



## Holdings-Based Diligence Reveals a Dividend Champion

The performance of an ETF is driven by the performance of its holdings. This observation should be inherently obvious, but it seems to be controversial among the investing community. Proponents of “passive” investing tell investors to ignore holdings and focus solely on past performance, costs, and sector/style diversification.

The proliferation of stock indices – there are now [3.3 million indices](#) compared to just 43 thousand stocks globally – makes the passive view untenable. To whatever piece of the market you want exposure, there are dozens of indices with that label, all with different strategies and compositions. Any investor that buys a fund based solely on the label puts themselves at risk, and any advisor that recommends an index fund without analyzing the holdings of that fund is not fulfilling their fiduciary [Duty of Care](#).

For years, we have analyzed<sup>1</sup> the holdings of over 7,500 U.S. ETFs and mutual funds daily to identify which fund managers and indices hold the most attractive stocks. We’re excited to see that others in the market increasingly understand the need for this holdings-based diligence, as evidenced by the announcement that Bank of America (BAC) will begin [rating ETF’s based on their holdings](#).

We think this increased appreciation for holdings quality research will make the market more efficient by pushing capital towards funds that hold highly profitable and undervalued stocks. In particular, the Schwab US Dividend Equity ETF (SCHD) stands out for the quality of its holdings and is this week’s [Long Idea](#).

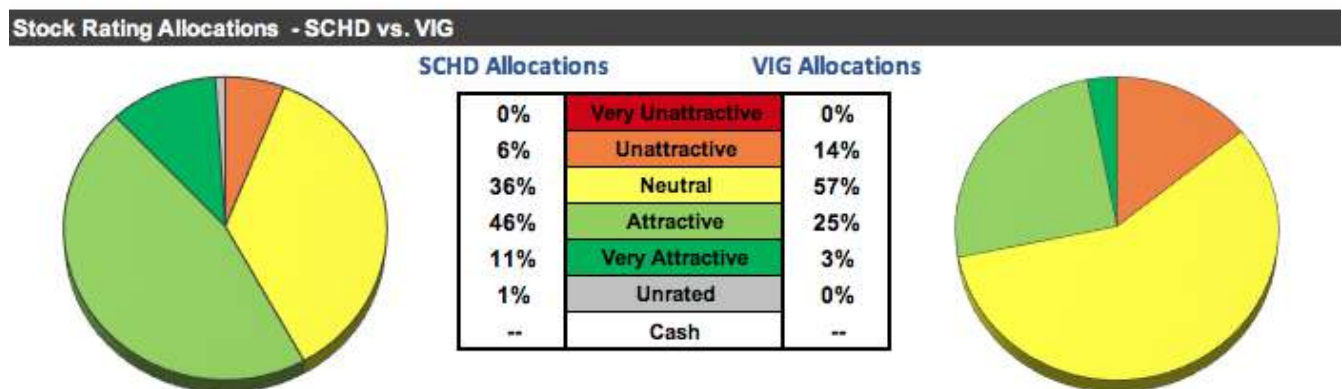
### Holdings Quality Sets SCHD Apart

SCHD is our top-rated [Large Cap Value fund](#) and one of our top-10 rated ETFs overall. Despite this fact, SCHD’s \$8 billion in assets are less than a third of the \$31 billion allocated to the Vanguard Dividend Appreciation Fund (VIG), our 25<sup>th</sup> ranked Large Cap Value fund.

Investors might think that these two funds, which both focus on large cap stocks with high dividends, are fundamentally similar. In that case, it would make sense for them to allocate more heavily to Vanguard, the provider with the [more trusted brand](#).

However, Figure 1 shows that the two ETFs are not the same at all. SCHD allocates twice as much of its portfolio to Attractive-or-better rated stocks (57% vs. 28%) and half as much to Unattractive stocks (6% vs. 14%).

Figure 1: SCHD Asset Allocation Compared to VIG



Sources: New Constructs, LLC and company filings

<sup>1</sup> Harvard Business School features our Robo-Analyst research automation technology in the case [New Constructs: Disrupting Fundamental Analysis with Robo-Analysts](#).



Mary Ann Bartels, the head of BAC's new ETF research team, explained the need for holdings-based research in a recent interview, saying:

*"With all the slicing and dicing that Wall Street has done in creating all of these products, maybe we should get out of the mindset that it's just an index and think about it as a portfolio. The construction of the index is important — and the construction is stocks — so we think you have to start looking at stocks again."*

When we look at the stocks in SCHD compared to VIG, it's clear which one is more attractive.

**Fund Flows Drive Performance of Low-Quality Stocks Too**

When investors buy ETFs based solely on labels and past performance, they don't just increase the risk to themselves. As we wrote in "[Hidden Trigger For Another \(Flash\) Crash: Passive Investing](#)," passive fund flows can create a "rising tide lifts all boats" effect where low quality stocks get pushed up due solely to their inclusion in an index.

This impact can be seen in the relative performance of SCHD and VIG. So far in 2018, VIG is up 2% while SCHD is down 2%. Not coincidentally, VIG has received ~50% higher inflows of investor capital, \$1.3 billion vs. \$900 million.

**Valuation of Holdings Favors SCHD**

The holdings of SCHD and VIG have similar profitability – both average a return on invested capital (ROIC) of 13% – but the divergent performance means that SCHD's holdings are significantly cheaper. Figure 2 compares the holdings of the two ETFs on the basis of [free cash flow yield](#), PEBV or [price to economic book value](#) (the market valuation vs. the zero-growth value of the companies), and market implied GAP or [growth appreciation period](#) (the years of growth required to justify the valuation).

**Figure 2: Valuation Comparison: SCHD vs. VIG**

Metric	SCHD	VIG
Free Cash Flow Yield	4%	1%
PEBV	1.4	1.8
Market Implied GAP	8 Years	19 Years

Sources: New Constructs, LLC and company filings

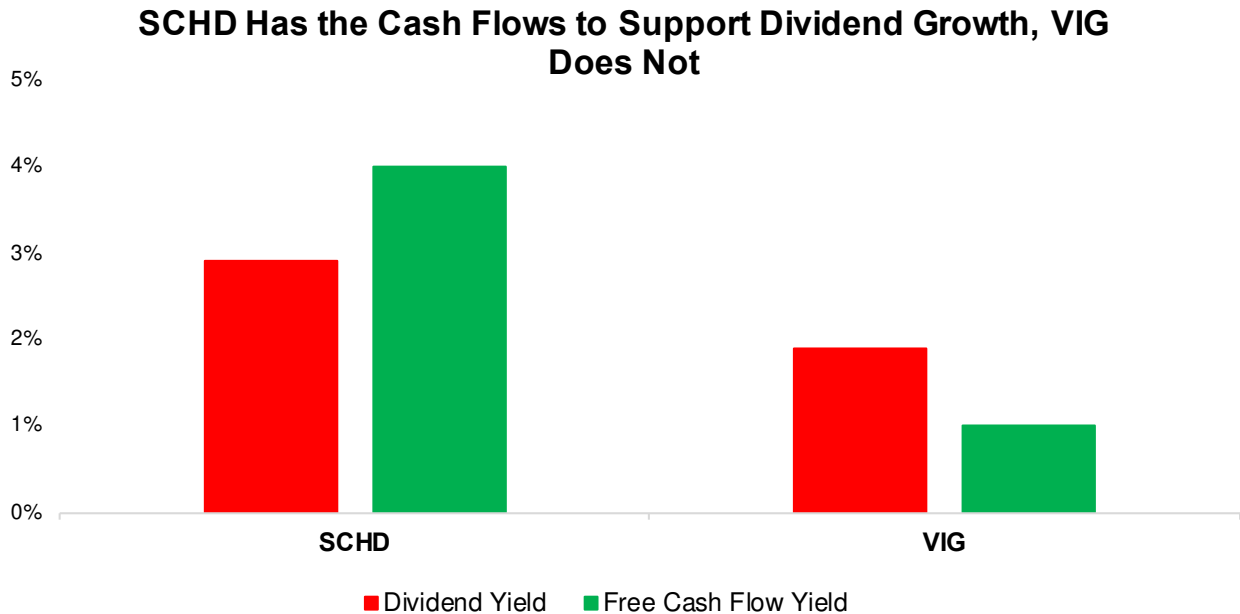
Per Figure 2, SCHD rates as cheaper than VIG across all three valuation metrics. Even better, SCHD has a higher dividend yield of 2.9%.

**SCHD's Cash Flow Advantage Lowers Risk and Powers Dividend Growth**

With a free cash flow yield of 4%, SCHD's holdings generate enough cash flow to support its dividend. On the contrary, VIG's 1% free cash flow yield is not enough to support its current dividend yield of 1.9%, much less provide the dividend growth that its name promises. See Figure 3.



**Figure 3: Free Cash Flow Compared to Dividend Yield: SCHD vs. VIG**



Sources: New Constructs, LLC and company filings

Fund flows have helped drive VIG’s superior performance so far in 2018, but superior quality holdings should help SCHD outperform in the future.

**Analysis of One of SCHD’s Quality Holdings**

Despite their similar labels, the top holdings of SCHD and VIG are very different. In particular, Intel (INTC) is SCHD’s top holding and accounts for 4.7% of its assets, but VIG has no position in INTC.

INTC is a high-quality holding for dividend-focused investors. The company has raised its dividend in each of the past four years and seven out of the past ten years. Better yet, its 3.6% free cash flow yield and \$21 billion in [excess cash](#) gives the company plenty of room to raise its dividend (currently yielding 2.5%) more in the future.

Most importantly, the overall economics of INTC’s business look attractive. Dividends are great, but it’s bad practice to invest in a stock that pays dividends and destroys value. INTC’s rising [economic earnings](#) per share – up 24% over the trailing twelve months – and low PEBV of 1.1 give us confidence that the company can outperform the market’s low expectations.

**Why Index Construction Matters**

VIG does not hold INTC due to the fact that its index – the [Nasdaq Dividend Achievers index](#) – only holds companies that have increased their dividends for 10 consecutive years.

SCHD, on the other hand, tracks the [Dow Jones U.S. Dividend 100 Index](#). The Dow Jones Dividend 100 only requires 10 consecutive years of dividend payments, not increases, and it weights stocks based on a variety of fundamental factors, including cash flow.

SCHD’s fundamentals-based methodology does a better job of giving investors exposure to sustainably high dividends. VIG, by just using the backward-looking criteria of dividend growth, runs the risk of allocating to stocks that have grown their dividends beyond sustainable levels by taking on debt or underinvesting in the business. These companies are at a risk for reduced cash flows and dividend cuts in the future.

**The Importance of Holdings Based Fund Analysis**

While it is easy to pick an ETF based on a label or a 5-Star rating from Morningstar, [research shows](#) such a strategy has risks and does not necessarily lead to outperformance. Smart ETF investing means analyzing the



holdings of each ETF. Unfortunately, most investors do not realize they can get high-quality research on ETF holdings and are content with investing based on past performance.

We hope that the entry of Bank of America into the world of holdings-based research will help investors realize that this level of diligence is both possible and necessary. The more this sort of diligence becomes the norm, the better it will be for individual investors and the market as a whole.

Our [Robo-Analyst technology](#) analyzes the holdings of all 67 ETFs and 893 mutual funds in the Large Cap Value style. The number of holdings in these ETFs and mutual funds varies from just 16 stocks to 1,085 stocks in a given fund. Our diligence on fund holdings allows us to find an ETF, like SCHD, with a portfolio that suggests future performance will be strong.

*This article originally published on [October 31, 2018](#).*

*Disclosure: David Trainer, Kyle Guske II, and Sam McBride 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.