Featured Stock in November's Dividend Growth Model Portfolio

10 new stocks make our Dividend Growth Stocks Model Portfolio this month, which was made available to members on November 29, 2018.

Recap from October's Picks

Our Dividend Growth Stocks Model Portfolio outperformed the S&P 500 last month. The Model Portfolio rose 3.4% on a price return basis and rose 3.5% on a total return basis. The S&P 500 fell 0.8% on a price return and total return basis. The portfolio's best performing stock was up 16%. Overall, 26 out of the 30 Dividend Growth Stocks outperformed the S&P last month.

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].

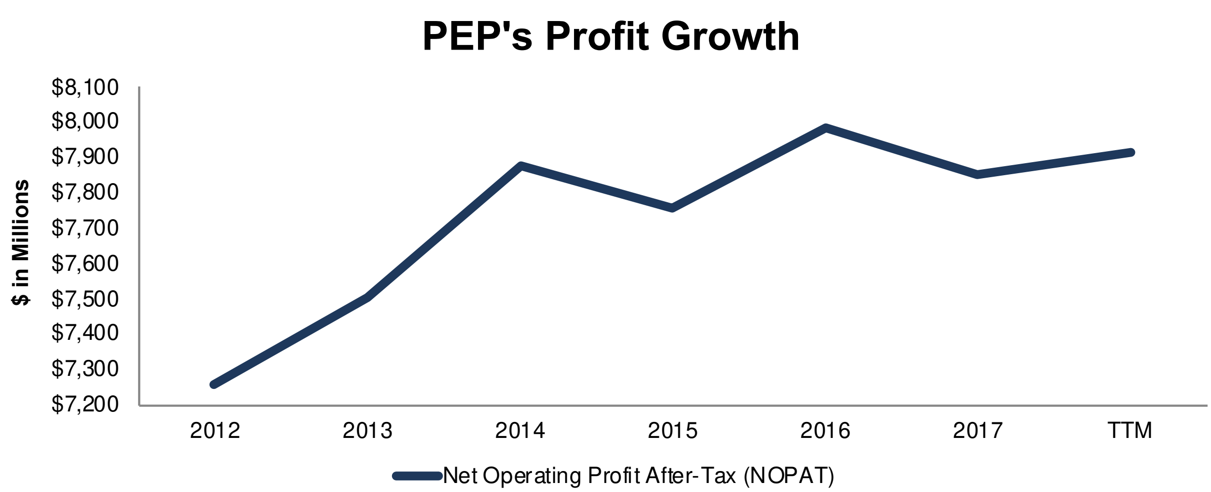
The methodology for this model portfolio mimics an All-Cap Blend style with a focus on dividend growth. Selected stocks earn an Attractive or Very Attractive rating, generate positive free cash flow (FCF) and economic earnings, offer a current dividend yield >1%, and have a 5+ year track record of consecutive 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 November: PepsiCo Inc. (PEP: $118/share)

PepsiCo (PEP) is the featured stock from November's Dividend Growth Stocks Model Portfolio. PEP was previously featured as a Long Idea in September 2017 and remains a top pick.

Since 2007, PEP has grown after-tax profit (NOPAT) by 3% compounded annually to $7.8 billion in 2017. Over the last twelve months, PEP's NOPAT has increased to $7.9 billion. PEP's NOPAT margin improved from 11.1% in 2012 to 12.2% TTM while its return on invested capital (ROIC) has averaged 10% over the past five years.

Figure 1: PEP After-Tax Operating Profit Since 2012



Sources: New Constructs, LLC and company filings

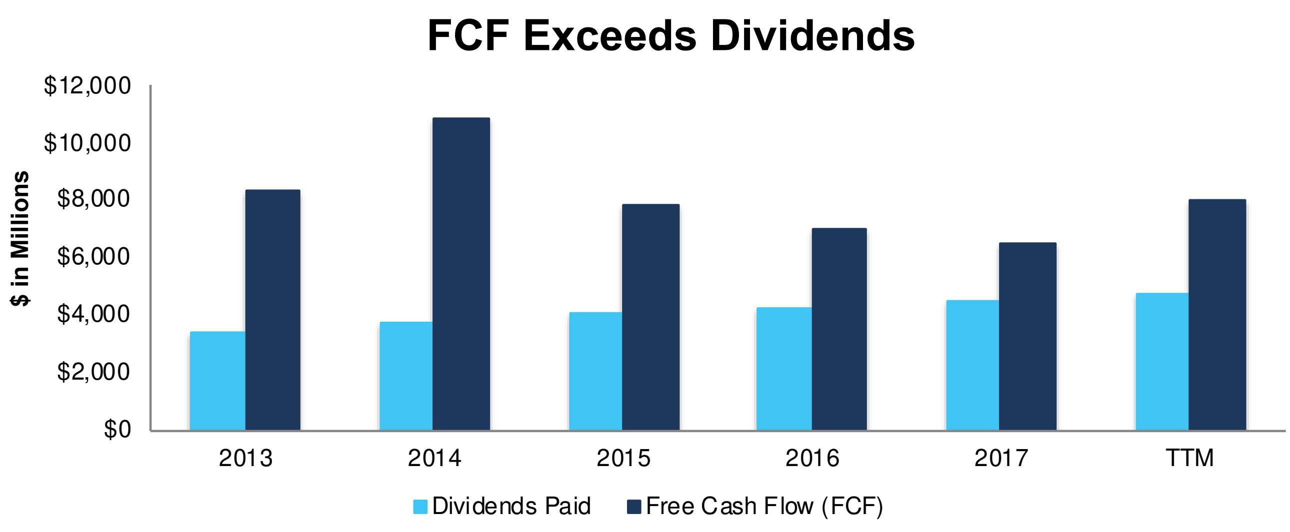
[1] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.
[2] Ernst & Young's recent white paper "Getting ROIC Right" proves the superiority of our holdings research and analytics.

Steady Dividend Growth Supported by FCF

PEP has increased its annual dividend each of the last 46 years. The current annualized dividend has grown from $2.24/share in 2013 to $3.71/share in 2018, or 11% compounded annually. Positive FCF fueled dividend growth in the past and should continue to do so in the future. From 2013-2017, PEP generated cumulative FCF of $40.4 billion (24% of market cap), which is more than double the $19.9 billion in dividends paid over the same time. Over the TTM, PEP has generated $7.9 billion in FCF and paid $4.8 billion in dividends.

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 of a company where FCF falls short of the dividend payment over time cannot be trusted to grow or even stay the same because of inadequate free cash flow.

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



Sources: New Constructs, LLC and company filings

PEP Presents Significant Upside Potential

At its current price of $117/share, PEP has a price-to-economic book value (PEBV) ratio of 1.2. This ratio means the market expects PEP's NOPAT to grow by no more than 20% over the remaining life of the firm. This expectation seems overly pessimistic for a firm that has grown NOPAT by 3% compounded annually over the past decade and 7% compounded annually since 1998.

If PEP can maintain current NOPAT margins (12% TTM) and grow NOPAT by just 4% compounded annually over the next decade, the stock is worth $138/share today – an 18% upside. Click here to see the math behind this dynamic DCF scenario. Add in PepsiCo's 3.2% dividend yield and history of dividend growth, and it's clear why this stock is in November's Dividend Growth Stocks Model Portfolio.

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 PepsiCo's 2017 10-K:

Income Statement: we made $6.3 billion of adjustments with a net effect of removing $3 billion in non-operating expense (5% of revenue). See all adjustments made to PEP's income statement here.

Balance Sheet: we made $55.9 billion of adjustments to calculate invested capital with a net increase of $17.7 billion. The most notable adjustment was $13.5 billion (23% of reported net assets) related to goodwill. See all adjustments to PEP's balance sheet here.

Valuation: we made $57.3 billion of adjustments with a net effect of decreasing shareholder value by $31.3 billion. The most notable adjustment to shareholder value was $3.4 billion in deferred tax liabilities. This adjustment represents 2% of PEP's market value. Despite the decrease in shareholder value, PEP 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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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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