Featured Stocks in January's Dividend Growth Model Portfolio

This report highlights last month's top performers and features a stock from the current portfolio. January's Dividend Growth Stocks Model Portfolio was made available to members on January 26, 2018.

Recap from December's Picks

Our Dividend Growth Stocks Model Portfolio underperformed the S&P 500 last month. The Model Portfolio rose 5.2% on a price return basis and 5.4% on a total return basis. The S&P 500 rose 5.7% on a price return and total return basis. The portfolio's best performing stock was Target Corporation (TGT), which was up 19%. Overall, 12 out of the 30 Dividend Growth Stocks outperformed the S&P last month, and 25 had positive returns.

The long-term success of our model portfolio strategies highlights the value of our Robo-Analyst technology, which scales our forensic accounting expertise (featured in Barron's) across thousands of stocks[1].

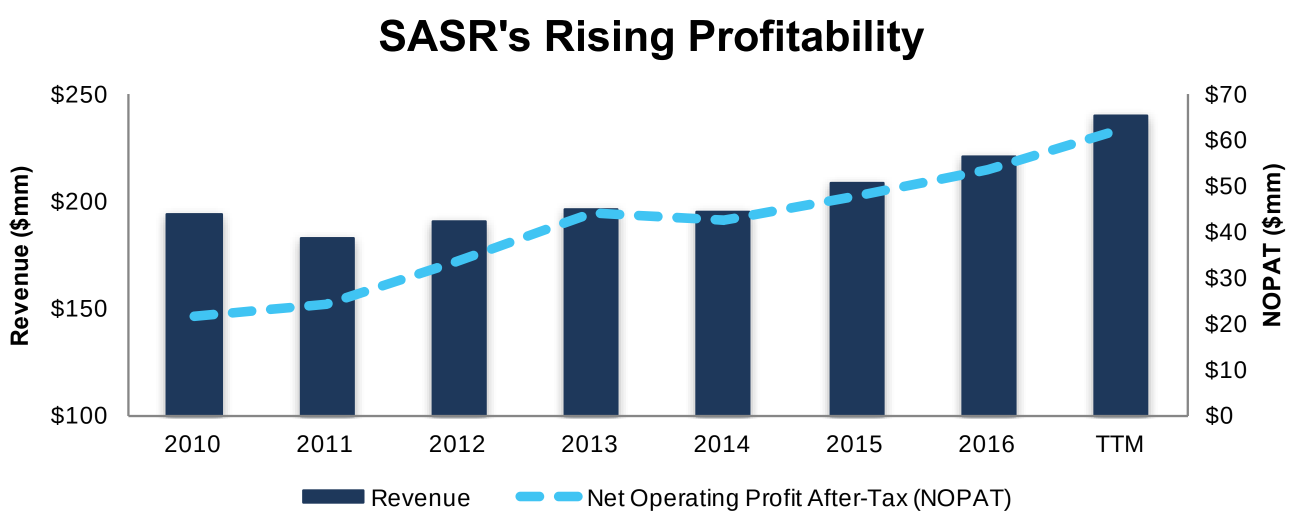
The methodology for this model portfolio mimics an All-Cap Blend style with a focus on dividend growth. Selected stocks earn an Attractive or Very Attractive rating, generate positive free cash flow (FCF) and economic earnings, offer a current dividend yield >1%, and have a 5+ year track record of consecutive 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 January: Sandy Springs Bancorp Inc. (SASR: $38/share)

Sandy Springs Bancorp (SASR), a regional mid-Atlantic bank, is the featured stock from January's Dividend Growth Stocks Model Portfolio.

Since 2010, SASR's revenue has grown 7% compounded annually while after-tax profits (NOPAT) have grown 16% compounded annually to $54 million in 2016. NOPAT increased to $62 million over the last twelve months (TTM), a 24% improvement over the prior TTM period. SASR's NOPAT margin has improved from 11% in 2010 to 26% TTM while its return on invested capital (ROIC) improved from 5% to 10%.

Figure 1: SASR's Revenue and NOPAT Since 2010



Sources: New Constructs, LLC and company filings

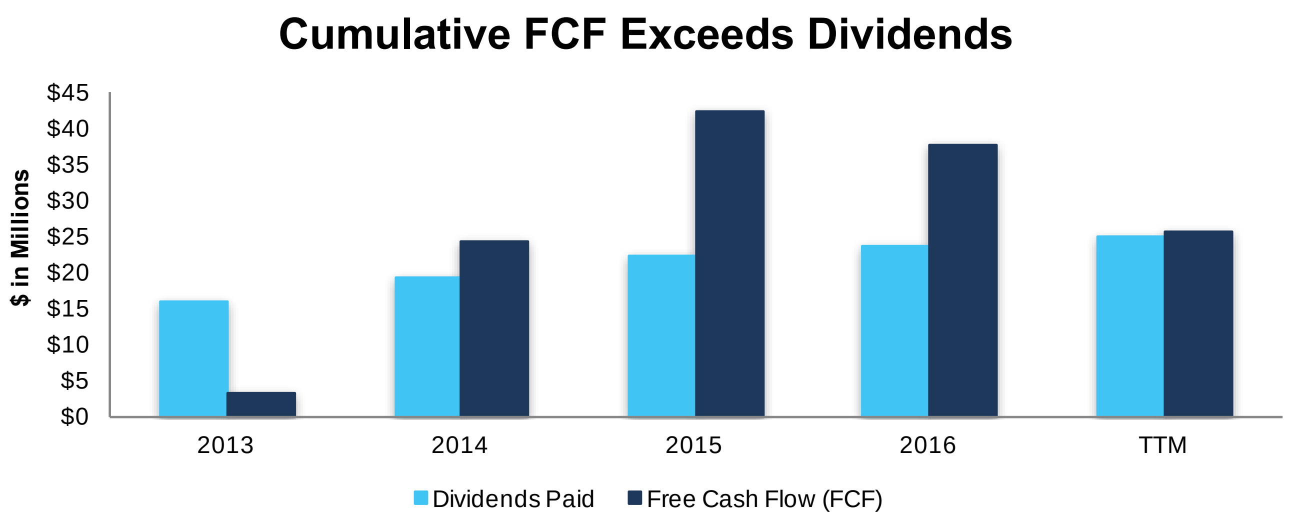
[1] Ernst & Young's recent white paper "Getting ROIC Right" proves the superiority of our holdings research and analytics.

Steady Dividend Growth Supported by FCF

SASR has increased its annual dividend in eight of the past 10 years. The current annualized dividend has grown from $0.64/share in 2013 to $1.04/share TTM, or 13% compounded annually. Positive FCF has fueled dividend growth in the past. From 2013-2016, SASR generated cumulative FCF of $108 million (12% of market cap) and paid out cumulative dividends of $81 million.

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 the current dividend as well as a higher dividend. On the flip side, the dividend growth trajectory of a company where FCF falls short of the dividend payment over time cannot be trusted to grow or sustain its dividend because of inadequate free cash flow.

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



Sources: New Constructs, LLC and company filings

SASR Remains Undervalued

SASR is up 49% over the past two years while the S&P 500 is up 47%. Despite slightly outperforming the S&P 500, SASR remains undervalued. At its current price of $38/share, it has a price-to-economic book value (PEBV) ratio of 1.0. This ratio means the market expects SASR's NOPAT to never meaningfully grow from current levels over the remaining life of the firm. This expectation seems overly pessimistic for a firm that has grown NOPAT by 7% compounded annually since 1998.

If SASR can maintain 2016 NOPAT margins of 24% (below TTM of 26%) and grow NOPAT by 8% compounded annually over the next decade, the stock is worth $53/share today – a 39% upside. Add in Sandy Springs Bancorp's 2.7% dividend yield and history of dividend growth, and it's clear why this stock is in January's Dividend Growth Stocks Model Portfolio.

Auditable Impact of Footnotes & Forensic Accounting Adjustments

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 Sandy Springs Bancorp's 2016 10-K:

Income Statement: we made $10 million of adjustments with a net effect of removing $6 million in non-operating expense (3% of revenue). We removed $8 million related to non-operating expenses and $2 million related to non-operating income. See all adjustments made to SASR's income statement here.

Balance Sheet: we made $105 million of adjustments to calculate invested capital with a net increase of $85 million. The most notable adjustment was $44 million (8% of reported net assets) related to total reserves. See all adjustments to SASR's balance sheet here.

Valuation: we made $37 million of adjustments with a net effect of decreasing shareholder value by $37 million. There were no adjustments that increased shareholder value. The largest adjustment to shareholder value was $32 million in off-balance sheet operating leases. This lease adjustment represents 3% of SASR's market value. Despite the decrease in shareholder value, SASR remains undervalued.

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Disclosure: David Trainer and Kyle Guske II 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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