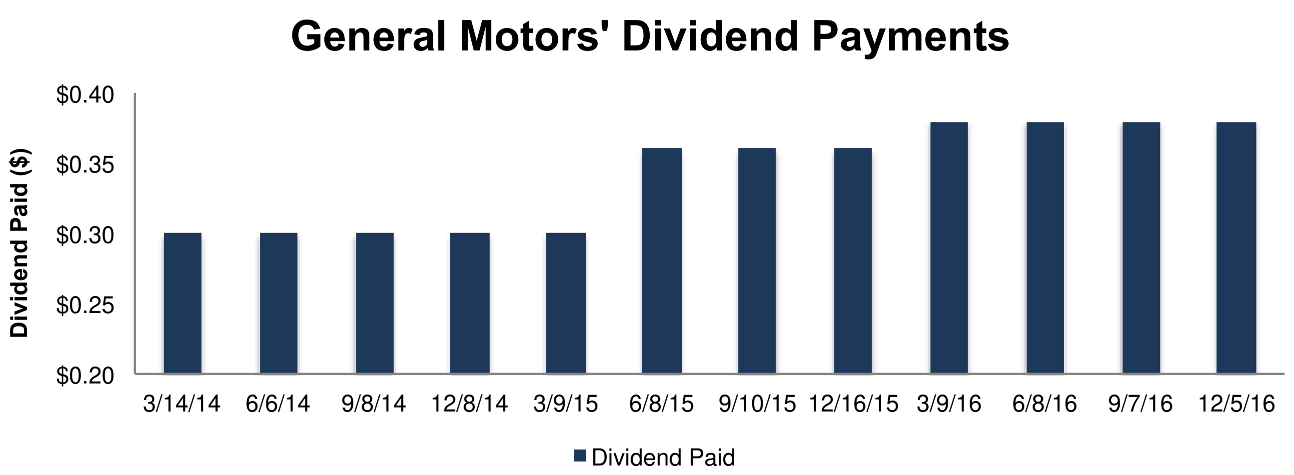
Sources: New Constructs, LLC and company filings

Free Cash Flow Supports Dividend Payments

General Motors has increased its dividend payment from $0.30/quarter in 2014 to $0.38/quarter in 2016, per Figure 2. The increase in dividend payment is made possible by GM's positive free cash flow (FCF). Over the past five years, General Motors has generated a cumulative $32 billion in FCF (58% of market cap).

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

Figure 2: Increasing Dividend Payment Since 2014



Sources: New Constructs, LLC and company filings

Despite Strong Fundamentals, GM Remains Undervalued

Despite General Motors' share price increasing 45% over the past five years, shares remain undervalued. At its current price of $37/share, GM has a price-to-economic book value (PEBV) ratio of 0.4. This ratio means the market expects GM's NOPAT to permanently decline by 60% from current levels. Such expectations seem overly pessimistic for a firm that has grown NOPAT by 23% compounded annually since 2012.

Even if GM were to never again grow profits from current levels, the economic book value, or no growth value of the firm is $93/share – a 150% upside from the current valuation.

If General Motors can grow NOPAT by just 2% compounded annually for the next five years, the stock is worth $96/share today – a 160% upside. Large upside potential coupled with GM's 4% dividend yield provide investors a great low risk/high reward opportunity.

Impacts of Footnotes Adjustments and Forensic Accounting

In order to derive the true recurring cash flows, an accurate invested capital, and a real shareholder value, we made the following adjustments to General Motors' 2016 10-K:

Income Statement: we made $10 billion of adjustments with a net effect of removing $211 million in non-operating income (<1% of revenue). We removed $4.9 billion related to non-operating expenses and $5.1 billion related to non-operating income. See all adjustments made to GE's income statement here.

Balance Sheet: we made $92 billion of adjustments to calculate invested capital with a net decrease of $18 billion. The most notable adjustment was $35 billion (39% of reported net assets) related to deferred tax assets. See all adjustments to GM's balance sheet here.

Valuation: we made $54 billion of adjustments with a net effect of decreasing shareholder value by $21 billion. The largest adjustment to shareholder value was $24 billion in underfunded pensions. This adjustment represents 44% of GM's market value. Despite the decrease in shareholder value, GM remains undervalued.

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Disclosure: David Trainer, Kyle Martone, and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.

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How New Constructs Creates Value for Clients

We find it. You benefit. Cutting-edge technology enables us to scale our forensic accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.

Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

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