New Stocks on Safest Dividend Yield Model Portfolio: July 2017

Five new stocks make our Safest Dividend Yield Model Portfolio this month, which was made available to members on July 21, 2017.

Recap from June's Picks

Our Safest Dividend Yields Model Portfolio outperformed the S&P 500 last month. The Model Portfolio rose 1.8% on a price return basis and rose 2.5% on a total return basis. The S&P 500 rose 1.7% on a price return and total return basis. The best performing stocks in the portfolio were large cap stock Kohl's Corporation (KSS), which was up 9%, and small cap stock, NVE Corporation (NVEC), which was up 9%. Overall, 10 out of the 20 Safest Dividend Yield stocks outperformed the S&P in June.

Since inception, this Model Portfolio is up 11% on a price return basis (S&P +14%) and 15% on a total return basis (S&P +16%).

The success of this Model Portfolio highlights the value of our Robo-Analyst technology, which scales our forensic accounting expertise (featured in Barron's) across thousands of stocks.

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.

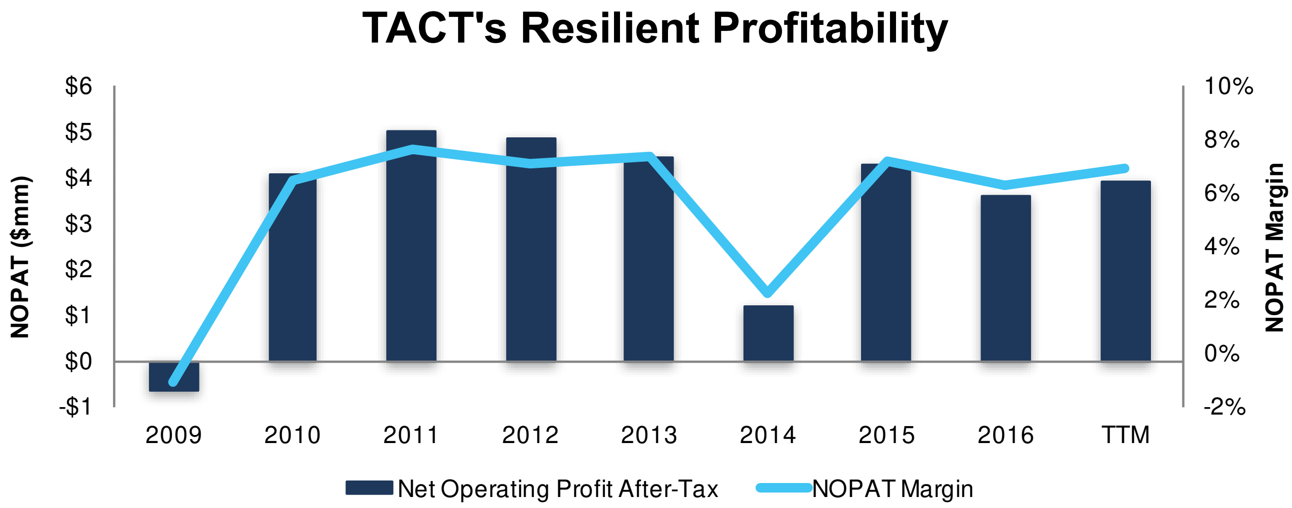
New Stock Feature for July: TransAct Technologies (TACT: $9/share)

TransAct Technologies (TACT), a manufacturer of specialty printers and terminals, is one of the additions to our Safest Dividend Yields Model Portfolio in July.

Over the years, TACT has shown the ability to overcome challenging market conditions and recover from periods of lackluster profitability. After the 2008/2009 recession, TACT improved its after-tax profit (NOPAT) margin from -1% in 2009 to 6% in 2010. Again, TACT improved its NOPAT margin from 2% in 2014 to 7% in 2015 after undertaking cost-cutting initiatives. Since 2009, TACT has remained consistently profitable while improving its return on invested capital (ROIC) from -2% in 2009 to a top-quintile 15% over the last twelve months.

Add in the 4% dividend yield and it's easy to see why TACT earned a spot on this month's Model Portfolio.

Figure 1: TACT Margins & NOPAT Since 2009



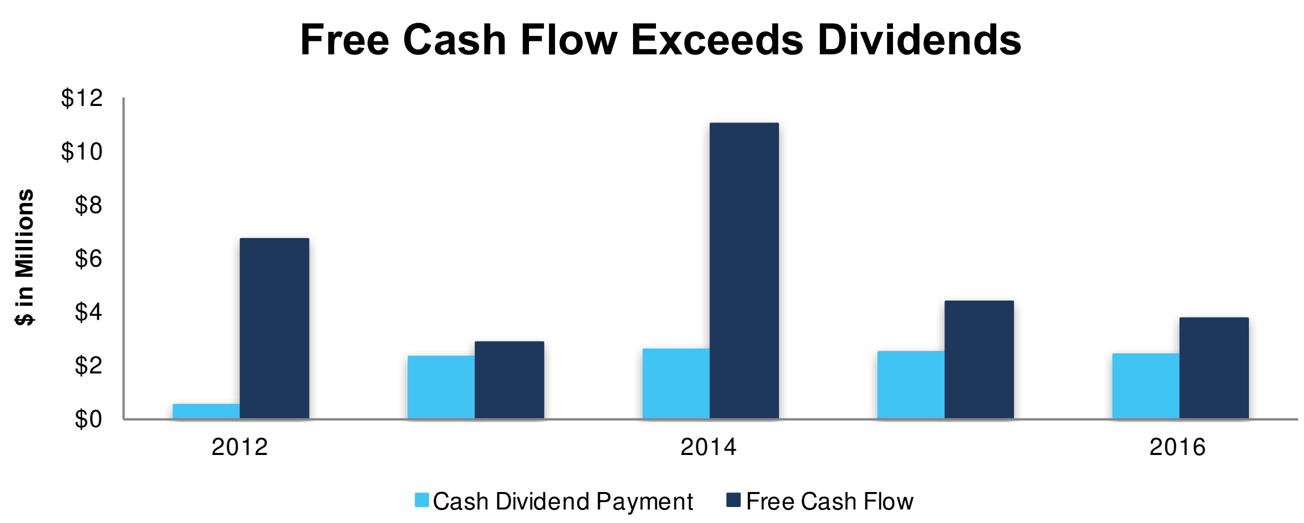
Sources: New Constructs, LLC and company filings

Free Cash Flow Supports Dividend Growth

TACT has increased its quarterly dividend from $0.06 in 4Q12 to $0.09 in in 2Q17, or 9% compounded annually. Dividend growth has been made possible by TACT's NOPAT and free cash flow. Per Figure 2, TACT has generated ample free cash flow to cover its dividend payments. Since 2012, TACT has generated cumulative FCF of $29 million (45% of market cap) and paid out cumulative dividends of $10 million. TACT's TTM FCF of $5 million equates to an 8% FCF yield compared to 2% for the average S&P 500 stock.

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: TACT's FCF vs. Dividend Since 2012



Sources: New Constructs, LLC and company filings

TACT Remains Undervalued

Even though TACT is up 32% year-to-date, while the S&P is up 11%, the stock remains undervalued. At its current price of $9/share, TACT has a price-to-economic book value (PEBV) ratio of 0.8. This ratio means the market expects TACT's NOPAT to permanently decline by 20%. This expectation seems rather pessimistic for a firm with a history of consistent NOPAT.

Even if TACT were to never again grow profits from current levels, the company's economic book value, or no growth value of the firm is $10.50/share – a 17% upside from the current valuation.

However, if TACT can maintain 2016 NOPAT margins of 6% (vs. 7% TTM) and grow NOPAT by just 3% compounded annually for the next decade, the stock is worth $12/share today – a 33% upside. Significant upside potential coupled with TACT's 4% 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 TransAct's 2016 10-K:

Income Statement: we made less than $1 million of adjustments with a net effect of removing <$1 million in non-operating expense (<1% of revenue). We removed <$1 million related to non-operating expenses and <$1 million related to non-operating income. See all adjustments made to TACT's income statement here.

Balance Sheet: we made $7 million of adjustments to calculate invested capital with a net increase of $1 million. The most notable adjustment was $3 million (14% of reported net assets) related to deferred tax assets. See all adjustments to TACT's balance sheet here.

Valuation: we made $3 million of adjustments with a net effect of decreasing shareholder value by $3 million. There were no adjustments that increased shareholder value. The largest adjustment to shareholder value was $3 million in outstanding employee stock options. This adjustment represents 2% of TACT'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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