Featured Stock in April's Dividend Growth Model Portfolio

Seven new stocks make our Dividend Growth Stocks Model Portfolio this month, which was made available to members on April 29, 2020.

Recap from March's Picks

On a price return basis, our Dividend Growth Stocks Model Portfolio (+7.9%) underperformed the S&P 500 (+9.9%) by 2.0% from March 26, 2020 through April 27, 2020. On a total return basis, the Model Portfolio (8.1%) underperformed the S&P 500 (+9.9%) by 1.8% over the same time. The best performing stock was up 40%. Overall, twelve out of the 30 Dividend Growth Stocks outperformed the S&P 500 from March 26, 2020 through April 27, 2020.

Only our research utilizes the superior data and earnings adjustments featured by the HBS & MIT Sloan paper, "Core Earnings: New Data and Evidence." 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.

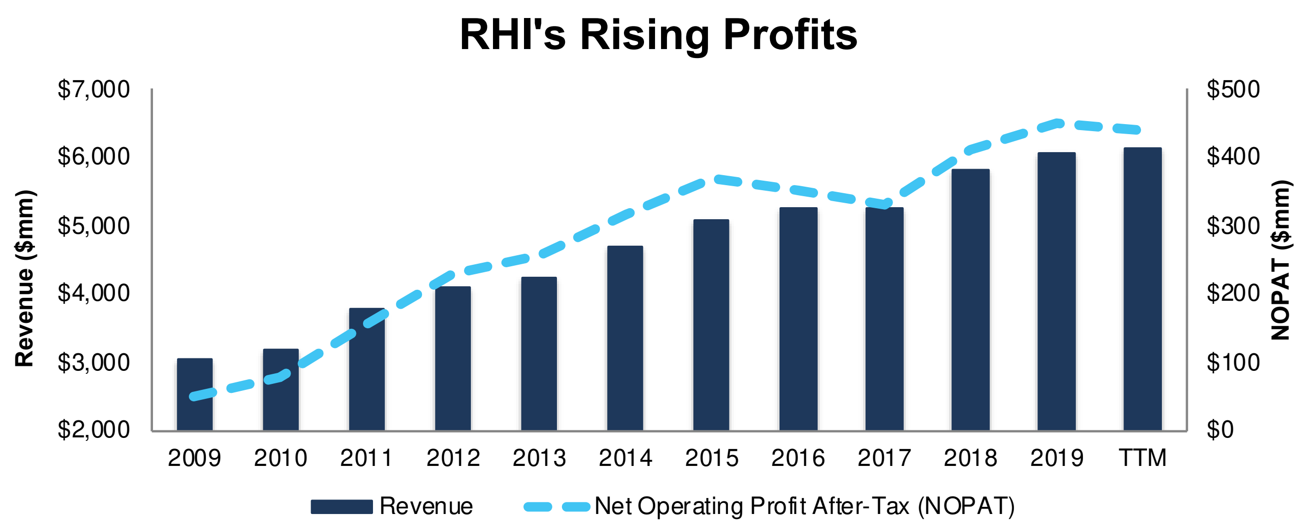
Featured Stock from April: Robert Half International, Inc. (RHI: $44/share)

Robert Half International, Inc. (RHI) is the featured stock from April's Dividend Growth Stocks Model Portfolio.

RHI has grown revenue by 7% compounded annually and net operating profit after-tax (NOPAT) by 25% compounded annually over the past decade. Longer term, RHI has grown NOPAT by 7% compounded annually over the past two decades. The firm's NOPAT margin has increased from 2% in 2009 to 7% over the trailing twelve months (TTM), while invested capital turns have improved from 2.7 to 4.4 over the same period. The combination of rising NOPAT margin and invested capital turns drives the firm's return on invested capital (ROIC) from 4% in 2009 to 32% over the TTM.

[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 Bloomberg and Capital IQ (SPGI) in a detailed appendix.

Figure 1: RHI's Revenue & NOPAT Since 2009

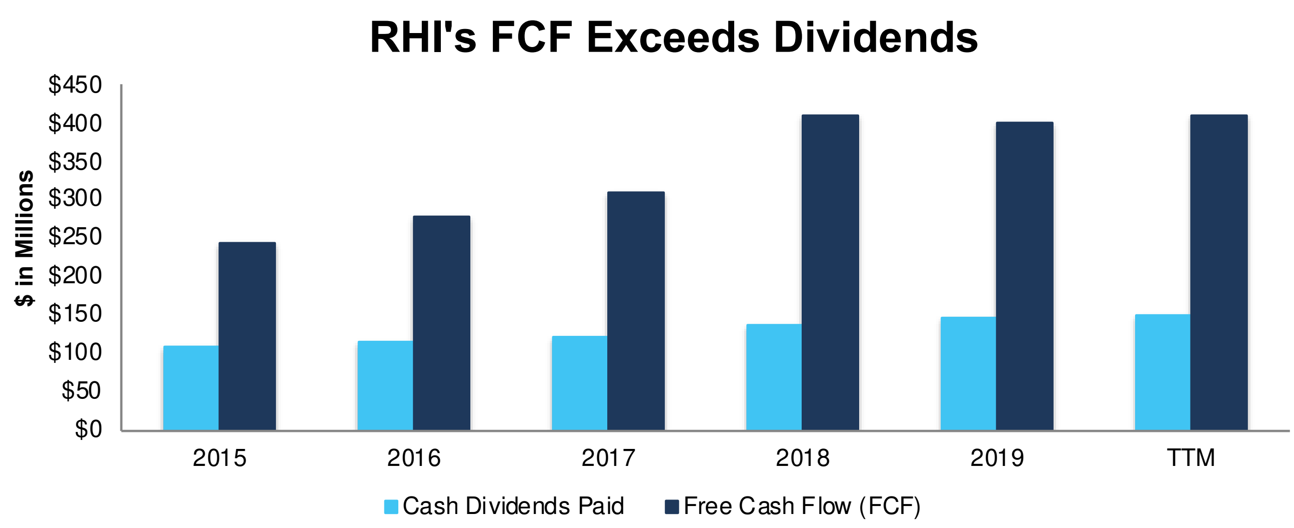


Sources: New Constructs, LLC and company filings

Steady Dividend Growth Supported by FCF

RHI has increased its dividend for 16 consecutive years and stated in the most recent earnings call that it planned to continue paying its dividend. The firm increased its annual dividend from $0.80/share in 2015 to $1.24/share in 2019, or 12% compounded annually. The current quarterly dividend, when annualized, equals $1.36/share and provides a 3.1% dividend yield. More importantly, RHI's dividend payment has been supported by the firm's strong free cash flow (FCF). RHI generated $1.6 billion (32% of current market cap) in FCF while paying $625 million in dividends from 2015 to 2019, per Figure 2. Over the TTM period, RHI has generated $409 million in FCF and paid out $148 million in dividends.

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



Sources: New Constructs, LLC and company filings

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 a higher dividend. On the other hand, the dividend of a company where FCF falls short of the dividend payment over time cannot be trusted to grow or even maintain its dividend because of inadequate free cash flow.

RHI is Undervalued

At its current price of $44/share, RHI has a price-to-economic book value (PEBV) ratio of 0.8. This ratio means the market expects RHI's NOPAT to permanently decline by 20% over its remaining corporate life. This expectation seems overly pessimistic given that RHI has grown NOPAT by 25% compounded annually over the past decade.

If RHI maintains TTM NOPAT margins of 7% and grows NOPAT by just 4% compounded annually for the next decade, the stock is worth $73/share today – a 66% upside. See the math behind this reverse DCF scenario.

Add in RHI's 3.1% dividend yield and history of dividend growth, and it's clear why this stock is in April'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 as shown in the Harvard Business School and MIT Sloan paper, "Core Earnings: New Data and Evidence".

Below are specifics on the adjustments we make based on Robo-Analyst findings in Robert Half's 2019 10-K:

Income Statement: we made $29 million of adjustments with a net effect of removing $3 million in non-operating income (<1% of revenue). See all adjustments made to RHI's income statement here.

Balance Sheet: we made $984 million of adjustments to calculate invested capital with a net decrease of $101 million. The most notable adjustment was $820 million (60% of reported net assets) in deferred compensation. See all adjustments to RHI's balance sheet here.

Valuation: we made $266 million of adjustments with a net effect of decreasing shareholder value by $266 million. There were no adjustments that increased shareholder value. The most notable adjustment to shareholder value was $19 million in operating leases. This adjustment represents less than 1% of RHI's market value. See all adjustments to RHI's valuation here.

This article originally published on May 8, 2020.

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

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HBS & MIT Sloan research reveals that:

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Combining human expertise with NLP/ML/AI technologies (featured by Harvard Business School), we shine a light in the dark corners (e.g. footnotes) of hundreds of thousands of financial filings to unearth critical details.

The HBS & MIT Sloan paper, Core Earnings: New Data and Evidence, shows how our superior data drives uniquely comprehensive and independent debt and equity research.

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

Learn more.

Quotes from HBS & MIT Sloan professors on our research:

Get better research:

"…the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications." – page 20

Pick better stocks:

"Trading strategies that exploit cross-sectional differences in firms' transitory earnings produce abnormal returns of 7-to-10% per year." – Abstract

Avoid losses from using other firms' data:

"…many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat…" – page 14

Build better models:

"Core Earnings [calculated using New Constructs' novel dataset] provides predictive power for various measures of one-year-ahead performance…that is incremental to their current-period counterparts." – page 4

Exploit market inefficiencies:

"These results … suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures." – page 26

Fulfill fiduciary duties:

"An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A." – page 33-34

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