New Stocks on Safest Dividend Yields Model Portfolio: April 2017

Ten new stocks make our Safest Dividend Yields Model Portfolio this month, which was made available to members on April 20, 2017.

Recap from March's Picks

Our Safest Dividend Yields Model Portfolio (+3.3%) outperformed the S&P 500 (-0.3%) last month. The best performing stocks in the portfolio were large cap stock Tupperware Brands (TUP), which was up 6% and small cap stock, CBL & Associates Properties (CBL), which was up 11%. Overall, 18 out of the 20 Safest Dividend Yields stocks outperformed the S&P in March.

The success of the Safest Dividend Yields Model Portfolio highlights the value of our Robo-Analyst technology that scales our forensic accounting expertise (featured in Barron's) across the footnotes in 10-Ks for 3000+ companies under coverage. Companies with strong free cash flow provide higher quality and safer dividend yields because we know they have the cash to support the dividend.

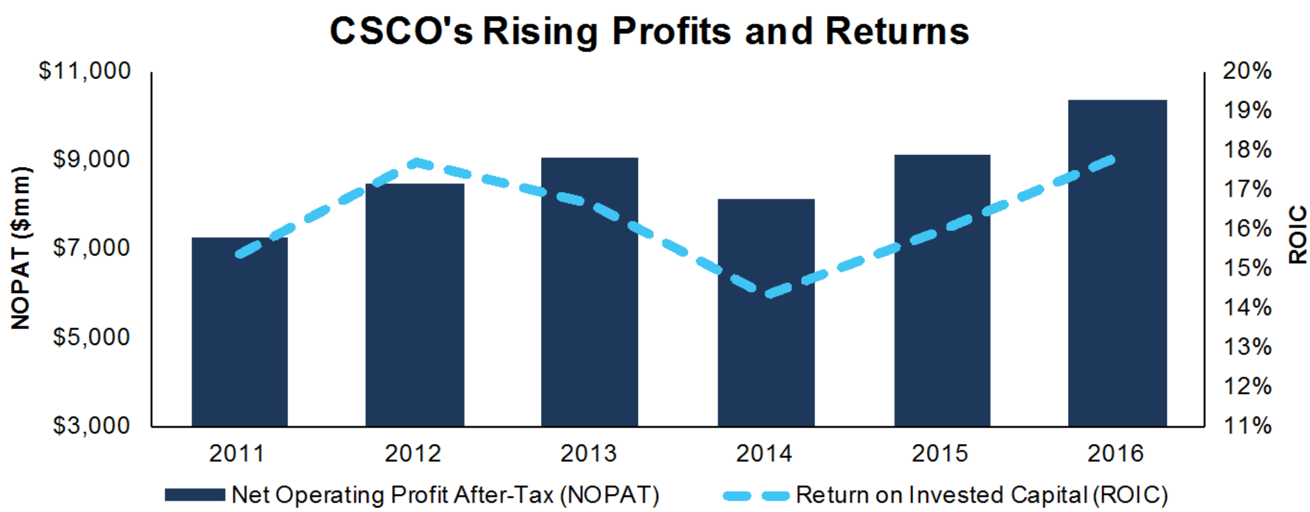
This Model Portfolio only includes stocks that earn an Attractive or Very Attractive rating, have positive free cash flow and economic earnings, and offer a dividend yield greater than 3%. We think this combination provides a uniquely well-screened group of stocks that can deliver returns greater than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

New Stock Feature for April: Cisco Systems, Inc. (CSCO: $33/share)

Cisco Systems, Inc. (CSCO) is one of the April additions to our Safest Dividend Yields Model Portfolio. We first featured CSCO as a top pick back in December 2014, when we highlighted the company's impressive return on invested capital (ROIC) and free cash flow (FCF) generation. Since then, the stock has outperformed the S&P 500 on a price (23% vs. 15%) and total return basis (33% vs. 20%).

CSCO has a long track record of profit growth and shareholder value creation. Since 1998, Cisco has increased after-tax profit (NOPAT) by 13% compounded annually. Over the same period, the company has earned an average ROIC of 15%, and Cisco currently earns a top-quintile ROIC of 17%. The company has improved its NOPAT margin from 17% in 2011 to 21% over the last twelve months (TTM).

Figure 1: Cisco Systems' Improving Fundamentals



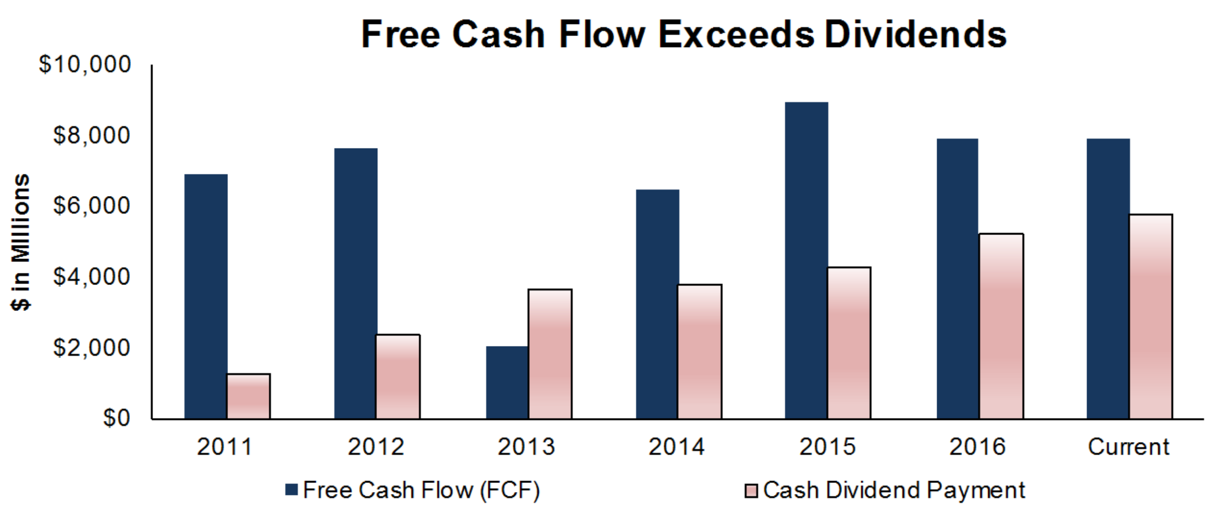
Sources: New Constructs, LLC and company filings

Free Cash Flow Generation Supports Dividend Growth

CSCO increased its quarterly dividend to $0.29 per share in 1Q17, an increase of nearly 12% year over year. The company has meaningfully increased its payout every year since 2011, when the quarterly dividend was just $0.06 per share. Per Figure 2, these increases represent a 30% compound annual growth rate over the past six years. The growth and sustainability of the dividend is enabled by CSCO's positive free cash flow (FCF) generation. Figure 2 shows how much Cisco's free cash flow exceeds its dividend every year since 2011 except for 2013. Over the same time, CSCO has generated a cumulative $41 billion in FCF (24% of market cap) while paying out just $21 billion in dividends.

Companies with strong free cash flow provide higher quality dividend yields because we know the firm generates 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 they may be financing the dividend with debt or cash on the balance sheet.

Figure 2: Cisco Systems (CSCO) Free Cash Flow vs. Dividends



Sources: New Constructs, LLC and company filings

CSCO Appears Undervalued in Light of Strong Fundamentals

At the current price of $33/share, CSCO has a price-to-economic book value (PEBV) ratio of 0.8. This ratio means the market expects CSCO's NOPAT to permanently decline by 20% from current levels. Such expectations seem overly pessimistic given CSCO's position in the growing global IT sector and its long-term track record of NOPAT growth.

Even if CSCO never grows profits from current levels, the company's economic book value, or the no-growth value of the firm, is $43/share – 30% upside from the current valuation.

If CSCO can maintain TTM NOPAT margins (21%) and grow NOPAT by just 3% compounded annually over the next decade, the stock is worth $50/share today – 52% upside from the current valuation. Meaningful upside potential coupled with CSCO's current 3.5% dividend yield provides investors with an attractive risk/reward opportunity.

Impacts of Footnotes Adjustments and Forensic Accounting

Our Robo-Analyst technology enables us to perform forensic accounting with scale and provide the research needed to fulfill fiduciary duties. In order to derive the true recurring cash flows, an accurate invested capital, and a real shareholder value, we made the following adjustments to Cisco Systems 2016 10-K:

Income Statement: we made $2.6 billion of adjustments with a net effect of removing $371 million in non-operating income (<1% of revenue). We removed $1.1 billion related to non-operating expenses and $1.5 billion related to non-operating income. See all adjustments made to CSCO's income statement here.

Balance Sheet: we made $105 billion of adjustments to calculate invested capital with a net decrease of $38 billion. The most notable adjustment was $19 billion (20% of reported net assets) related to goodwill. See all adjustments to CSCO's balance sheet here.

Valuation: we made $108 billion of adjustments with a net effect of increasing shareholder value by $34 billion. The largest adjustment to shareholder value was $71 billion of excess cash. This adjustment represents 42% of CSCO's market value.

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

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Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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