Featured Stock in September's Safest Dividend Yields Model Portfolio

Six new stocks make our Safest Dividend Yields Model Portfolio this month, which was made available to members on September 20, 2019.

Recap from August's Picks

Our Safest Dividend Yields Model Portfolio outperformed the S&P 500 from August 21, 2019 through September 18, 2019. The Model Portfolio rose 6.1% on a price return basis and 6.6% on a total return basis. The S&P 500 rose 3.0% on a price return and total return basis. The best performing large cap stock was up 18%, and the best performing small cap stock was up 10%. Overall, 15 out of the 20 Safest Dividend Yield stocks outperformed the S&P in from August 21, 2019 through September 18, 2019.

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

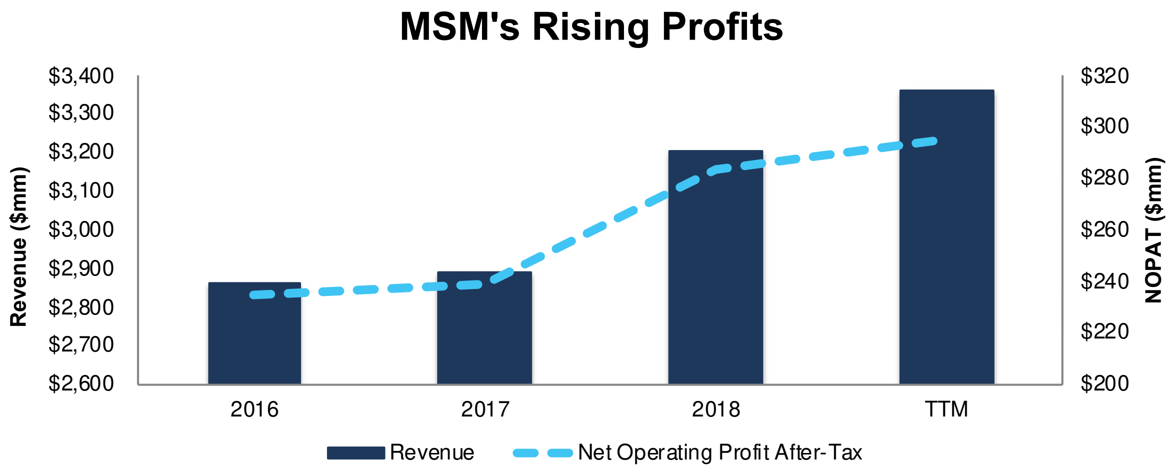
This Model Portfolio only includes stocks that earn an Attractive or Very Attractive rating, have positive free cash flow and economic earnings, and offer a dividend yield greater than 3%. Companies with strong free cash flow provide higher quality and safer dividend yields because we know they have 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 September: MSC Industrial Direct Co. (MSM: $69/share)

MSC Industrial Direct is the featured stock in September's Safest Dividend Yields Model Portfolio.

MSM has grown revenue by 6% compounded annually and after-tax operating profit (NOPAT) by 10% compounded annually since 2016. Trailing twelve months (TTM) NOPAT is up 8% over the prior TTM period. NOPAT margin has increased from 8% in 2016 to 9% TTM while return on invested capital (ROIC) has improved from 13% to 14% over the same time.

Figure 1: MSM's Revenue & NOPAT Since 2016



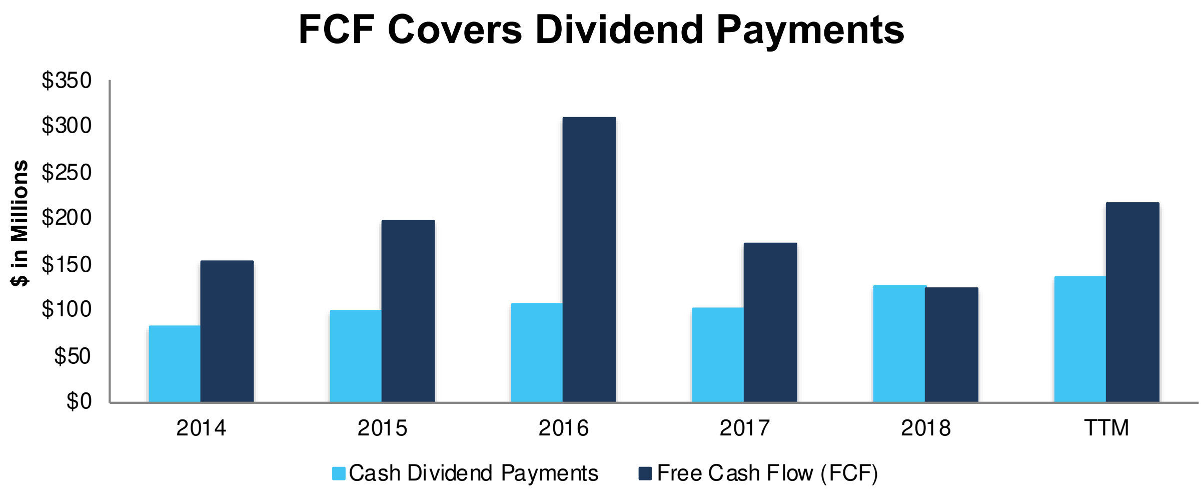
Sources: New Constructs, LLC and company filings

[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] This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

MSM's Free Cash Flow Supports Dividend Payments

Since 2014, MSM has increased its annualized standard dividend from $1.32/share to $2.47/share TTM, or 13% compounded annually. This dividend payment has been supported by MSM's free cash flow. Since 2014, MSM has generated $955 million (25% of market cap) in FCF while paying $515 million in dividends.

Figure 2: MSM's FCF vs. Dividends Since 2014



Sources: New Constructs, LLC and company filings

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.

MSM's Current Valuation Provides Upside

At its current price of $69/share, MSM has a price-to-economic book value (PEBV) ratio of 1.0. This ratio means the market expects MSM's NOPAT to never grow from current levels. This expectation seems pessimistic given that MSM has grown NOPAT by 11% compounded annually over the past two decades.

If MSM can maintain TTM NOPAT margins (9%) and grow NOPAT by just 4% compounded annually for the next decade, the stock is worth $89/share today – a 29% 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 MSC Industrial Direct's fiscal 2018 10-K:

Income Statement: we made $83 million of adjustments with a net effect of removing $45 million in non-operating income (1% of revenue). See all adjustments made to MSM's income statement here.

Balance Sheet: we made $395 million of adjustments to calculate invested capital with a net increase of $207 million. The most notable adjustment was $60 million (3% of reported net assets) related to midyear acquisition adjustments. See all adjustments to MSM's balance sheet here.

Valuation: we made $676 million of adjustments with a net effect of decreasing shareholder value by $676 million. There were no adjustments that increased shareholder value. The most notable adjustment to shareholder value was $90 million in deferred tax liabilities. This adjustment represents 2% of MSM's market value. See all adjustments to MSM's valuation here.

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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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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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