Featured Stock in November's Safest Dividend Yields Model Portfolio

Six new stocks make our Safest Dividend Yield Model Portfolio this month, which was made available to members on November 21, 2018.

Recap from October's Picks

The best performing large cap stock was up 17%, and the best performing small cap stock was up 8%. Overall, 11 out of the 20 Safest Dividend Yield stocks outperformed the S&P in October.

This Model Portfolio leverages our Robo-Analyst technology[1], which scales our forensic accounting expertise (featured in Barron's) across thousands of stocks.[2]

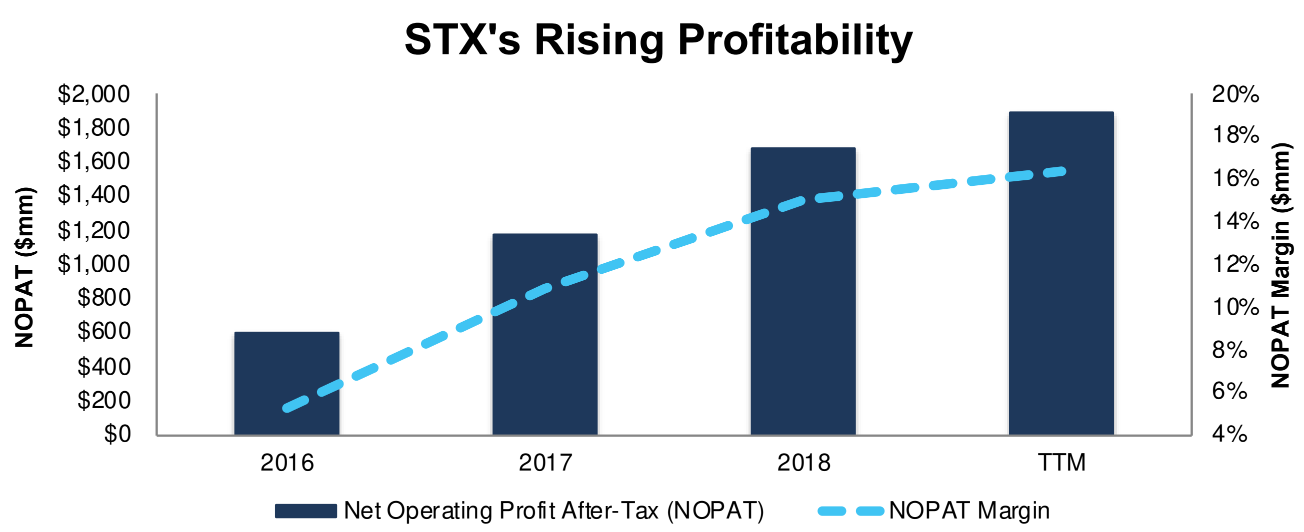
This Model Portfolio only includes stocks that earn an Attractive or Very Attractive rating, have positive free cash flow and economic earnings, and offer a dividend yield greater than 3%. Companies with strong free cash flow provide higher quality and safer dividend yields because we know they have the cash to support the dividend. We think this portfolio provides a uniquely well-screened group of stocks that can help clients outperform.

Featured Stock for November: Seagate Technology (STX: $43/share)

Seagate Technology (STX) is the featured stock in November's Safest Dividend Yield Model Portfolio.

Since 2016, STX has grown after-tax operating profit (NOPAT) by an astounding 68% compounded annually. Over the trailing twelve months, NOPAT has grown 53%year-over-year. NOPAT margin has increased from 5% in 2016 to 16% TTM while return on invested capital (ROIC) has improved from 8% to a top-quintile 26% over the same time.

Figure 1: STX Profitability Since 2016



Sources: New Constructs, LLC and company filings

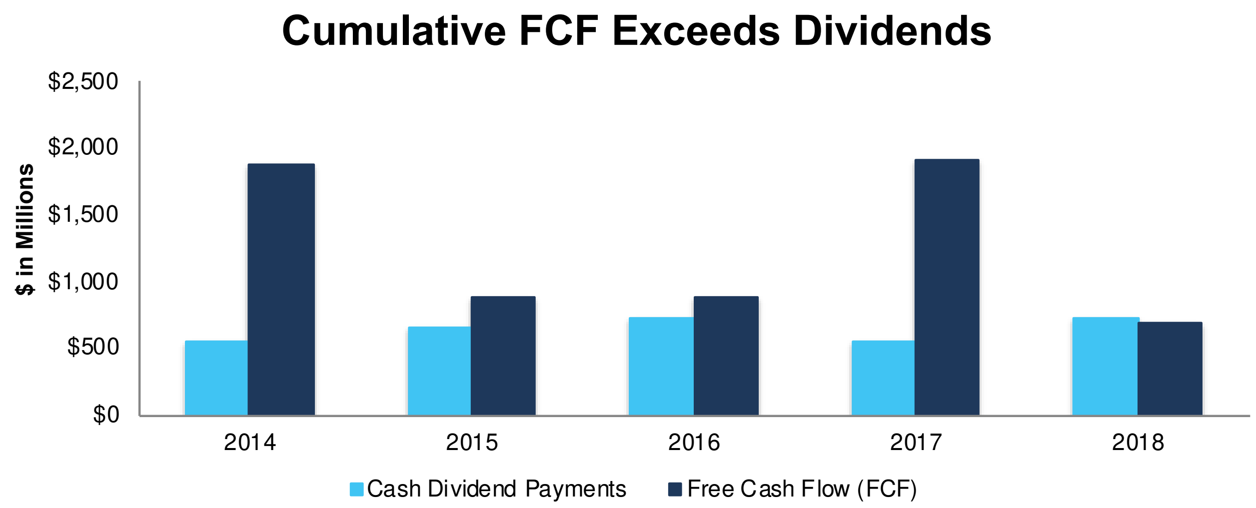
[1] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.
[2] Ernst & Young's recent white paper "Getting ROIC Right" proves the superiority of our holdings research and analytics.

STX's Free Cash Flow Supports Dividend Payments

Over the past five years, STX has increased its annual dividend from $1.67/share to $2.52/share, or 11% compounded annually. This dividend payment has been supported by STX's free cash flow. From 2014-2018, STX generated a cumulative $6.2 billion (51% of market cap) in FCF while paying $3.2 billion in dividends.

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: STX's FCF vs. Dividends Since 2014



Sources: New Constructs, LLC and company filings

Valuation Implies Permanent Profit Decline

At its current price of $43/share, STX has a price-to-economic book value (PEBV) ratio of 0.7. This ratio means the market expects STX's NOPAT to permanently decline by 30%. This expectation seems pessimistic given that STX has grown NOPAT by 7% compounded annually since 2003 and much faster in recent years.

If STX can maintain TTM NOPAT margins (16%) and grow NOPAT by just 5% compounded annually for the next five years, the stock is worth $74/share today – a 72% upside. See the math behind this dynamic DCF scenario.

Critical Details Found in Financial Filings by Our Robo-Analyst Technology

As investors focus more on fundamental research, research automation technology is needed to analyze all the critical financial details in financial filings. Below are specifics on the adjustments we make based on Robo-Analyst findings in Seagate Technology's 2018 10-K:

Income Statement: we made $570 million of adjustments with a net effect of removing $494 million in non-operating expense (4% of revenue). See all adjustments made to STX's income statement here.

Balance Sheet: we made $5.5 billion of adjustments to calculate invested capital with a net increase of $846 million. The most notable adjustment was $2.6 billion (41% of reported net assets) related to asset write-downs. See all adjustments to STX's balance sheet here.

Valuation: we made $6.3 billion of adjustments with a net effect of decreasing shareholder value by $3.6 billion. The largest adjustment to shareholder value was $4.9 billion in total debt, which includes $73 million in off-balance sheet operating leases. This lease adjustment represents 1% of STX's market value.

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

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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.

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