Featured Stock in June's Dividend Growth Model Portfolio

Nine new stocks make our Dividend Growth Stocks Model Portfolio this month, which was made available to members on June 30, 2020.

Recap from May's Picks

On a price return basis, our Dividend Growth Stocks Model Portfolio (-1.5%) underperformed the S&P 500 (-1.0%) by 0.5% from May 28, 2020 through June 26, 2020. On a total return basis, the Model Portfolio (-1.3%) underperformed the S&P 500 (-0.5%) by 0.8% over the same time. The best performing stock was up 11%. Overall, 11 out of the 30 Dividend Growth Stocks outperformed the S&P 500 from May 28, 2020 through June 26, 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 June: Lockheed Martin Corp (LMT: $362/share)

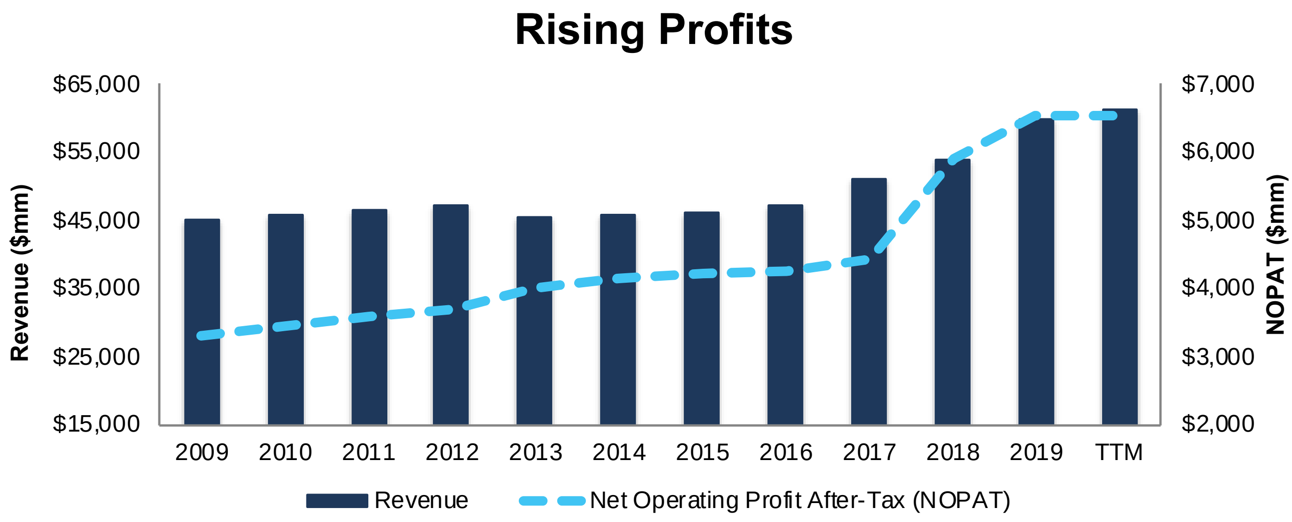
Lockheed Martin Corp (LMT) is the featured stock from June's Dividend Growth Stocks Model Portfolio.

Lockheed Martin has grown revenue by 3% compounded annually and net operating profit after-tax (NOPAT) by 7% compounded annually over the past decade. Longer term, Lockheed Martin has grown NOPAT by 12% compounded annually over the past two decades. The firm's NOPAT margin has increased from 7% in 2009 to 11% over the trailing twelve months (TTM), while return on invested capital (ROIC) has improved from 10% in 2009 to 13% over the same time.

[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] Compare our analytics on a mega cap company to Bloomberg and Capital IQ's (SPGI) analytics in the detailed appendix of this paper.

Figure 1: Lockheed Martin's Revenue & NOPAT Since 2009



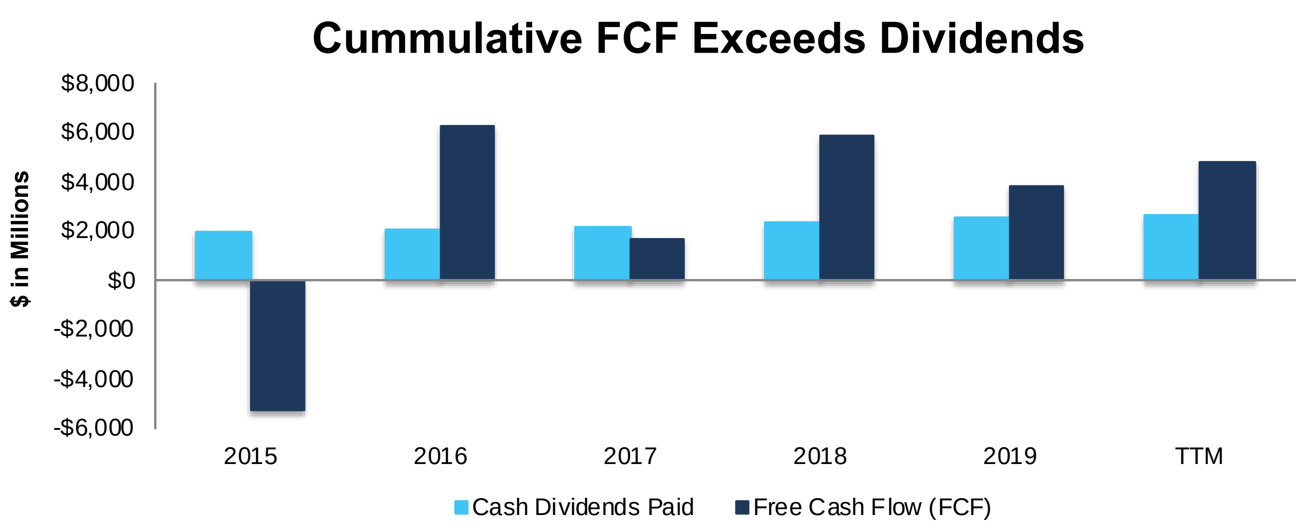
Sources: New Constructs, LLC and company filings

Steady Dividend Growth Supported by FCF

Lockheed Martin has increased its dividend for 18 consecutive years and stated in its 1Q20 earnings call that the company's plan for the rest of the year is, "still to declare and pay dividends." The firm increased its dividend from $6.15/share in 2015 to $9.00/share in 2019, or 10% compounded annually. The current quarterly dividend, when annualized, equals $9.60/share and provides a 2.7% dividend yield.

More importantly, Lockheed Martin's strong free cash flow (FCF) supports the firm's dividend payment. Lockheed Martin generated $12.4 billion (12% of current market cap) in FCF while paying $11.0 billion in dividends from 2015 to 2019, per Figure 2. Over the TTM period, Lockheed Martin has generated $4.8 billion in FCF and paid out $2.6 billion 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.

LMT Has Upside Potential

At its current price of $362/share, LMT has a price-to-economic book value (PEBV) ratio of 1.0. This ratio means the market expects Lockheed Martin's NOPAT to never meaningfully grow over its remaining corporate life. This expectation seems overly pessimistic given that Lockheed Martin has grown NOPAT by 10% compounded annually over the past five years and 7% compounded annually over the past decade.

If Lockheed Martin maintains TTM NOPAT margins of 11%, and the firm grows NOPAT by just 4% compounded annually for the next decade, the stock is worth $492/share today – a 36% upside. See the math behind this reverse DCF scenario.

Add in Lockheed Martin's 2.7% dividend yield and history of dividend growth, and it's clear why this stock is in June'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 Lockheed Martin's 2019 10-K:

Income Statement: we made $2.7 billion of adjustments with a net effect of removing $296 million in non-operating expense (<1% of revenue). See all adjustments made to Lockheed Martin's income statement here.

Balance Sheet: we made $29.3 billion of adjustments to calculate invested capital with a net increase of $16.3 billion. The most notable adjustment was $15.6 billion (46% of reported net assets) related to other comprehensive income. See all adjustments to Lockheed Martin's balance sheet here.

Valuation: we made $34.0 billion of adjustments with a net effect of decreasing shareholder value by $30.4 billion. Apart from total debt, the most notable adjustment to shareholder value was $15.0 billion in underfunded pensions. This adjustment represents 15% of Lockheed Martin's market value. See all adjustments to Lockheed Martin's valuation here.

This article originally published on July 6, 2020.

Disclosure: David Trainer, Kyle Guske II, and Matt Shuler 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.

Footnotes adjustments matter. We are the ONLY source.

We provide ratings, models, reports & screeners on U.S. 3,000 stocks, 700 ETFs and 7,000 mutual funds.

HBS & MIT Sloan research reveals that:

- **Markets are inefficiently assessing earnings because no one reads the footnotes.**
- **Corporate managers hide gains/losses in footnotes to manage earnings.**
- **Our technology brings the material footnotes data to market for the first time ever.**

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

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.