Featured Stocks in March’s Dividend Growth Model Portfolio

This report highlights last month’s top performers and features a stock from the current portfolio. March’s Dividend Growth Stocks Model Portfolio was made available to members on March 28, 2018.

Recap from February’s Picks

Our Dividend Growth Stocks Model Portfolio outperformed the S&P 500 on a price return basis and performed in line on a total return basis last month. The Model Portfolio fell 2.1% on a price return basis and fell 2.0% on a total return basis. The S&P 500 fell 2.4% on a price return basis and fell 2.0% on a total return basis. The portfolio’s best performing stock was Nu Skin Enterprises (NUS), which was up 5%. Overall, 16 out of the 30 Dividend Growth Stocks outperformed the S&P last month, and eight had positive returns.

The long-term success of our model portfolio strategies highlights the value of our Robo-Analyst technology\(^1\), which scales our forensic accounting expertise (featured in Barron’s) across thousands of stocks\(^2\).

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 March: American Express Company (AXP: $93/share)

Credit card provider American Express Company (AXP) is the featured stock from March’s Dividend Growth Stocks Model Portfolio. AXP was first featured in our January 2016 case study on how return on invested capital (ROIC) impacts stock valuation. Since then, the stock is up 52% while the S&P 500 is up 27%. Despite this outperformance, AXP remains undervalued.

Since 2010, AXP’s revenue has grown 2% compounded annually while its after-tax profit (NOPAT) has grown 18% compounded annually. AXP’s NOPAT margin has improved from 6% in 2010 to 16% in 2017 while its return on invested capital (ROIC) improved from 6% to 14%.

Figure 1: AXP Revenue & NOPAT Since 2010

AXP’s Rising Profitability

Sources: New Constructs, LLC and company filings

\(^1\) Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

\(^2\) Ernst & Young’s recent white paper “Getting ROIC Right” proves the superiority of our holdings research and analytics.
Steady Dividend Growth Supported by FCF

AXP has increased its annual dividend for six consecutive years. The current annualized dividend has grown from $0.89/share in 2013 to $1.34/share in 2017, or 11% compounded annually. Positive FCF has fueled dividend growth in the past and should continue to do so in the future. From 2013-2017, AXP generated cumulative FCF of $25.6 billion (32% of market cap) and paid out cumulative dividends of $5.6 billion.

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

Cumulative FCF Exceeds Dividends

<table>
<thead>
<tr>
<th>Year</th>
<th>Dividends Paid</th>
<th>Free Cash Flow (FCF)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>$1,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>2014</td>
<td>$1,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>2015</td>
<td>$1,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>2016</td>
<td>$1,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>2017</td>
<td>$1,000</td>
<td>$2,000</td>
</tr>
</tbody>
</table>

Sources: New Constructs, LLC and company filings

AXP Remains Undervalued

At its current price of $93/share, AXP has a price-to-economic book value (PEBV) ratio of 0.9. This ratio means the market expects AXP’s NOPAT to permanently decline by 10%. This expectation seems overly pessimistic for a firm that has grown NOPAT by 6% compounded annually since 1998 and 18% compounded annually since 2010.

If AXP can maintain 2017 NOPAT margins (16%) and grow NOPAT by 3% compounded annually over the next decade, the stock is worth $127/share today – a 47% upside. Add in American Express’ 1.5% dividend yield and history of dividend growth, and it’s clear why this stock is in March’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 American Express’ 2017 10-K:

Income Statement: we made $3 billion of adjustments with a net effect of removing $3 billion in non-operating expense (9% of revenue). We removed $3 billion related to non-operating expenses and there were no adjustments related to non-operating income. See all adjustments made to AXP’s income statement here.

Balance Sheet: we made $7.1 billion of adjustments to calculate invested capital with a net increase of $3.8 billion. The most notable adjustment was $2.4 billion (7% of reported net assets) related to other comprehensive income. See all adjustments to AXP’s balance sheet here.

Valuation: we made $1.7 billion of adjustments with a net effect of decreasing shareholder value by $1.7 billion. There were no adjustments that increased shareholder value. The largest adjustment to shareholder value was...
$872 million in off-balance sheet operating leases. This lease adjustment represents 1% of AXP’s market value. Despite the decrease in shareholder value, AXP remains undervalued.

This article originally published on April 5, 2018.

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

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.
New Constructs® - Research to Fulfill the Fiduciary Duty of Care

Ratings & screeners on 3000 stocks, 450 ETFs and 7000 mutual funds help you make prudent investment decisions.

New Constructs leverages the latest in machine learning to analyze structured and unstructured financial data with unrivaled speed and accuracy. The firm's forensic accounting experts work alongside engineers to develop proprietary NLP libraries and financial models. Our investment ratings are based on the best fundamental data in the business for stocks, ETFs and mutual funds. Clients include many of the top hedge funds, mutual funds and wealth management firms. David Trainer, the firm's CEO, is regularly featured in the media as a thought leader on the fiduciary duty of care, earnings quality, valuation and investment strategy.

To fulfill the Duty of Care, research should be:

1. **Comprehensive** - All relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including footnotes and the management discussion & analysis (MD&A).

2. **Un-conflicted** - Clients deserve unbiased research.

3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.

4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

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.
DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, “New Constructs”) is an independent organization with no management ties to the companies it covers. None of the members of New Constructs’ management team or the management team of any New Constructs’ affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs’ Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs’ reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs. Copyright New Constructs, LLC 2003 through the present date. All rights reserved.