OUR DIVIDEND GROWTH NEWSLETTER

Valuentum Securities

Stock Analysis: From Value through Momentum Investing

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Valuentum Securities Inc.
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Soon: Swapping out CVX; Swapping in XLE

Annualized Return	Annualized Goal	Outperformance
16.7%	Mid-High Single Digits	9.2pts

*Please see note below regarding performance measurement.

INSIDE THIS ISSUE

When the Facts Change

By Brian Nelson, CFA

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Best Dividend Growth Ideas: MO, AAPL, COH, CSCO, CVX, ETP, GE, HAS, HCP, INTC, JNJ, KMI, MDT, MSFT, O, PG, PPL

The most valuable quality of any portfolio manager is the ability to change his or her mind, *and not look back*. When the facts change, so should the thesis. And the facts have changed with Dividend Growth portfolio holding Chevron (CVX)—4.0% annual dividend yield.

A look at the oil giant's fourth-quarter results revealed a balance sheet that we flat-out were hoping to avoid, particularly for a commodity-producing entity. What was once a healthy net cash position just a few quarters ago has now ballooned into a $15 billion net debt position and a $27 billion total debt position overall. The pace of change has been incredible, and Chevron continues add more leverage as we write. Just last week, it sold *another* $6 billion in bonds.

There's nothing necessarily wrong with adding more leverage to the balance sheet during difficult times, especially when the price of its product has been cut in half, but this is just the beginning of its debt-raising cycle, by our estimate. For Chevron to sustain its massive capital spending program *and* its healthy dividend, the firm will have to keep coming back to the debt markets. Chevron is simply spending too much. Its $31 billion cash capital and exploratory budget for 2015 is too high. Chevron *burned* through $4.8 billion in cash during the most recent quarter alone.

Almost our entire dividend growth thesis on Chevron has hinged on the firm's strong balance sheet position as a backdrop to (an insurance policy for) the inherent unpredictability of crude oil prices. The firm's AA rating from Standard & Poor's still speaks to its strong credit health, of course, but being able to refinance debt via an assessment of the probability of bankruptcy (which a credit rating measures) is much different than assessing the company's ability to satisfy shareholders (which are interested in capital appreciation and income growth). Shareholders are lower on the hierarchy of the capital structure than debt holders.

We find the pace of deterioration in Chevron's balance sheet shocking. A look at the firm's presentation slide decks from a few years ago reveals a management team that was highlighting its net cash position relative to its major peers. They were highlighting it. And then, poof, that favorable aspect of its business and our dividend growth thesis has become tarnished. Such writing may seem sudden for new members, but when the facts change, so does our thesis. We're removing Chevron from the Dividend Growth portfolio, at roughly its cost basis.

> "In light of the uncertain credit health of many oil & gas companies, diversified exposure to dividend growth may make the most sense in the energy sector."
> – Brian Nelson, CFA

***NOTE**: The Dividend Growth portfolio's goal is to generate a mid-to-high single digit annual return (about 7.5%) over rolling 3-5 year periods. As of today, March 1, 2015, the portfolio is significantly exceeding this goal.

Please see *When the Facts Change…*on next page

When the Facts Change...**from previous page**

In its place, we'll be swapping the Energy Select Sector SPDR ETF (XLE), which incidentally holds a 13% position in Chevron. In light of the collapse in crude oil prices, a diversified approach to address the credit deterioration across the energy space makes the most sense regarding dividend growth at the moment. If Chevron has to resort to such aggressive and accelerated debt-raising efforts, much of the rest of the energy sector will as well. Balance sheets across the sector will look much different in the coming quarters, and it won't be pretty.

The dividend yield of the Energy Select Sector SPDR is ~2.5%, a much better risk-adjusted dividend growth idea in light of recent developments. We have to be very clear about this change, however. It is not about being right or wrong on Chevron, but appropriately pursuing the best risk-adjusted idea within energy that serves the goal of the Dividend Growth portfolio, which is sustained income growth.

In other news, Dividend Growth portfolio holdings Apple (AAPL)—1.4% annual dividend yield—and Altria (MO) —3.7% annual dividend yield— keep powering ahead, and while the share price of the latter is starting to get pricey, we're holding until its technical and momentum indicators roll over (this is a core part of the Valuentum process). Both companies have been blockbuster winners in the Dividend Growth portfolio, and we've pounded the table time and time again on them in the past. Profit taking on them and others, however, is drawing nigh, particularly as valuations become increasingly stretched.

Even some of steadiest companies on the market are trading at multiples not seen since the bubble days of the dot-com era. Please don't become complacent or overconfident.

Price almost never equals value. Price is what you pay for a company, and value is what you get, as measured by a company's net cash on the balance sheet and its future enterprise free cash flow stream. Just like stock prices can overshoot valuations to the downside as in the panic bottom of March 2009, they can overshoot to the upside as well (e.g. the dot-com era). A "frothy" market is the environment we're in right at the moment, and *there's no question about it*. Don't overreact, however.

An overpriced market can still get more overpriced, and we're not necessarily taking on added risk by letting winners run. In fact, selling too early or at fair value is a major pitfall of the "value" process, which truncates overall returns. Many pure "value" investors, for example, have been out of the equity markets for years. Bargains are certainly few and far between, but we're still uncovering underpriced gems with high probabilities of price-to-fair value convergence. We think 2015 still has the makings of a difficult year for the equity markets as a whole, but this just means that stock-selection is *that* much more important.

The Dividend Growth portfolio does not follow an indexing strategy, and while overall market forces will impact portfolio performance in coming periods to a degree, we're looking to generate outsize returns and achieve above-average income growth, not accept the mediocre returns of an index. We have no intentions, however, to be fully invested at today's valuations. The markets will do all that it can to try to bait us to add to the portfolios at these lofty levels, but that's why discipline is so important.

Just like the American patriots at the Battle of Bunker Hill, "don't fire until you see the whites of their eyes." As they always do, the markets will eventually come closer to bargain-priced levels, and we're keeping some dry powder just for that moment. We don't waste ammunition until we have a clear sight to outperformance. Our favorite dividend growth ideas are included in the Dividend Growth portfolio.

Interest Rate Risk More Pronounced Than in Previous Cycles

By Brian Nelson, CFA

The utilities sector is full of entities that boast steadily-growing earnings and regulated returns that are set by local government authorities within a defined ratemaking process. This monopolistic tendency of the largest regulated public utilities translates into a high degree of investor confidence in future expected operating performance across constituents in the sector.

The regulatory framework under which a utility conducts business is the primary determinant of its overall profitability and ability to meet both debt and dividend obligations. Most utilities' balance sheets are swollen with significant net debt positions, which were built to fuel rate bases, or the value of property on which a public utility can earn a regulated business return. Not only do ratemaking authorities determine the magnitude of regulated returns (economic profit) on these rate bases, but government commissions also dictate the timeline for the recovery of costs incurred. A favorable regulatory environment in which to recover the large capital expenditures related to public infrastructure needs is therefore critical for regulated utilities to meet the demands of all stakeholders, especially those of shareholders.

Offering greater stability and visibility than any one particular utility holding company, however, is a basket of broad utilities held within an ETF, which helps to diversify away firm-specific regulatory uncertainty, geographic concentration risk, and the unregulated business volatility of individual sector constituents. We find this useful characteristic of well-diversified utilities sector ETFs to be a large advantage over owning any individual utility itself, no matter how well diversified that utility may be.

Most portfolio managers seek sector utilities exposure for several reasons: to attain large and growing income potential, to reduce portfolio volatility, or to capture macroeconomic dynamics most closely tied to the direction of interest rates.

Though there have been at least two specific instances in the past few years where a large, established utility holding company cut its dividend to shareholders--in the cases of Exelon (EXC) —3.7% annual dividend yield— and First Energy (FE) —4.0% annual dividend yield—for the most part, utilities' dividends can be viewed as less risky than those in other sectors, all else equal. It is not, however, because of utilities' financial considerations, and more specifically, their balance sheets that lead us to say so, but instead it is the statutory protections that mandate the recovery of incurred costs that offer what we would describe to be the "cushion" behind most utility's operations and dividend health.

In fact, most large public utility holding companies have raw, unadjusted cash-flow derived Dividend Cushion ratios below 1, indicating that future expected free cash flows over the near term are completely absorbed by net debt obligations and future expected dividend payments. Utilities' high dividend payout ratios (dividends paid per share divided by earnings per share) and elevated capital outlays--both of which prevent the buildup of cash on the balance sheet--coupled with the ballast of hefty debt obligations, which are higher on the capital structure than any equity concerns, prevent most utilities from receiving a healthy Dividend Cushion ratio, a pure financial-statement based comprehensive assessment of the coverage of the dividend.

Please see *Interest Rate Risk…*on next page

***Interest Rate Risk...*from previous page**

Paradoxically, the healthy issuer credit ratings, which are often cited as a proxy of a utility's ability to pay growing dividends to shareholders, are not derived *wholly* by financial considerations, but in at least one instance, are derived heavily from the qualitative assessments of a utility holding company's regulatory framework, ability to recover costs and earn returns, and diversification considerations. The mere loose connection between a utility holding company's issuer credit rating and its cash-flow generating ability to pay dividends to shareholders is why investment grade utility holding companies should not be viewed as completely immune to dividend cuts.

The Dividend Cushion methodology may, in theory, pull forward debt maturities into the 5-year forecast measurement period, generating a more punitive assessment of a utility's dividend health, but the measure is a more tangible, objective and financial-focused measure of dividend health within and across the utilities sector than issuer credit ratings alone. The Dividend Cushion accurately predicted the heightened financial risk that ultimately led to the dividend cuts at Exelon and First Energy (two highly-rated credits), but such leveraged balance sheets and significant capital requirements—major red flags for any large dividend payer—are not uncommon for most operators in the utility space.

In this light, the Dividend Cushion, while highlighting risks appropriately, may have a greater number of "false positives" in the utilities sector regarding the extent of dividend risks than in other sectors due in part to the greater dependence on qualitative, non-financial analysis in assessing the fundamentals of utilities operations, and by extension, a utility's ability to keep paying a growing dividend.

From our perspective, investors must accept the reality that public utilities are almost entirely dependent on the regulatory environment to offset the well documented balance sheet and free-cash-flow risk associated with their operations.

For those that are uncomfortable knowing that pure financial analysis may be but a secondary consideration in determining the health of an individual utility, sector utilities ETFs become a much more attractive alternative.

Though the largest-AUM sector utilities ETFs have equity betas less than 1, signaling less-volatile returns relative to a broad market benchmark, directionally speaking, we cannot say that we are overly enthused by the valuation opportunity presented by the group. According to third-party sources, the 12-month forward price-to-earnings ratio in the utilities sector is approaching 17 times, greater than both the trailing 5-year and 10-year averages of less than 15 times. The group may exhibit less share-price volatility than the overall market, but we cannot rule out a bout of underperformance should current forward multiples converge to longer term averages, a very real risk.

In an environment where interest rates are paltry, income-oriented investors have flocked to the robust dividend yields of utilities to fulfill income needs. This asset class shift, however, has effectively altered the return dynamics of utilities equities to be more closely correlated with fixed-income instruments, in our view (despite, of course, the income growth potential of equities). Though higher discount rates (interest rates) within the equity valuation process will be negative to underlying equity valuations in all sectors during a tightening credit environment, all else equal, threats of an interest rate increase may *abnormally* hurt the prices of utilities equities relative to other sectors, given the unprecedented relationship between current interest rates and utility dividend yields.

Never in history, other than the present time, have utilities' sector dividend yields (~3%) been larger than that of the 10-year Treasury rate (~2%), the common benchmark onto which risk premiums (spreads) are added to derive coupon yields on corporate debt instruments.

We're in unchartered territory, and financial advisors and individual investors should take note.

The Dividend Growth Portfolio

Annualized Return	Annualized Goal	Outperformance
16.7%	Mid-High Single Digits	9.2pts

DIVIDEND GROWTH PORTFOLIO -- as of March 1, 2015 — Dividend Growth Portfolio Inception Date: January 1, 2012

Company Name	First Purchase	Avg Cost ($)	# of Shares	Total Cost ($)	Last Close	Current Value ($)	% of Portfolio	Exp. Yrly Div's ($)
Altria (MO)	12/30/2011	29.65	202	5,996.30	56.29	11,370.58	7.0%	420.16
Apple (AAPL)	7/24/2013	63.17	77	4,870.76	128.46	9,891.42	6.1%	144.76
Chevron (CVX)	12/30/2011	106.40	56	5,965.40	106.68	5,974.08	3.7%	239.68
Cisco (CSCO)	11/14/2014	26.15	100	2,622.00	29.51	2,951.00	1.8%	84.00
Coach (COH)	9/19/2014	37.55	80	3,011.00	43.55	3,484.00	2.1%	108.00
Energy Transfer (ETP)	12/30/2011	45.85	142	6,517.70	59.48	8,446.16	5.2%	565.16
General Electric (GE)	10/21/2013	26.18	240	6,290.20	25.99	6,237.60	3.8%	220.80
Hasbro (HAS)	12/30/2011	31.89	220	7,022.80	62.31	13,708.20	8.4%	404.80
HCP (HCP)	9/19/2014	40.11	75	3,015.25	42.36	3,177.00	1.9%	169.50
Intel (INTC)	12/30/2011	24.25	289	7,015.25	33.25	9,609.25	5.9%	277.44
Johnson & Johnson (JNJ)	12/30/2011	65.58	107	7,024.06	102.51	10,968.57	6.7%	299.60
Kinder Morgan (KMI)	10/22/2014	38.72	157	6,086.04	41.01	6,438.57	4.0%	282.60
Medtronic (MDT)	12/30/2011	38.25	157	6,012.25	77.59	12,181.63	7.5%	191.54
Microsoft (MSFT)	12/30/2011	25.96	154	4,004.84	43.85	6,752.90	4.1%	190.96
Proctor & Gamble (PG)	12/30/2011	66.71	105	7,011.55	85.13	8,938.65	5.5%	269.85
PP&L (PPL)	12/30/2011	29.42	238	7,008.96	34.10	8,115.80	5.0%	354.62
Realty Income (O)	7/24/2013	44.35	60	2,668.00	50.06	3,003.60	1.8%	136.20
Last Trade: The position in MSFT was trimmed on January 27.								
Cash				2,363.42		31,674.76	19.4%	4,359.67
Dividend Growth Portfolio				100,000.00		**162,923.77**	100.0%	TBD
DG Portfolio Annualized Return (from inception through current date)								**16.7%**
DG Portfolio Annualized Return Goal (Mid-to-High Single Digit Returns)								7.5%
DG Portfolio Annualized Return Outperformance								**9.2%**

UR = Under Review

** Upper bound of fair value range noted.

**** The yield an investor would have received if they had held the fund over the last 12 months assuming the most recent NAV.

This portfolio is not a real money portfolio. Data as of March 1, 2015. Cost basis includes commissions. Results include divdends, but no interest received on cash balance.

DIVIDEND GROWTH PORTFOLIO -- as of March 1, 2015

Company Name	Yrly Div's Paid ($) / Shr	Div Yield %	Ex Div Date	Next Pay Date (cycl)	Div Cushion™	Div Safety	Div Growth	Fair Value	VBI Score	Price/Fair Value
Altria (MO)	2.08	3.70%	mid-Mar 2015	mid Mar 2015 (quart)	1.1	GOOD	GOOD	$47.00	6	1.20
Apple (AAPL)	1.88	1.46%	early-May 2015	May 2015 (quart)	5.1	EXCELLENT	EXCELLENT	$139.00	6	0.92
Chevron (CVX)	4.28	4.01%	mid-May 2015	early June 2015 (quart)	0.2	VERY POOR	VERY POOR	$115.00	3	0.93
Cisco (CSCO)	0.84	2.85%	early Apr 2015	early Apr 2015 (quart)	3.4	EXCELLENT	EXCELLENT	$33.00	9	0.89
Coach (COH)	1.35	3.10%	early Mar 2014	early Mar 2015 (quart)	2.1	GOOD	EXCELLENT	$50.00	6	0.87
Energy Transfer (ETP)	3.98	6.69%	late Apr 2015	May 2015 (quart)	2.3	GOOD	GOOD	$63.00	4	0.94
General Electric (GE)	0.92	3.54%	early June 2015	June 2015 (quart)	2.0	GOOD	GOOD	$30.00	7	0.87
Hasbro (HAS)	1.84	2.95%	late Apr 2015	mid May 2015 (quart)	1.9	GOOD	EXCELLENT	$62.00	6	1.01
HCP (HCP)	2.26	5.34%	early May 2015	early May 2015 (quart)	1.8	GOOD	EXCELLENT	$46.00	3	0.92
Intel (INTC)	0.96	2.89%	early May 2015	early June 2015 (quart)	2.1	GOOD	EXCELLENT	$35.00	6	0.95
Johnson & Johnson (JNJ)	2.80	2.73%	late May 2015	early June 2015 (quart)	2.3	GOOD	EXCELLENT	$110.00	6	0.93
Kinder Morgan (KMI)	1.80	4.39%	late Apr 2015	mid May 2015 (quart)	1.2	GOOD	GOOD	$42.00	3	0.98
Medtronic (MDT)	1.22	1.57%	early Apr 2015	Apr 2015 (quart)	4.1	EXCELLENT	EXCELLENT	$72.00	7	1.08
Microsoft (MSFT)	1.24	2.83%	mid May 2015	mid June 2015 (quart)	3.2	EXCELLENT	EXCELLENT	$55.00	6	0.80
Proctor & Gamble (PG)	2.57	3.02%	mid Apr 2015	early May 2015 (quart)	1.7	GOOD	EXCELLENT	$84.00	7	1.01
PP&L (PPL)	1.49	4.37%	early Mar 2015	early Mar 2015 (quart)	Held for diversification reasons.			$35.00	6	0.97
Realty Income (O)	2.27	4.53%	monthly	monthly	2.0	GOOD	GOOD	$60.00	6	0.83

Big Buy Backs from Two Dividend Growth Portfolio Holdings

By Brian Nelson, CFA

Triple-A rated Microsoft and Hasbro are turning up the gears in buying back stock.

Following what can best be described as a difficult quarter, Microsoft (MSFT)—2.8% annual dividend yield—is stepping up its game in buying back its own undervalued stock. Before the end of 2016, the software giant plans to put to work the $31 billion remaining on its share repurchase program. To help it do so, the company is selling $7+ billion in debt, and the timing couldn't be better. Shares of Microsoft are hovering just over $40 each, and with our fair value pegged in the mid-$50s, levering up the company via buying its own underpriced stock makes a lot of sense.

The financial team at Microsoft is creating significant economic value by this move.

Microsoft's Dividend Cushion ratio is north of 3 at present, and while adding debt to buy back stock will lower its coverage of the dividend a bit, the firm generates gobs and gobs of free cash flow, to the tune of $26.7+ billion in the last fiscal year alone. What's a measly $7 billion in incremental debt, right? After all, Microsoft ended calendar 2014 with over $90 billion in total cash and short-term investments. It's almost as if Microsoft is floating this debt to remind the equity and credit markets of the extent of its financial health.

From our perspective, Microsoft's dividend may be the strongest 3%-yielder on the market today. That's why it remains a key position in the Dividend Growth portfolio, even as we took some profits more recently. Though we have a few concerns with Microsoft's technicals at the moment, we don't have any concerns with the triple-A-rated firm's ability to keep raising its investors' income streams year after year.

Ideally, we'd like to see Microsoft up its dividend payout by $0.46 on an annual basis, to $1.70 per share, creating a ~4% annual dividend yield at current prices. At that level, we would expect substantial fundamental support for the stock. Such an increase would represent a rather large ~40% bump from current levels, but the revised annual dividend payout would *only* amount to $14.1 billion annually on its ~8.3 billion shares, still less than half of Microsoft's free cash flow generation in any given year.

Importantly, however, as Microsoft buys back more stock, its annual dividend obligations at a higher payout level shrink relative to the obligations that it otherwise would incur with the higher share count. Perhaps this is exactly what Microsoft is doing with its aggressive buy backs – setting up for a huge dividend increase on a reduced number of shares. In this light, it's difficult to *not* be excited about the debt deal.

Another Dividend Growth portfolio holding Hasbro (HAS)—2.9% annual dividend yield—reported a fantastic fourth quarter. I can't begin to tell you how pleased I am with the firm's performance relative to Mattel (MAT)—5.8% annual dividend yield. We clearly picked the winner of the two, and we have the Dividend Cushion ratio to thank for that. Excluding currency impacts, net revenue advanced an impressive 7% in its calendar fourth quarter, as adjusted net earnings swelled to $1.22 per share, up a dime on a year-over-year basis.

Please see *Big Buy Backs…*on next page

*Big Buy Backs…*from previous page

Not bad for a toy company, no?

Well, as we've said time and time before, Hasbro is no such thing – it is a licensing company, and the market is finally figuring it out. Hasbro's shares surpassed $60 during trading following its release, and we're letting this winner run. We value the company at $62 per share at present. It was added to the Dividend Growth portfolio in the low-$30s.

Hasbro also announced that it has bolstered its share repurchase program by another $500 million. Though we like the news, the value-creating impact of its buyback program won't be as large as that of Microsoft's because Hasbro's shares are trading relatively close to our fair value estimate. Microsoft, on the other hand, continues to trade at a steep discount to our estimate of its intrinsic value.

Remember, when it comes to buybacks, not all of them are value-creating. If shares are overvalued, management is destroying value in buying back stock, akin to the same risks that investors take when investing in overpriced stock themselves. Only when shares are undervalued do buybacks make sense.

In both Microsoft's and Hasbro's cases, they do.

No Interest Rate Hikes Soon, As Expected

By Brian Nelson, CFA

It wasn't surprising to read in the FOMC minutes that the Federal Reserve is in no hurry to increase the federal funds rate. The prices of almost every commodity from crude oil and refined energy products to iron ore and copper have fallen sharply in recent months, and the strengthening of the US dollar has only accelerated the declines of dollar-denominated commodities for US-centric operators.

While we remain encouraged by the ongoing recovery in the construction and housing markets, pockets of weakness remain, and housing prices have yet to fully recover to pre-crisis levels in many parts of the country. Food prices are dropping, too – can you believe that 10 chicken nuggets at Burger King (QSR)—0.8% annual dividend yield— cost a measly $1.49? There are value menus everywhere, from Yum! Brands' (YUM)—2.1% annual dividend yield—Taco Bell to Wendy's (WEN)—1.9% annual dividend yield—and beyond. Seniors can get a coffee at my local McDonald's (MCD)—3.4% annual dividend yield— for $0.63. A family of four can fill up on a $5 pizza from Little Caesars.

With *reality* as it is, how in the world can the Fed make any reasonable argument about inflationary risks? If the Fed may be creating any inflation through its lax monetary policies, from my perspective, it is creating real personal wealth, as in the example of rising stock prices. Investors are simply "getting rich" and their purchasing power is receiving an added boost as living costs all around them fall or hold steady. There is simply no need for credit tightening just yet. Everything seems to be working wonderfully. Employment is even at "full" levels.

Please see *No Interest Rate Hikes…*on next page

*No Interest Rate Hikes…*from previous page

Can you imagine if the Fed raises rates, and the equity markets collapse as a result? Ms. Yellen is not going to create problems that don't exist. The Fed is well-schooled in Depression economics, and given what we know about current prices and employment, any premature credit tightening after arguably the worst economic environment in the post-WWII era is just not going to happen, at least not anytime soon. The Fed would rather be too late than too early. Even moderately elevated inflation is a much better proposition than the downward economic spiral of a deflationary crisis.

Much of the REIT industry popped on the dovish news, including newsletter positions HCP (HCP)—5.4% annual dividend yield—and Realty Income (O)—4.6% annual dividend yield. The latter is also coming off a nice fourth-quarter report February 16 that showcased revenue and funds-from-operations growth in the mid-teens relative to last year's marks. Same-store rents at the self-proclaimed Monthly Dividend Company jumped 1.7% in the last quarter of 2014, and the REIT ended the year with portfolio occupancy at 98.4%, up 20 basis points on a year-over-year basis. Realty Income increased its annualized dividend per share 3% last month, to $2.268; that's good for a forward yield of 4.3%. We value Realty Income's shares at $60 each, revealing prospects for both capital appreciation and well-documented dividend growth.

In other news, the Dividend Cushion ratio struck again! This time it highlighted the risk of Transocean's (RIG) dividend before it slashed its payout 80% on February 16. The company's CEO also resigned, and frankly, we're not seeing the investment case in shares at the moment, especially given the significant uncertainties that remain. This is the third instance so far in a young 2015 that the Dividend Cushion ratio warned of a dividend cut that was realized. Last month, the Dividend Cushion ratio revealed the significant risks related to Peabody (BTU) and Cliffs Natural (CLF), and both slashed their payouts, much to the dismay of income investors.

If you are not yet familiar with the Dividend Cushion ratio, please be sure to read up on the topic. I haven't seen anything that comes close to its predictive value in assessing the financial risks related to a company's dividend.

The Price-to-Earnings Ratio Demystified

By Brian Nelson, CFA

A version of this article first appeared on our website June 9, 2013.

I was recently reading an article about the price-to-earnings (PE) ratio. The article made it sound like the PE ratio was the holy grail of investing, and if investors just used it simplistically and liberally, they'd be well on their way to knowing everything there is to know about valuation.

First, I was saddened. The article had significant reach, and having trained hundreds of equity and credit analysts across three continents, I know that instructing investors on how to 'unlearn' the wrong ways of thinking about things is a lot harder than molding a fresh thinker into a great investment professional.

Please see *The Price-to-Earnings Ratio…*on next page

*The Price-to-Earnings Ratio…*from previous page

Second, I was overwhelmed. I suddenly remembered that, in the many years I have been in this business, I had come across dozens of articles just like the one I had read. It got me thinking about how difficult it must be for a pure, open-minded investor to find good information to absorb. I believe the financial industry has now become more about what a select few with large distribution networks think than what actually is the truth. How can Valuentum get these investors the correct and complete information?

And then I became worried. What if investors, after reading the article I just read, scoop up every low-PE stock out there, thinking that they had found the secret to perpetual outperformance in the stock market? After all, the market has practically gone straight up since the generational bottom in March 2009, so investors might be drawn in and associate a low PE with continued strong performance.

I'm hoping that conveying Valuentum's views on the construction of the PE ratio will help investors of all types.

The Price-to-Earnings Ratio Demystified

The price-to-earnings (PE) ratio seems so easy, right? The trailing PE is just the price per share of the stock divided by the annual net diluted earnings per share the firm generated in its last fiscal (calendar) year. The forward PE is the price per share of the stock divided by next fiscal (calendar) year's annual net diluted earnings per share of the firm (or the forward 12-month period).

The PE is probably the most common measure to help investors compare how cheap or expensive a firm's shares are, as stock prices, for lack of a better term, are arbitrary. For example, firms like Warren Buffett's Berkshire Hathaway (BRK.A), which has never split its stock, have traded as high as $190,000 per share, while other well-known companies like Sprint (S) can trade for just a few bucks per share. And Citigroup (C) was once a penny stock before its 10-to-1 reverse split in 2011. Apple (AAPL) is probably the most recent example. The company effected a 7:1 stock split June 2014.

It's only when investors compare a firm's share price to its annual net diluted earnings per share that they can get a sense for whether a company's shares are expensive (overvalued, overpriced) or cheap (undervalued, underpriced). The higher the PE, the more expensive the company's stock--all else equal. This seems way too simple, so why would we (or better yet, how could we) devote so much time to talking about such a basic financial concept? Well, the truth is that the PE ratio is not as simple as you think (and even some of the most seasoned investors continue to use this powerful multiple incorrectly).

How the PE Ratio Is Used Incorrectly

As Valuentum members know, the second pillar of our Valuentum Buying Index™ considers a company's forward PE ratio by comparing this measure to that of its industry peers to determine if the company is trading at a comparatively attractive valuation. *The forward PE in the 16-page stock reports represents the company's current stock price divided by its forward earnings per share.* If the firm's PE is lower than its peer median, an investor is paying less per unit of earnings than the median of its peer group. Investors are getting a good deal in this case, all else equal, right? Well, **the problem is that companies are never equal**, and even comparisons among firms that are in the same industry can be misleading.

Please see *The Price-to-Earnings Ratio…*on page 13

Stocks with High Valuentum Buying Index Ratings and Strong Dividend Growth Prospects

By Valuentum Analysts

The table below showcases firms in our coverage universe that have high Valuentum Buying Index™ ratings and strong dividend growth prospects. The table represents a list of interesting dividend-paying stocks that are *among* the most timely dividend growth ideas based on our stock-selection methodology. You'll see that many of them are already holdings in our Dividend Growth portfolio (see page 5).

Though our dividend-growth portfolio is near fully-invested, we may swap in firms on this list or firms on our dividend-growth watch list (see the next page) at the right price or if our analyst team determines that a new add has more potential total return opportunity than a current holding. At any time, however, our favorite dividend growth ideas are included in the Dividend Growth portfolio.

Name	Symbol	Industry	Div Yield	VBI	Div Growth	Div Cushion
Corrections Corp	CXW	Management Services	5.5%	7	EXCELLENT	1.3
Universal Health Realty	UHT	REIT - Healthcare	5.0%	6	GOOD	2.2
Reynolds American	RAI	Tobacco	4.6%	7	GOOD	1.1
LTC Properties	LTC	REIT - Healthcare	4.6%	6	EXCELLENT	1.6
Meridian	VIVO	Diagnostic Substances	4.5%	7	GOOD	1.7
Verizon	VZ	Telecom Services - diversified	4.4%	7	GOOD	2.0
Realty Income Corp	O	REIT - Retail	4.4%	6	EXCELLENT	2.0
Courier Corp	CRRC	Book Publishing	4.3%	6	GOOD	2.3
Rio Tinto	RIO	Mining - diversified	4.2%	6	EXCELLENT	1.9
Altria Group	MO	Tobacco	4.2%	6	GOOD	1.1
Healthcare Realty Trust	HR	REIT - Healthcare	4.2%	6	GOOD	2.1
Ventas	VTR	REIT - Healthcare	4.1%	6	EXCELLENT	1.6
Entergy	ETR	Utilities - Large	4.0%	6	GOOD	1.5
Retail Properties of America	RPAI	REIT - Retail	3.8%	6	EXCELLENT	2.8
Unilever N.V.	UN	Food Products - Large	3.8%	7	EXCELLENT	1.3
Unilever PLC	UL	Food Products - Large	3.7%	7	EXCELLENT	1.3
General Electric	GE	Conglomerates	3.7%	7	GOOD	2.0
Computer Prog and Syst	CPSI	Medical Srvc Providers	3.6%	6	EXCELLENT	1.6
DDR	DDR	REIT - Retail	3.6%	6	EXCELLENT	2.5
Thomson Reuters Corp	TRI	Securities Research	3.5%	7	GOOD	1.2
Ameren	AEE	Utilities	3.5%	6	GOOD	1.5
American Eagle	AEO	Retail - Under 30	3.5%	6	EXCELLENT	2.4
Paychex	PAYX	Staffing Services	3.4%	6	EXCELLENT	2.9
Pfizer	PFE	Pharmaceuticals - Big	3.4%	6	GOOD	2.2
General Motors	GM	Auto Manufacturers	3.4%	6	GOOD	3.2
Clorox	CLX	Household Products	3.3%	6	GOOD	1.1
Coach	COH	Luxury - Ultra & Aspirational	3.2%	6	EXCELLENT	2.1
Hasbro	HAS	Leisure	3.2%	6	EXCELLENT	1.9
Lexmark	LXK	Computer Hardware	3.2%	6	EXCELLENT	2.6
Olin Corp	OLN	Chemicals - mid/small	3.2%	7	GOOD	1.4
Lockheed Martin	LMT	A&D Prime	3.1%	6	EXCELLENT	1.7
Sysco	SYY	Food Retailers	3.1%	6	GOOD	1.5
GameStop	GME	Specialty Retailers	3.0%	6	EXCELLENT	3.4
Procter & Gamble	PG	Household Products	3.0%	7	EXCELLENT	1.7
Cisco	CSCO	Networking Equipment	3.0%	9	EXCELLENT	3.4
Cracker Barrel	CBRL	Restaurants - Fast Cas & Full Svc	3.0%	6	GOOD	1.4

At any time, our favorite dividend growth ideas are included in the Dividend Growth portfolio, page 5.

The Dividend Growth Watch List

By Valuentum Analysts

The dividend growth watch list, which is proprietary to the Dividend Growth Newsletter, showcases firms commonly held in many dividend growth portfolios. As with the list on the previous page, we may replace firms held in the Dividend Growth portfolio (see page 5) with companies found in the table below should their dividend growth potential (and/or total return potential) become relatively more attractive than portfolio constituents'. We find tremendous value in keeping track of dividend growth firms in order to better monitor ideal entry points. We continue to scour our coverage universe for firms to add to our dividend growth watch list, which we update in every edition of our Dividend Growth Newsletter.

DIVIDEND GROWTH WATCH LIST - as of March 1, 2015

Company Name	Yrly Div's Paid ($)/Shr	Div Yield %	Div Cushion™	Div Safety	Div Growth	Fair Value	VBI Score	Price/Fair Value	Price ($)
3M (MMM)	4.10	2.43%	1.6	GOOD	EXCELLENT	$134.00	6	1.26	168.65
Abbott (ABT)	0.96	2.03%	3.2	EXCELLENT	GOOD	$43.00	3	1.10	47.37
AbbVie (ABBV)	2.04	3.37%	1.9	GOOD	EXCELLENT	$71.00	3	0.85	60.50
ADP (ADP)	1.96	2.21%	6.0	EXCELLENT	EXCELLENT	$94.00	3	0.95	88.84
Analog Devices (ADI)	1.60	2.73%	2.8	EXCELLENT	EXCELLENT	$52.00	3	1.13	58.54
Becton, Dickinson (BDX)	2.40	1.64%	2.5	GOOD	EXCELLENT	$108.00	3	1.36	146.72
Bob Evans (BOBE)	1.24	2.12%	1.7	GOOD	EXCELLENT	$46.00	4	1.27	58.58
Boeing (BA)	3.64	2.41%	2.5	GOOD	EXCELLENT	$141.00	6	1.07	150.85
Chicago Rivet (CVR)	0.72	2.11%	2.9	EXCELLENT	GOOD	$33.00	3	1.03	34.08
Coca-Cola (KO)	1.32	3.05%	1.7	GOOD	EXCELLENT	$37.00	6	1.17	43.30
Colgate-Palmolive (CL)	1.52	2.15%	1.9	GOOD	EXCELLENT	$56.00	3	1.26	70.82
Collectors Universe (CLCT)	1.40	6.15%	1.4	GOOD	GOOD	$20.00	3	1.14	22.77
Cracker Barrel (CBRL)	4.00	2.65%	1.4	GOOD	GOOD	$130.00	6	1.16	151.03
Deere (DE)	2.40	2.65%	1.9	GOOD	EXCELLENT	$88.00	6	1.03	90.60
Dover (DOV)	1.60	2.22%	2.1	GOOD	EXCELLENT	$77.00	4	0.94	72.05
DuPont (DD)	1.88	2.41%	2.1	GOOD	GOOD	$66.00	6	1.18	77.85
Eli Lilly (LLY)	2.00	2.85%	2.0	GOOD	GOOD	$61.00	6	1.15	70.17
Exxon Mobil (XOM)	2.76	3.12%	1.3	GOOD	EXCELLENT	$85.00	3	1.04	88.54
General Dynamics (GD)	2.48	1.79%	3.6	EXCELLENT	EXCELLENT	$122.00	3	1.14	138.78
Genuine Parts (GPC)	2.46	2.56%	1.8	GOOD	EXCELLENT	$81.00	6	1.19	96.08
H&R Block (HRB)	0.80	2.34%	4.4	EXCELLENT	GOOD	$35.00	3	0.98	34.15
Harris (HRS)	1.88	2.42%	1.9	GOOD	EXCELLENT	$72.00	3	1.08	77.68
Honeywell (HON)	2.07	2.01%	3.0	EXCELLENT	EXCELLENT	$99.00	7	1.04	102.78
Hormel Foods (HRL)	1.00	1.71%	3.1	EXCELLENT	EXCELLENT	$45.00	4	1.30	58.51
IBM (IBM)	4.40	2.72%	2.4	GOOD	EXCELLENT	$170.00	6	0.95	161.94
Illinois Tool Works (ITW)	1.94	1.96%	2.6	GOOD	EXCELLENT	$82.00	6	1.21	98.86
Kimberly-Clark (KMB)	3.52	3.21%	1.3	GOOD	EXCELLENT	$103.00	4	1.06	109.66
Lockheed Martin (LMT)	6.00	3.00%	1.7	GOOD	EXCELLENT	$169.00	6	1.18	200.05
Mattel (MAT)	1.52	5.78%	1.3	GOOD	EXCELLENT	$36.00	4	0.73	26.32
Merck (MRK)	1.80	3.07%	2.2	GOOD	GOOD	$54.00	6	1.08	58.54
Northrop Grumman (NOC)	2.80	1.69%	2.8	EXCELLENT	EXCELLENT	$137.00	6	1.21	165.71
Occidental Petrol (OXY)	2.88	3.70%	1.3	GOOD	EXCELLENT	$78.00	3	1.00	77.88
Owens & Minor (OMI)	1.01	2.83%	1.7	GOOD	EXCELLENT	$33.00	4	1.08	35.66
Paychex (PAYX)	1.52	3.05%	2.9	EXCELLENT	EXCELLENT	$42.00	6	1.19	49.83
Phillip Morris (PM)	4.00	4.82%	1.0	GOOD	GOOD	$86.00	4	0.96	82.96
Raytheon (RTN)	2.42	2.22%	2.8	EXCELLENT	EXCELLENT	$92.00	6	1.18	108.77
St. Jude (STJ)	1.16	1.74%	2.9	EXCELLENT	EXCELLENT	$70.00	4	0.95	66.68
Texas Instr (TXN)	1.36	2.31%	1.6	GOOD	EXCELLENT	$41.00	3	1.43	58.80
United Technologies (UTX)	2.56	2.10%	1.9	GOOD	EXCELLENT	$119.00	7	1.02	121.91
UPS (UPS)	2.92	2.87%	2.0	GOOD	EXCELLENT	$102.00	6	1.00	101.73
VF Corp (VFC)	1.28	1.67%	2.3	GOOD	EXCELLENT	$63.00	7	1.22	76.66
Verizon (VZ)	2.20	4.45%	2.0	GOOD	GOOD	$56.00	7	0.88	49.45
Walgreen (WBA)	1.35	1.62%	2.0	GOOD	EXCELLENT	$69.00	6	1.20	83.08
Wal-Mart (WMT)	1.96	2.34%	1.5	GOOD	EXCELLENT	$75.00	6	1.12	83.93

UR = Under Review

Yields to Avoid

By Valuentum Analysts

As many investors know, firms can often become cheap for good reasons. That is, they are not trading cheaply because of Mr. Market's irrational behavior, but instead are trading at depressed levels due to deteriorating underlying fundamental characteristics that actually justify its current share price, even if traditional valuation techniques suggest the firm's shares are inexpensive. On a similar note, firms that boast high dividend yields may do so because the market has little confidence in the sustainability of its dividend and believes a cut may be just around the corner.

Though we fall short of saying the following list of firms will slash their respective dividends anytime soon, our dividend-cut predictive indicator—the Valuentum Dividend Cushion™--indicates that the firms below are at significant risk for a dividend cut in coming years. We think the dividend-growth investor should steer clear of the following firms' shares:

Name	Symbol	Industry	Est Div Yield	Div Safety	Div Cushion
Range Resources	RRC	Independent Oil & Gas	0.3%	VERY POOR	-16.1
Ryder System	R	Rental and Leasing	1.6%	VERY POOR	-14.1
D. R. Horton	DHI	Homebuilders	1.0%	VERY POOR	-12.4
CONSOL Energy	CNX	Industrial Minerals	0.7%	VERY POOR	-10.7
Yamana Gold	AUY	Metals & Mining - gold	1.5%	VERY POOR	-10.6
Chesapeake	CHK	Independent Oil & Gas	1.8%	VERY POOR	-8.0
Cablevision	CVC	Media - CATV	2.9%	VERY POOR	-7.7
Peabody Energy	BTU	Industrial Minerals	*cut*	VERY POOR	*cut*
Barrick Gold	ABX	Metals & Mining - gold	1.6%	VERY POOR	-7.3
Pioneer Natural Resources	PXD	Independent Oil & Gas	0.1%	VERY POOR	-6.0
Tidewater	TDW	Energy Equipment	3.0%	VERY POOR	-5.3
Roundy's Inc	RNDY	Food Retailers	14.5%	VERY POOR	-5.3
Cliffs Natural Resources	CLF	Mining - diversified	*cut*	VERY POOR	*cut*
Newmont Mining	NEM	Metals & Mining - gold	0.4%	VERY POOR	-4.7
Textainer	TGH	Rental and Leasing	5.6%	VERY POOR	-3.9
Apache	APA	Independent Oil & Gas	1.6%	VERY POOR	-3.4
TAL Intl	TAL	Rental and Leasing	7.0%	VERY POOR	-3.4
MDC	MDC	Homebuilders	4.0%	VERY POOR	-3.2
Service Corp Intl	SCI	Personal Services	1.5%	VERY POOR	-2.6
Quad/Graphics Inc	QUAD	Book Publishing	6.1%	VERY POOR	-2.1
Windstream	WIN	Telecom Services - diversified	10.0%	VERY POOR	-1.9
Noble Energy	NBL	Independent Oil & Gas	1.5%	VERY POOR	-1.9
Murphy Oil	MUR	Refiners	2.5%	VERY POOR	-1.6
Frontier Comm	FTR	Telecom Services - diversified	5.8%	VERY POOR	-1.5
DineEquity	DIN	Restaurants - Fast Cas & Full Svc	3.2%	VERY POOR	-1.5
Time Warner Cable	TWC	Media - CATV	2.0%	VERY POOR	-1.5
Centurylink	CTL	Telecom Services - diversified	5.3%	VERY POOR	-1.4
Cimarex	XEC	Independent Oil & Gas	0.6%	VERY POOR	-1.2
ConAgra Foods	CAG	Food Products - Large	2.7%	VERY POOR	-1.0
Regal	RGC	Movie Production	4.6%	VERY POOR	-1.0

The Valuentum Dividend Cushion™ has an excellent track record of predicting dividend cuts. For more information, please select the following link (login required):

http://www.valuentum.com/articles/20130528

*The Price-to-Earnings Ratio…*from page 9

It is also inappropriate for investors to apply a firm's historical median (or average) price-to-earnings ratio to the same firm's future earnings stream. But why? It's the same stock. Shouldn't it be relevant and applicable? Well, yes and no. First, it's great for investors to have an idea of what "multiple range" a company has traded at in the past – there's a lot of value to this, and most relevant for cyclical firms (mainly industrials) that may, from a fundamental standpoint, exhibit similar (but not identical) patterns with respect to both earnings and their PE through the course of each economy cycle: think Boeing (BA) and the commercial aerospace cycle; Ford (F) and consumer demand for auto sales; or United Continental (UAL) with respect to premium air travel demand. But for less-cyclical firms (and even for cyclicals where structural industry dynamics have altered over time), investors are wrongly assuming that the forward outlook of the past (which determined the historical multiple) will be the same as the forward outlook of the present (which determines the current multiple). **This, unfortunately, is never true.**

So what is an investor to do? We know that it's imperfect to compare a firm's current or forward PE ratio to its peers or even to the median or average of its peers. No two firms are identical. And it's even more imperfect to compare a firm's current or forward price-to-earnings ratio to its historical measure. Look at Apple's outlook in 2002 versus its outlook in 2009 – a lot different, would you say? One wouldn't apply the same multiple to Apple's earnings in both years, or if you did, it would be for different reasons/underlying factors. We also believe that comparing a firm's PE to the average market multiple is imprecise. A firm is simply different than the aggregate market, so how can this comparison be significantly relevant?

Why Do We Use the PE Ratio

Okay, you may then ask: why does Valuentum use a PE ratio at all in its process if the measure is so imperfect? The answer rests in what drives stock prices. Not all investors use a discounted cash-flow process to value equities, and as a result, they resort to the short-form PE ratio to make decisions. There exists, as a result, what we'd describe to be *self-fulfilling* market forces (buying and selling) that make the price-to-earnings ratio a meaningful consideration.

In other words, if Portfolio Manager A likes a stock because its PE ratio is trading at the lower end of its historical PE valuation range or is trading at a discount to its peers' average PE, he/she might buy it, and this buying pressure itself causes the stock to rise, therefore making the PE in this form a relevant consideration for investors. This idea hits at the heart of the Valuentum process--striving to have a complete understanding of all market forces (investment philosophies) that drive stock prices, such that we can capitalize on them for members. For this reason, we include a relative value assessment in the Valuentum Buying Index, and the forward PE and PEG (price-earnings-to-growth) ratios, more specifically.

Cash Flows Tell a More Accurate Story

So, with that said, how do we look at the PE? Valuentum followers know that we use a discounted cash-flow valuation process (the first pillar of our Valuentum Buying Index) to uncover the intrinsic worth of every company in our coverage universe. Okay, now you may ask: "Why do you use a free cash flow model when stock prices are driven by earnings?" After all, we just defined the stock price as a function of its earnings and a P/E multiple (the share price divided by net diluted earnings per share is the PE)? Well, yes. But earnings are a component of cash flow, and evaluating future free cash flows has its benefits.

Please see *The Price-to-Earnings Ratio…*on next page

*The Price-to-Earnings Ratio…*from previous page

For starters, the variations between earnings and cash flow not only arise in working capital changes over time (their influence on a firm's cash flow from operations), but also in the timing of the cost of replacing those assets that generate earnings (capital expenditures versus depreciation). Plus, varying levels of interest rates paid on debt loads can also muddy the water on earnings – not to mention that there are various analytical ways to account for rent expense (whether to capitalize such assets or to allow the expense to flow through the operating line). So there are some major differences between assessing a company's value based on earnings versus based on using a discounted cash-flow model. And because earnings quality (are earnings being converted to cash flow?) and capital efficiency (how much capital needs to be plowed back into the firm to maintain earnings) are critical to assessing the health of a company and its valuation, using free cash flow to evaluate companies is a better, more comprehensive process.

The PE Ratio is a Driver Behind Valuation

As we outlined above, a PE ratio is traditionally calculated from a company's stock price and its earnings to determine if the stock is cheap or expensive. For example, if a firm is trading at $100 per share and its net diluted earnings-per-share for next year is $10, the firm is trading at 10 times forward earnings. Many investors may say this stock is cheap in comparing it to the market multiple of ~13-15 times forward earnings. We've addressed the pitfalls of doing so above. While the PE is an output in this analysis, the discounted cash-flow model makes PE an input in solving what the firm *should* be trading at on the basis of its unique fundamentals.

The cash-flow derived PE represents the difference between saying a firm is trading at 20 times earnings and saying a firm *should* be trading at 20 times earnings. A stock trading at 20 times may be cheap or expensive in the first case, but we know that a stock trading at 20 times is fairly valued in the second. In order to uncover which PE multiple is most appropriate to place on a firm's earnings stream (its net diluted earnings per share), we must use a discounted cash flow process.

By calculating the present value of a company's future enterprise free cash flows (free cash flows to the firm), considering the firm's net balance sheet impact (cash less debt) and making other adjustments, one arrives at the company's intrinsic equity value. In dividing intrinsic equity value by diluted shares outstanding, the investor then arrives at equity value per share. Taking this equity value per share and dividing it by next fiscal year's earnings of the firm leaves you with the forward price-to-earnings (P/E) ratio. Because a discounted cash-flow process captures the unique intricacies of the exact firm one is modeling at the exact time one is modeling it (and taking into consideration all future factors at the time), it is far superior to any relative peer or historical PE multiple analysis.

Why We're Fans of the Discounted Free Cash Flow Model

By now, you can probably see why we're such big fans of using a discounted free cash flow valuation model. Though there are many, many ways of looking at a stock—in fact, varying perspectives remain core to our process—using a free cash flow process is perhaps the only way investors can truly arrive at the "correct" intrinsic PE multiple to place on a company's earnings.

Please see *The Price-to-Earnings Ratio…*on next page

*The Price-to-Earnings Ratio…*from previous page

Let's examine this even further. Have you ever wondered why capital-light companies (software, advertising companies) garner higher earnings multiples than capital-intensive companies (auto manufacturers)? Well, capital-intensive companies have to re-invest a significant amount of earnings back into their businesses, thereby reducing future free cash flow, and by extension, the PE multiple that investors are willing to pay for that earnings stream. Simply put, not all earnings streams are created equal--even given equivalent future expected growth trajectories in them. Investors should prefer the earnings stream in this case that requires the least amount of re-invested maintenance capital.

The discounted cash-flow process is also going to uncover situations where the health of a firm's balance sheet will impact the correct PE multiple to place on a company's earnings stream. For example, all else equal, firms with billions in net cash should garner higher PE multiples than firms with billions in net debt. The net balance sheet position is captured in a discounted cash-flow process, but it is not readily apparent in any PE multiple assessment that only considers a firm's stock price and its earnings per share.

Nuts & Bolts

At this point, we hope that we have at least convinced you to be careful about arbitrarily placing a PE multiple on a firm's earnings to arrive at a target price (fair value). Even if that multiple is based on historical ranges (medians or averages) or is comparable to industry peers or the market as a whole, investors fall short of capturing the uniqueness of a company's future cash flow stream and balance sheet via a discounted cash flow process, which considers all of the qualitative factors of a company--from a competitive assessment to the company's efficiency initiatives and beyond. Using a discounted free cash flow model forces investors to think about the key valuation drivers of a company long into the future, thereby reinforcing forward-looking analysis and a critical understanding of what we'd describe as needle-moving inputs (revenue, WACC, etc.).

Without further delay, below is our complete definition of the PE ratio. This is the PE ratio that drives what a company *should* be trading at on the basis of its firm-specific fundamentals. You'll notice that the PE ratio is forward-looking and considers a variety of different components:

Forward Price to Earnings Ratio =

{[(Sum of Discounted Future Enterprise Free Cash Flows – Total Debt – Preferred Stock + Total Cash)/Shares Outstanding]/ Next Fiscal Year's Earnings Per Share}

Upon examination of the definition of the PE ratio above, one can see that a PE ratio is a short-form discounted cash-flow model. The numerator defines how one calculates the fair value estimate of a company's shares, while the denominator uses expected net diluted earnings per share. The discounted cash-flow process solves what a firm's shares *should* be trading at -- it represents the multiple that is applied to the company's earnings: the PE multiple.

What Are the Drivers of a Firm's Stock Price?

Because the PE ratio is also a function of the price of a stock as we outlined at the very beginning of this article (stock price divided by earnings), the factors of a discounted cash-flow model, the numerator of the definition above, are also the drivers behind the firm's stock price.

Please see *The Price-to-Earnings Ratio…*on next page

*The Price-to-Earnings Ratio…*from previous page

Below, we show how a number of qualitative factors influence the PE multiple and (by extension) stock prices and whether each factor is positively or negatively correlated to a company's intrinsic value and stock price. You'll notice the list is much more comprehensive than what many investors point to as the main reason for different PE ratios.

Revenue Growth: Impacts Future Enterprise Cash Flows (Mostly Positive)

Operating Earnings Growth: Impacts Future Enterprise Cash Flows (Positive)

Taxes: Impacts After-tax Earnings; Cost of Debt (Mostly Negative)

Capital Expenditures: Impacts Future Enterprise Cash Flows (Negative)

Return on Invested Capital (ROIC): Function of Operating Earnings and Net New Investment, Capital Expenditures (Positive)

Risk-free Rate, 10-year Treasury: Impacts WACC (Negative)

Discount Rate (WACC): Impacts Present Value of Enterprise Cash Flows (Negative)

Total Debt: Impacts Enterprise Value and Discount Rate (Mostly Negative)

Preferred Stock: Impacts Enterprise Value and Discount Rate (Mostly Negative)

Total Cash: Impacts Enterprise Value (Positive)

Shares Outstanding: Changes in Shares Outstanding (Neutral, assuming reinvestments' ROIC equal the firm's WACC)

Key Takeaways

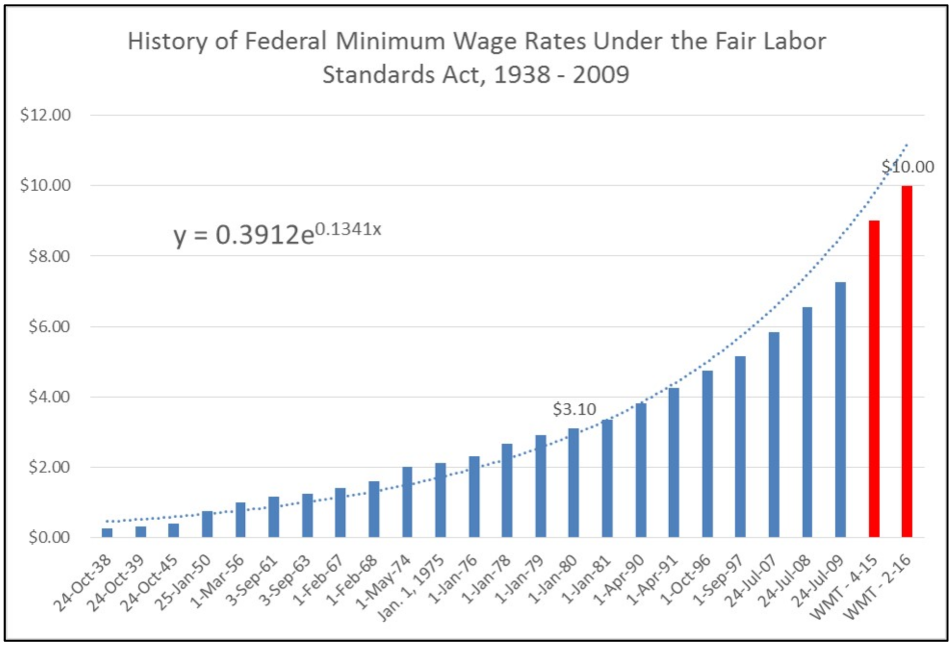
The key takeaways are: 1) without using a discounted cash-flow model, the PE ratio that *should* be applied to a company's earnings stream can never be appropriately calculated, and by extension, 2) when investors assign an arbitrary price-to-earnings multiple to a company's earnings (based on historical trends or industry peers or the market multiple), they are essentially making estimates for all of the drivers behind a discounted cash-flow model in one fell swoop (and sometimes hastily).

As earnings for next year are often within sight and can be estimated with some confidence (though this certainly varies among firms), calculating the price-to-earnings ratio, in our opinion, is of far greater importance than worrying about whether a firm will beat or miss earnings in its next fiscal year. Because the PE ratio is a discounted cash-flow model that considers the long-term qualitative dynamics of a particular entity, cash-flow analysis remains the first and most important pillar of our Valuentum Buying Index.

And finally, investors cannot ignore valuation analysis or the future. Valuation is an important driver behind stock prices, and it is based on future expectations that can only be estimated. This is just a fact of the markets. Thank you for reading.

10 Bucks per Hour; What It Really Means

By Brian Nelson, CFA



Source: US Department of Labor, Walmart

Walmart (WMT)—2.3% annual dividend yield—is quite savvy. The big box retailer announced February 19 it would raise the minimum wage for all of its US workers to $9 per hour in April of this year and at least $10 per hour by next February. The move comes amid ongoing public scrutiny of its labor practices, elevated worker turnover, and general malaise among the ranks on social media platforms. At face value, the news headlines show Walmart caving to public pressure, and a win for big labor, but in reality, the retailing giant is merely doing what good businesses do – pleasing customers (which are its workers, too) and widening its economic moat.

Hiking wages accomplishes both.

By our estimates, Walmart will experience a negligible negative monetary impact from this act of "goodwill" that will affect several thousand of its employees. In fact, the effect may actually be a positive one. In a job market where skilled and dedicated labor is becoming more difficult to find, in hiking wages, the company will be better able to keep its best talent, and perhaps reduce training costs from the resulting lower turnover. The cost of a job position isn't only measured in the wage for that position, but in all the time that supervisors spend in training the person for that role. Costco (COST)—1.0% annual dividend yield—has put this concept into practice for some time, using higher wages to build worker loyalty, thereby reducing hefty recurring training costs.

Hiking minimum wage also widens Walmart's economic moat. Walmart knows its greatest competitive advantage rests in scale and purchasing power, and the way to ensure such dominance long into the future is to make it prohibitively more expensive for new entrants to achieve the same thing.

Please see *10 Bucks per Hour…*on next page

*10 Bucks per Hour...*from previous page

If federal lawmakers use Walmart's expected future wage hikes as the baseline for new federal statutes governing minimum wage, franchisees and small businesses across the country may feel irreversible pain. The only ones that lose in this game are the small mom and pop businesses that can't afford higher labor costs, or the start-up that can no longer compete due to its higher marginal cost curve. Innovation and competition are therefore stifled as the mandatory minimum wage is hiked.

But it's only a few bucks per hour, right? How much could it possibly hurt?

A lot. One doesn't have to look very far today to see disgruntled workers picketing and "striking" for $15 per hour wages, and it's possible we may eventually get to a mid-teens minimum wage this decade, if not, the next. The strength of labor today has probably never been stronger given dislocations brought about by the Great Recession. Workers are staying in the job market longer, and as a result, millennials, disgruntled by the lack of opportunities, are resorting to social movements to alter the course of their wage profiles. Though employment levels are "full," underemployment (employees not working a job in their field of expertise, for example) is still rather elevated.

If increases in the minimum wage since the adoption of the Fair Labor Standards Act in 1938 truly fit an exponential curve going forward as they have in the past, we simply haven't seen anything yet. Real inflation-adjusted minimum wage increases over the next 75 years or so *will be staggering*, and only then will we see the frightening path of labor costs that Walmart has set. If lawmakers choose to use its trajectory as a guide, restaurants and merchandise retailers and beyond will certainly feel the impact in the many decades ahead (and during the troughs of the economic cycle), even if they are spared of profit pressure during good times.

Only those entities with the strongest pricing power are best equipped to navigate such a market environment, and we'd only expect bigger companies to "get bigger" as entry barriers become incrementally more difficult to overcome for greenfield start-ups as a result of the higher labor expenses.

Gold is But a Shiny Yellow Metal

By Brian Nelson, CFA

"What motivates most gold purchasers is their belief that the ranks of the fearful will grow. During the past decade that belief has proved correct. Beyond that, the rising price has on its own generated additional buying enthusiasm, attracting purchasers who see the rise as validating an investment thesis. As 'bandwagon' investors join any party, they create their own truth – for a while." -- Warren Buffett (2011 annual letter to shareholders)

Gold prices have been under pressure for years, and now they've given up all their modest gains in 2015.

I'm always uncomfortable talking about the investment prospects of gold (GLD). It's a sensitive issue. My opinion, like that of Warren Buffett's, is rather unpopular. For one, there are readers out there that have stocked up on gold coins, buying into those fancy "convincing" infomercials that we see in the wee hours of the morning on television, just in case of the coming financial apocalypse, or so they warn.

We're taught that gold is somehow, someway a hedge against global inflation, but yet besides some loose historical price correlations (brought about by learned buyer behavior), there's no fundamental reason why buying a shiny yellow metal will help offset potentially weaker purchasing power of paper money. Mr. Nixon stopped the conversion of the US dollar, the world's favorite reserve currency, into gold in 1971. It's been more than 40 years.

Please see *Gold...*on next page

*Gold...*from previous page

With no tangible conversion rate to the US dollar, gold coins are simply collectibles, just like baseball cards and comic books. There is no cash-flow-derived intrinsic value; they don't pay dividends, and their value is only in the eye of the beholder. Investors only think gold is worth something in the same way that investors think Mickey Mantle's rookie baseball card is worth something and the first appearance of Superman in a comic book is worth something. Gold "collecting" is simply a hobby.

Please stop watching those infomercials!

A person buying gold, in any form, is playing the game of "greater fools." He or she is hoping that a "greater fool" will eventually in the future buy the yellow metal from him or her at an ever higher price. This is different than buying a company, which generates earnings and pays out dividends to shareholders. I know my opinion on gold is an unpopular one, but just so you know I'm not off my rocker, let's take a look at what the Oracle of Omaha said in his 2011 annual letter to shareholders:

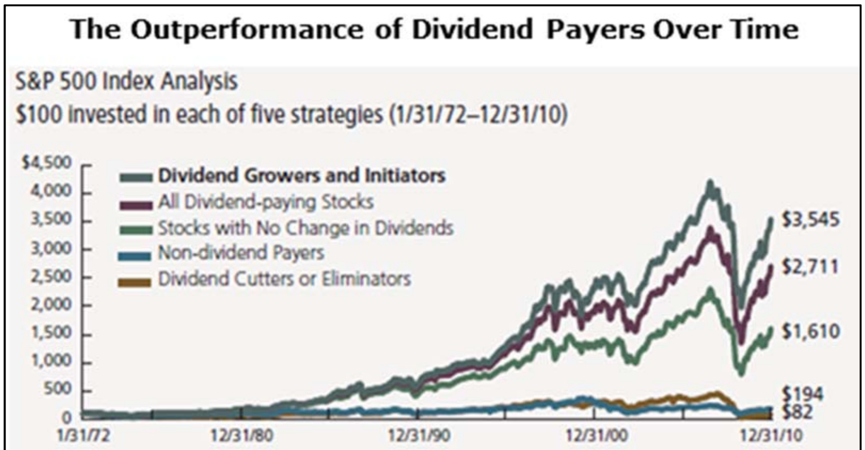
> "Today the world's gold stock is about 170,000 metric tons. If all of this gold were melded together, it would form a cube of about 68 feet per side. (Picture it fitting comfortably within a baseball infield.) At $1,750 per ounce...its value would be about $9.6 trillion. Call this cube pile A.
>
> Let's now create a pile B costing an equal amount. For that, we could buy all U.S. cropland (400 million acres with output of about $200 billion annually), plus 16 Exxon Mobils (the world's most profitable company, one earning more than $40 billion annually). After these purchases, we would have about $1 trillion left over for walking-around money (no sense feeling strapped after this buying binge). Can you imagine an investor with $9.6 trillion selecting pile A over pile B?"
>
> ...A century from now the 400 million acres of farmland will have produced staggering amounts of corn, wheat, cotton, and other crops – and will continue to produce that valuable bounty, whatever the currency may be. Exxon Mobil will probably have delivered trillions of dollars in dividends to its owners and will also hold assets worth many more trillions (and, remember, you get 16 Exxons). The 170,000 tons of gold will be unchanged in size and still incapable of producing anything. You can fondle the cube, but it will not respond.
>
> Admittedly, when people a century from now are fearful, it's likely many will still rush to gold. I'm confident, however, that the $9.6 trillion current valuation of pile A will compound over the century at a rate far inferior to that achieved by pile B."

Mr. Buffett has it right. Read up on the greater fool theory! And beware of those gold peddlers.

About the Valuentum Dividend Cushion™

By Valuentum Analysts

History has revealed that the best performing stocks during the previous decades have been those that shelled out ever-increasing cash to shareholders in the form of dividends. In a recent study, S&P 500 stocks that initiated dividends or grew them over time registered roughly a 9.6% annualized return since 1972 (through 2010), while stocks that did not pay out dividends or cut them performed poorly over the same time period.



Source of the chart data: Ned Davis Research, 12/31/10. Image Source: Capital Markets Perspectives, "Investing for Dividend Growth", Oppenheimer Funds. Based on an equal-weighted geometric average of total return of dividend-paying historical S&P 500 Index stocks, rebalanced annually. The chart uses actual annual dividends to identify dividend-paying stocks and changes on a calendar-year basis. Past performance does not guarantee future results.

Such analysis is difficult to ignore, and we believe investors may be well-rewarded in future periods by finding the best dividend-growth stocks out there. As such, we've developed a rigorous dividend investment methodology that uncovers firms that not only have the safest dividends but also ones that are poised to grow them long into the future.

How did we do this? Well, first of all, we scoured our stock universe for firms that have cut their dividends in the past to uncover the major drivers behind the dividend cut. This is what we found out: The major reasons why firms cut their dividend had to do with preserving cash in the midst of a secular or cyclical downturn in demand for their products/services or when faced with excessive leverage (how much debt they held on their respective balance sheets).

The Importance of Forward-Looking Dividend Analysis

Armed with this knowledge, we developed the forward-looking Valuentum Dividend Cushion™, which is a ratio that gauges the safety of a dividend over time.

Most dividend analysis that we've seen out there is backward-looking – meaning it rests on what the firm has done in the past. Although analyzing historical trends is important, we think assessing what may happen in the future is even more important. The S&P 500 Dividend Aristocrat List, or a grouping of firms that have raised their dividends for the past 25 years, is a great example of why backward-looking analysis can be painful. One only has to look over the past few years to see the removal of well-known names from the Dividend Aristocrat List (including General Electric and Pfizer) to understand that backward-looking analysis is hardly worth your time. After all, you're investing for the future, so the future is all you should care about.

Please see *About Our Valuentum Dividend Cushion…*on next page

***About Our Valuentum Dividend Cushion…*from previous page**

We want to find stocks that will increase their dividends for 25 years into the future, not use a rear-view mirror to build a portfolio of names that may already be past their prime dividend growth years. The Valuentum Dividend Cushion™ measures just how safe the dividend is in the future. It considers the firm's net cash on its balance sheet (cash and cash equivalents less debt) and adds that to its forecasted future free cash flows (cash from operations less capital expenditures) and divides that sum by the firm's future expected dividend payments. At its core, it tells investors whether the firm has enough cash to pay out its dividends in the future, while considering its debt load. If a firm has a Valuentum Dividend Cushion™ above 1, it can cover its dividend, but if it falls below 1, trouble may be on the horizon.

In our study, the Valuentum Dividend Cushion™ process caught every dividend cut made by a non-financial, operating firm that we have in our database, except for one (Marriott). But interestingly, the Valuentum Dividend Cushion™ indicated that Marriott should have never cut its dividend, and sure enough, two years after the firm did so, it raised it to levels that were higher than before the cut.

Here are the results of the study (a Valuentum Dividend Cushion™ below 1 indicates the dividend may be in trouble). The Valuentum Dividend Cushion™ score shown in the table below is the measure in the year before the firm cut its dividend, so it represents a predictive indicator. The measure continues to do well by members in real-time as well (beyond the constraints of any academic study).

The Valuentum Dividend Cushion Caught These Dividend Cuts in Advance

A Valuentum Dividend Cushion Score Below 1 Indicates a Firm's Dividend is At Risk in the Years Ahead

Dividend Cutter	Cut Date	Dividend Cushion (Before Cut)	Reason for Dividend Cut
Avery Dennison (AVY)	31-Jul-09	0.66	Reduced dividend to support debt-reduction efforts.
ConAgra Foords (CAG)	16-Mar-06	-0.59 (1)	Restructuring, divestitures.
Constellation (CEG)	18-Feb-09	-4.36	Refocus on core business of generating and selling power.
DR Horton (DHI)	6-May-08	-0.03	Housing turmoil.
Gannett Co. (GCI)	25-Feb-09	-0.06	Excessive debt; preserve cash amid downturn of newspaper industry.
La-Z-Boy (LZB)	17-Feb-09	0.89	Suspended dividend to preserve cash amid downturn in home furnishings.
Marriott Intl (MAR)	1-May-09	2.18 (2)	Suspended dividend in the wake of weak business travel, but dividend achieved record highs again, May 6, 2011.
Masco Corp (MAS)	11-Feb-09	-0.74	Cut dividend to ensure ability to fund operations and service debt coming due.
New York Times (NYT)	20-Nov-08	0.04	Effort to preserve cash. Downturn in newspaper industry. Loss of investment-grade credit rating.
Pfizer (PFE)	26-Jan-09	0.54	Bought Wyeth to diversify revenue base. Raised $22 billion+ in debt.
Sara Lee Corp (SLE)	8-Aug-06	0.70	Streamlining operations, business unit divestitures to raise cash.
Sunoco Inc. (SUN)	6-Oct-09	-0.85 (3)	Poor margins, overseas competition.
SuperValu (SVU)	20-Oct-09	-5.78	Rising unemployment, competition from Wal-Mart, etc.
Valero Energy (VLO)	27-Jan-10	0.15	Lower demand for gas and diesel.
Vulcan Materials (VMC)	14-Oct-11	-1.42	Free up much-needed cash amid downturn in aggregate demand.

(1) Forecast period for ConAgra, 2007 through 2011.
(2) Marriott is an instance where management prematurely cut its dividend, in our opinion. The Cushion reflected little risk at the time of cut, and sure enough Marriott restored its payout to record high
(3) Forecasts adjusted to reflect Sunoco's poor free cash flow trends beyond last reported year.
Backtesting Methodology: Net balance sheet (year prior to dividend cut). Free cash flow for years beginning in year of dividend cut through reported years. If reported years do not total five, last reported year is extrapolated for remainder of forecast period. Dividends paid reflects what the dividends would be ex dividend cut.

At the very least, using the Valuentum Dividend Cushion™ can help you avoid firms that are at risk of cutting their dividends in the future. And we are the only firm out there that does this type of in-depth analysis for you. We provide the Valuentum Dividend Cushion™ score in the dividend reports and monthly Dividend Growth Newsletter, and we also scale the safety of a firm's dividend based on this measure in simple terms: Excellent, Good, Poor, Very Poor.

Please see *About Our Valuentum Dividend Cushion…*on next page

***About Our Valuentum Dividend Cushion...*from previous page**

Here's a glimpse of the Valuentum Dividend Cushion™ score (as of November 2011) for a sample set of firms in our coverage universe. Please note that the current score on these and hundreds more are available with a membership to our website:

Company Name	Dividend Cushion
Abbott Labs (ABT)	2.3
Coca-Cola (KO)	1.9
Family Dollar (FDO)	4.4
International Business Machines (IBM)	3.7
Johnson & Johnson (JNJ)	2.5
Merck (MRK)	2.5
Molex (MOLX)	2.5
Pepsi (PEP)	1.3
Proctor & Gamble (PG)	1.4
Wal-Mart (WMT)	1.4

Subscribe to Valuentum to monitor the Dividend Cushion of firms you own.

Understanding Dividend Growth

It takes time to accumulate wealth through dividends, so dividend growth investing requires a long-term perspective. We assess the long-term future growth potential of a firm's dividend, and we don't take management's word for it. Instead, we dive into the financial statements and make our own forecasts of the future to see if what management is saying is actually achievable. We use the Valuentum Dividend Cushion™ as a way to judge the capacity for management to raise its dividend – how much cushion it has – and we couple that assessment with the firm's dividend track record, or management's willingness to raise the dividend.

In many cases, we may have a different view of a firm's dividend growth potential than what may be widely held in the investment community. That's fine by us, as our dividend-growth investment horizon is often longer than others'. We want to make sure that the firm has the capacity and willingness to increase the dividend years into the future and will not be weighed down by an excessive debt load or cyclical or secular problems in fundamental demand for their products/services. We scale our dividend-growth assessment in an easily-interpreted fashion: Excellent, Good, Poor, Very Poor.

What Are the Dividend Ideas We Seek to Deliver to You in Our Newsletter?

First of all, we're looking for stocks with dividend yields that are greater than the average of the S&P 500, or about 2% (but preferably north of 3%). This excludes many names, but we think such a cutoff eliminates firms whose dividend streams aren't yet large enough to generate sufficient income. Second, we're looking for firms that register an 'EXCELLENT' or 'GOOD' rating on our scale for both safety and future potential growth. And third, we're looking for firms that have a relatively lower risk of capital loss, as measured by our estimate of the company's fair value.

The Valuentum Dividend Cushion™ has an excellent track record of predicting dividend cuts. For more information, please select the following link (login required):

http://www.valuentum.com/articles/20130528

Valuentum Dividend Growth Newsletter: Volume 4, Issue 3

Valuentum's Dividend Growth Newsletter is published monthly. To receive this newletter on a monthly basis, please subscribe to Valuentum by visiting our website at http://www.valuentum.com. Or contact us at info@valuentum.com.

Fair Value Range. The fair value range represents an upper bound and lower bound, between which we would consider the firm to be fairly valued. The range considers our estimate of the firm's fair value and the margin of safety suggested by the volatility of key valuation drivers, including revenue, gross margin, earnings before interest, and enterprise free cash flow (the determinants behind our ValueRisk™ rating).

ValueRisk™. This is a proprietary Valuentum measure. ValueRisk™ indicates the historical volatility of key valuation drivers, including revenue, gross margin, earnings before interest, and enterprise free cash flow. The standard deviation of each measure is calculated and scaled against last year's measure to arrive at a percentage deviation for each item. These percentage deviations are weighted equally to arrive at the corresponding fair value range for each stock, measured in percentage terms. The firm's performance is measured along the scale of LOW, MEDIUM, HIGH, and VERY HIGH. The ValueRisk™ rating for each firm also determines the fundamental beta of each firm along the following scale: LOW (0.85), MEDIUM (1), HIGH (1.15), VERY HIGH (1.3).

Dividend Track Record. We assess each firm's dividend track record based on whether the fundamentals of the firm have ever forced it to cut its dividend. If the firm has ever cut its dividend (within the last 10 years), we view its track record as RISKY. If the firm has maintained and/or raised its dividend each year (over the past 10 years), we view its track record as HEALTHY.

Dividend Safety. We measure the safety of a firm's dividend by adding its net cash to our forecast of its future cash flows and divide that sum by our forecast of its future dividend payments. This process results in a ratio called the Dividend Cushion™. Scale: Above 2.75 = EXCELLENT; Between 1.25 and 2.75 = GOOD; Between 0.5 and 1.25 = POOR; Below 0.5 = VERY POOR.

Valuentum Dividend Cushion™. This is a proprietary Valuentum measure that drives our assessment of the firm's Dividend Safety rating. The forward-looking measure assesses dividend coverage via the cash characteristics of the business.

Dividend Growth Potential. We blend our analysis of a firm's Dividend Safety with its historical Track Record, while also considering historical dividend growth trends. We believe such a combination captures a firm's capacity (cash flow) and willingness (track record) to raise its dividend in the future. Scale: EXCELLENT, GOOD, POOR, VERY POOR.

Risk of Capital Loss. We think capital preservation is key for the dividend investor. As such, we evalute the risk of capital loss by assessing the intrinsic value of each firm based on our discounted cash-flow process. If a firm is significantly OVERVALUED, we think the risk of capital loss is HIGH. If a firm is FAIRLY VALUED, we think the risk of capital loss is MEDIUM, and if a firm is UNDERVALUED, we think the risk of capital loss is LOW.

Dividend Strength. Our assessment of the firm's dividend strength is expressed in a matrix. If the safety of a firm's dividend is EXCELLENT and its growth prospects are also EXCELLENT, it scores high on our matrix (top right). If the firm's dividend safety and the potential future growth are VERY POOR, it scores lower on our scale (bottom left).

Excerpt from *The 13 Steps to Understand the Stock Market*

Step #12: **Valu**e and Mom**entum** Outperform Everywhere

Momentum is the biggest embarrassment to efficient markets (according to the "father of modern finance" and Nobel laureate in Economics, Eugene Fama), academic research continues to conclude that 'Value and Momentum' combined outperform in every market across every asset class, and we continue to demonstrate empirical evidence of the superiority of a combined value-momentum process in the portfolio of our Best Ideas Newsletter. Key takeaway: Value and momentum combined outperform in every market across every asset class.

-- The **Valu**-**entum** Team

For general information about Valuentum's products and services, please contact us at info@valuentum.com.