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HIGH YIELD DIVIDEND NEWSLETTER

The Fed Brings Good News

Prior changes to simulated High Yield Dividend Newsletter
Added: 10% in Vanguard Real Estate ETF (VNQ)
Removed: Huge winner in Realty Income (O)
Watching: AT&T (T), Australia ETF (EWA) Iron Mountain, Schlumberger (SLB)

INSIDE THIS ISSUE

1 The Fed Brings Good News
2 Watching Iron Mountain (IRM) Very Closely
3 Mortgage REITs Still Dangerous Income Vehicles
4 Payout Cuts and the Necessary Warnings (BPT, MMLP)
7 **Spotlight:** *NEW* Southern Company's (SO) Fiscal Discipline and Promising Growth Trajectory Supports Modest Annual Payout Growth Over the Coming Years
13 Big Bank Roundup, J.P. Morgan Kicks Off Earnings of the Banks
18 Meet President Brian Nelson in Silicon Valley
20 The High Yield Dividend Newsletter Portfolio
21 Screen of the Month – The Financially-Healthiest Dividend Payers Yielding Over 2%
22 Dividend Report Page 2 – Lockheed Martin (LMT)

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"WITH THE FED NOW ON PAUSE AND MANY EVEN CONSIDERING A RATE CUT AS A DISTINCT POSSIBILITY, WE'RE VIEWING THE DEVELOPMENTS AS GREAT NEWS FOR HIGH-YIELD DIVIDEND INVESTORS." – BRIAN NELSON, CFA

A version of this article was released to High Yield Dividend Newsletter members on April 18.

We continue to be excited about the high yield dividend space in 2019. Through the course of 2018, we were rather concerned about this investment arena given the Fed's focus on raising benchmark rates. However, much of that changed in December/January following the market's mini-crash, and now the Fed has reached the point where rate expectations seem to be much more neutral. From the recent Fed minutes:

> *"Several of these participants noted that the current target range for the federal funds rate was close to their estimates of its longer-run neutral level and foresaw economic growth continuing near its longer-run trend rate over the forecast period. Participants continued to emphasize that their decisions about the appropriate target range for the federal funds rate at coming meetings would depend on their ongoing assessments of the economic outlook, as informed by a wide range of data, as well as on how the risks to the outlook evolved.* ***Several participants noted that their views of the appropriate target range for the federal funds rate could shift in either direction based on incoming data and other developments.*** *Some participants indicated that if the economy evolved as they currently expected, with economic growth above its longer-run trend rate, they would likely judge it appropriate to raise the target range for the federal funds rate modestly later this year."*

With the Fed now on pause and many even considering a *rate cut* as a distinct possibility, we're viewing the developments as great news for high-yield dividend investors. What was once a newsletter speaking of tremendous caution with respect to the risk of capital impairment across the high-yield space (in a rising interest-rate environment) is now one that is much more optimistic about trends. Unlike 2018, during 2019, I think we'll have the Fed at our backs, and if not only the Fed, President Donald Trump, too, who wants the Fed to cut rates.

Now that is not to say that there's still not abnormal risks of investing in this area, however. For starters, a previously-removed idea Senior Housing (SNH) cut its payout April 2, but the company had been removed from the High Yield Dividend Newsletter portfolio in May 2018 in the teens, at a price *more than double what it is today (removed mostly because of its ominous share-price action)*. Remember--price declines are fundamental for high yield dividend-paying equities. Unlike the declines of net-cash rich and free-cash-flow generating powerhouses, many high-yield equities are pushing their balance sheets to the limit and free-cash-flow generation might be rather tight, implying capital-market dependence risk.

For those that missed my thoughts on the REIT versus MLP question (which is better?), please be sure to read my comments in an article by S&P Global, REITs vs MLPs: Assessing the better high-yield play: https://www.spglobal.com/marketintelligence/en/news-insights/trending/bfc2cgthOGM6XiMLzyQqyg2

I think our team has done a fantastic job nailing the trend toward C-corp conversion across the MLP space, and probably to no surprise, a previously-removed idea AmeriGas Partners (APU) was rolled up into UGI Corp (UGI) as a subsidiary (APU is no longer an MLP). What was surprising was the price, however. Had UGI not stepped in, things may have only gotten worse for AmeriGas. We can't look back on this one.

Watching Iron Mountain Very Closely

A version of this article was released to High Yield Dividend Newsletter members on April 29.

High Yield Dividend Newsletter portfolio idea Iron Mountain reported first-quarter results April 25 that showed cost pressures and an elevated debt load. We're watching this near-7% yielding company closely. Key takeaways shown below.

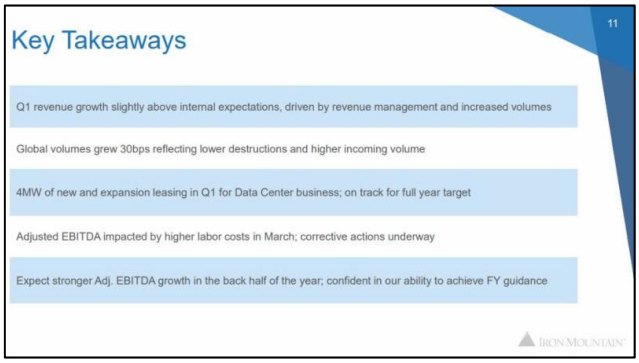


Image Source: *Iron Mountain's Q1 Slide Deck*

In an environment of ultra-low interest rates, as we still are in, high yield equals high risk, and Iron Mountain (IRM) is no exception. The storage and information management services REIT posted challenging first-quarter numbers April 25 that may have assuaged some of the concerns regarding volume, but the quarter was saddled with what management described as temporary "higher labor costs in (its) North American businesses in March."

The executive team believes it is a one-time issue and reiterated its outlook for full-year financial performance but make no mistake about it: This near-7% yielder is not for the faint of heart. The REIT is among the most shorted stocks on the market, and even sell-side brokerage outfits are casting a shadow on the firm, with a downgrade April 26. We didn't like the company's first-quarter EBITDA number of $324.5 million versus the $355+ million consensus (and $343 million from last year's quarter), but we're not overreacting.

We would expect more negative commentary in the coming weeks as a result of this miss, particularly given the firm's capital-market dependence risk. The REIT's Dividend Cushion ratio is 0.8, reflecting caution (any measure below 1 is not as healthy as we would like), and the weak ratio is primarily due to the company's huge long-term debt load. At the end of the first quarter of 2019, long-term debt alone was $8.4 billion, significantly higher than the $161 million of cash on the books. Nearly 70% is fixed-rate debt, and the company's net lease adjusted leverage stands at 5.8x.

2019 Guidance Maintained

$ in MM	2019 Guidance	2019 Guidance (midpoint)	Y/Y Change (vs. midpoint)	Constant Currency Y/Y Change [1]
Revenue	$4,200 - $4,400	$4,300	1.8%	3.3%
Adj. EBITDA	$1,420 - $1,530	$1,475	2.7%	4.1%
EPS	$1.08 - $1.18	$1.13	2.7%	3.7%
AFFO	$870 - $930	$900	3.0%	4.5%

Image Source: *Iron Mountain's Q1 Slide Deck*

That said, while it's likely management may reduce full-year 2019 guidance at a future date this year (and perhaps the stock may react negatively again), Iron Mountain still expects revenue growth for 2019, on a constant-currency basis, to come in the range of 1% to 6%. Full-year constant currency adjusted EBITDA growth is expected to be flat to up 8%, while adjusted funds from operations expansion is targeted at 1% to 8% expansion for the year. Management continues to believe the business is moving in the right direction.

We're maintaining our fair value estimate for shares at $34 each (they are trading at ~$32 each). We're reiterating the risk to the dividend, as evidenced by the company's sub-1 Dividend Cushion ratio, and we note Iron Mountain's massive debt load leaves a lot to be desired. If shares face meaningful selling pressure, we won't hesitate to remove them from the High Yield Dividend Newsletter portfolio. Price declines are fundamental for high yield stocks as a lower market capitalization inhibits their ability to raise capital to support the dividend.

Mortgage REITs Still Dangerous Income Vehicles

Image: *Since late May 2013, mortgage REITs, as measured by the iShares Trust Mortgage Real Estate ETF (REM), middle, have fallen more than 20%, while the master limited partnership space, as measured by the Alerian MLP ETF (AMLP), has fallen by nearly 45%, bottom. Meanwhile, the S&P 500 (SPY) has rallied more than 75%, all on a price-basis, top.*

There's nothing "safe" about mortgage REITs (REM). The industry caught a lot of attention with the high-profile performance of some of the larger players, including AGNC Investment (AGNC) and Annaly Capital (NLY), in years past, but the hype has fizzled out. Not only has the mortgage REIT industry vastly underperformed a broad market benchmark such as the S&P 500 during the past few years, but the industry is not easy for many to understand. Even a greater understanding of the space may not lead to investment success either. We think investors should continue to steer clear of the space, as we said in late May 2013. Excerpted from our May 2013 write-up:

> *The good times are over for mortgage REITs.*
>
> *Mortgage market dynamics are inherently difficult to predict.*
>
> *A flatter yield curve has negatively impacted net interest rate spread income across the entire mortgage REIT universe. We're already seeing deteriorating gross ROE's from some of the largest industry constituents.*
>
> *The Fed has only caused a marginal tightening in mortgage spreads, and in our view, a marginal widening due to reduced Fed activity (if/when it happens) is perhaps the best-case scenario as it relates to spread income for the group. A continuation of spread tightening is likely the base-case scenario, which is negative for the group.*
>
> *Net interest rate spread income and gross ROE's will only be materially enhanced in the future through more risky dealings and increased leverage. Adding leverage is like "pulling the wool over investors' eyes." It's a very, very low-quality way of bolstering returns relative to core net interest margin expansion.*
>
> *The book value of some mortgage REITs will be punished regardless of what happens to interest rates. However, a rising interest rate environment can be devastating by causing other comprehensive losses (unrealized losses on investments marked to market) that will completely wipe out period spread income, causing rapid and uncomfortable declines in book value.*

Dividend payments may not be sustainable under these conditions.

The issue with the mortgage REIT business model is rather straightforward. Many generate minute net interest spreads, and they have to throw on considerable leverage to create a leveraged net interest spread sufficient enough to generate economic value for shareholders. This means some can be leveraged as much as 6-8x, sometimes higher. But here's the catch: Even if net spread income ROE is high, a mortgage REIT's book value could still be eroded if it experiences other comprehensive losses as holdings are marked down. Here was our conclusion in late May 2013 that still is true today:

> *Though we admit mortgage market dynamics are inherently difficult to predict, we think the odds are stacked against many constituents in the mortgage REIT industry. Participants must deal with tightening interest rate spreads and deteriorating investment portfolios (book values) in the event of a rising interest rate environment. By extension, declining net asset values will pressure the capital decisions of industry constituents, and we would not be surprised if additional dividend cuts are around the corner. We continue to steer clear of the group.*

Fast forward more than 6 years now, and the mortgage REIT industry continues to feel the pain. It's hard to believe others can be bullish on this space, with Nomura, for example, launching coverage in late March with buy ratings on Annaly Capital, Redwood Trust (RWT), New Residential Investment (NRZ), Chimera Investment (CIM), PennyMac Mortgage (PMT), Dynex (DX), and New York Mortgage Trust (NYMT). The mortgage market dynamics are way too difficult to predict to have any sort of buy ratings, in our view.

One has to look no further than the news April 24 with AGNC Investment cutting its monthly dividend to $0.16 from $0.18, indicating that "with the Federal Reserve expected to hold short term rates steady and an even more dovish stance communicated by the European Central Bank, the LIBOR-repo rate funding dynamic that AGNC enjoyed throughout 2018 is unlikely to return to the previously favorable levels in the near term." Income investors are simply playing with fire when they are considering the income stream of a mortgage REIT. We maintain our view that the best way to "play" this group is to stay as far away from it as possible.

Payout Cuts and What Went Wrong

Two companies in the oil & gas space, BP Prudhoe Bay Royalty Trust and Martin Midstream Partners L.P., recently slashed their payouts by enormous amounts over concerns about their ability to keep making good on those payments in light of weak cash flow generation. We will highlight why BP Prudhoe Bay's payout is unlikely to recover as output from the storied Alaskan oil field is set to continue sliding lower while Alaska North Slope pricing is unlikely to offer much relief over the long-term. Then we will cover why the midstream master limited partnership Martin Midstream was forced to cut its distribution in half, with an eye on the inherent flaws of the midstream model.

By Callum Turcan

Don't Trust BPT After Huge Payout Cut

Alaska, America's great frontier. Home to a population of almost 740,000, Alaska is often viewed as one of America's major oil producing states but what isn't usually discussed (outside of energy circles) is the long-term decline facing Alaska's upstream industry. Crude oil output peaked back in 1988 at over 2 million barrels per day before sliding all the way down to less than half a million barrels per day by 2014, about where it stands today. This trajectory is due entirely to the rise and fall of the Prudhoe Bay oil field, which started producing oil back in 1969 (commercial levels of production started up in 1977) after being discovered in 1968. The Alaska Oil and Gas Conservation Commission notes that output from the field peaked at over 1.6 million barrels of crude per day in 1987, before dropping down to around 0.3 million barrels per day as of 2017 according to BP plc (BP). Keep in mind almost all of this oil is sold at Alaskan North Slope prices, which has traded at a premium to West Texas Intermediate due to the WTI-Brent spread widening back up.

BP Prudhoe Bay Royalty Trust (BPT) – annualized forward yield of 6.6% – was formed back in 1989 and is currently managed by the The Bank of New York Mellon Trust Company (BK). As a trust, unitholders only have some voting rights and in many instances the trustee can act unilaterally. The trust owns a 16.4%

overring royalty interest on the first 90,000 barrels per day of net oil and condensate production from the Prudhoe Bay oil field BP Alaska is entitled to, or the average net production BP Alaska is entitled to in a given period, whichever is lower.

What that means is that as output from the oil field moves lower, BP Prudhoe Bay Royalty Trust receives a smaller amount of income assuming realized raw energy resource prices and certain costs are kept flat. As 'Chargeable Costs' have grown from $16.80 per barrel during the fourth quarter of 2013 to $20.00 per barrel for most of 2018, BP Prudhoe Bay Royalty Trust had no choice but to gut its quarterly payout by roughly two-thirds during the first quarter of 2019. Rising expenses and declining production leaves rising WTI/ANS pricing as the only source of upside for BP Prudhoe Bay Royalty Trust, but that isn't a sustainable strategy.

Keep in mind Alaska is not a core focus area for BP. Last year, the firm traded some of its upstream and midstream assets in Alaska to ConocoPhillips (COP) in return for a greater stake in the United Kingdom's offshore Clair Ridge oil field. As BP trains its focus elsewhere, there is a less likely chance that the ultimate recovery rate of the Prudhoe Bay oil field will increase. While the field is estimated to have held 25 billion barrels of oil in place, not all of that will be recovered. BP Alaska notes that the field has already produced over 13 billion barrels of oil, indicating a recovery rate north of 50% which is very impressive for the conventional upstream industry.

Going forward, in many ways BP Alaska is in uncharted territory as that recovery rate already indicates (under previous assumptions) that the field is tapped out. In other mature regions like the North Sea, operational improvements in recent years have enabled operators to achieve similar recovery rates, but little is known about how much more can be extracted.

During the first quarter of 2019, BP Prudhoe Bay Trust was entitled to the income on just 77,400 barrels of crude and condensate per day. That is likely to keep moving aggressively lower as we approach the 2020s. Even worse, 'Chargeable Costs' are set to rise up to $23.75 per barrel this year before climbing to $26.50 in 2020. After 2020, 'Chargeable Costs' will rise by $2.75 per barrel per year. These increases are to take into account the additional costs and complexities associated with recovering oil from a very mature field and diminishing economies of scale as output continues marching lower. Even worse (from the trust's 2018 10-K filing);

> *"Based on the 2018 twelve-month average WTI Price of $65.56 per barrel, current Production Taxes, and the Chargeable Costs adjusted as prescribed by the Overriding Royalty Conveyance,* ***it is estimated that royalty payments to the Trust will continue through the year 2022, and would be zero in the following year. Therefore, no proved reserves are currently attributed to the BP Prudhoe Bay Royalty Trust after that date.*** *Even if expected reservoir performance does not change, the estimated reserves, economic life and future net revenues attributable to the Trust may change significantly in the future. This may result from sustained periods of change in the WTI Price, the Production Tax or from changes in other prescribed variables utilized in calculations as defined by the Overriding Royalty Conveyance."*

Beware BP Prudhoe Bay Royalty Trust and don't trust its forward annualized yield of 6.6%. Costs are creeping up, it isn't certain that the recent bounce in oil prices can be maintained over the coming years, and ultimately, production out of the Prudhoe Bay oil field has been in terminal decline for decades. The trust's latest payout cut won't be its last, and there are enormous downside risks as it relates to capital depreciation. We are staying far away from BP Prudhoe Bay Royalty Trust.

Martin Midstream Highlights Flaws of Midstream Model

We have brought this up many times in the past, but it's worth noting again now that Martin Midstream Partners L.P. (MMLP) – annualized forward yield of 12.6% – just gutted its distribution. The company reported a net loss during the first quarter of 2019 and due to very serious cash flow concerns, management was forced to cut the midstream master limited partnership's payout in half. Its unit price tanked on the news, but there may be more carnage ahead as Martin Midstream's business model is full of problems.

Note that this isn't the first time Martin Midstream has had to cut its payout, as its quarterly distribution was cut by 38% in 2016.

For starters, Martin Midstream's total debt load of $785 million at the end of last quarter vastly outpaced a negligible cash balance while its current ratio was just 0.36x due to a large tranche of its debt maturing within a year. The MLP's operating income dropped by 59% year-over-year during the first quarter which pushed its net income into the red as relatively hefty interest expenses more than ate up the rest. A $664 million revolving credit facility will provide the company access to liquidity. However, that revolver had already been drawn by $401 million as of the end of March 2019.

Using the company's adjusted EBITDA as a rough measure of its organic performance in the eyes of management, Martin Midstream has been doing poorly. Its adjusted EBITDA came in at $169 million in 2016, which fell to $124 million in 2018 after also declining in 2017. At the end of 2018, the firm sported a net debt to adjusted EBITDA ratio of 5.3x, which is very high even in the midstream space. Moody's Corporation (MCO) gives Martin Midstream a credit rating of B2, placing its unsecured bonds firmly in junk status. While the MLP's credit rating was upgraded to a positive outlook back in June 2018, its financial performance has continued to weaken since then. The outlook upgrade was a product of Martin Midstream divesting its non-operated stake in West Texas LPG Pipeline last year and using the $195 million in proceeds to pay down its revolving credit line.

The whole idea behind the midstream business model is that the MLP owns cash flow generating assets with stable revenue streams. In reality, it isn't that simple at Martin Midstream. Last quarter, the company's adjusted EBITDA dropped by 34% year-over-year. Martin Midstream's 'Sulfur Services' performance missed internal expectations due to weak fertilizer sales, a product of adverse weather conditions impacting the planting season of American farmers. The company also posted weak 'Natural Gas Services' performance due to warm weather driving down propane sales and lackluster butane pricing. Furthermore, Martin Midstream's 'Transportation, Terminalling and Storage' performance missed expectations likely due to subdued demand for several of its core offerings.

Part of the company's problems stem from many of its midstream operations being exposed to fluctuations in market prices and consumer demand. For instance, the company buys natural gas liquids from downstream producers (refineries and processing plants) to then resell as wholesale deliveries. That isn't a volume or fee-based business, that is an arbitrage play pretending to be a logistics service (Martin Midstream's 'Natural Gas Service' segment is supported by 2.4 million barrels of natural gas liquids storage capacity). Midstream assets like pipelines or some gas processing plants where revenue streams are generated by volume-based fees are prime cash flow cows, but most of Martin Midstream's assets don't fall into that category. This leaves its payout very exposed at all times, as does its hefty net debt load.

We are very wary of Martin Midstream and question its ability to keep making good on its payout, even after the latest distribution cut. The midstream firm's cash flow generation keeps deteriorating and it's very exposed to numerous downside risks. That includes the farm planting cycle in America, major weather events in the Gulf Coast due to its large 'Marine Transportation' segment and reliance on fertilizer demand, fluctuations in natural gas liquids prices which are predominately influenced by fickle oil pricing benchmarks, cost of capital increases, and the chance the U.S. FED raises rates if the economy picks up steam. This is one midstream firm to stay far away from.

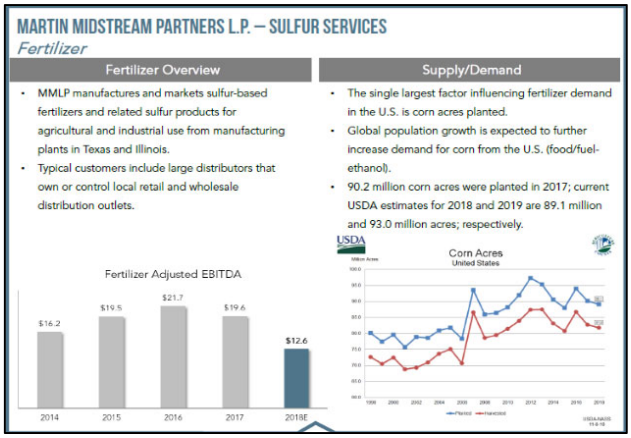


Image Source: *Martin Midstream – December 2018 IR presentation*

Disclosure: *The author of this piece, Callum Turcan, does not own any of the companies mentioned above.*

High Yield Spotlight: Southern Company's (SO) Fiscal Discipline and Promising Growth Trajectory Supports Modest Annual Payout Growth Over the Coming Years

Southern Company (SO) **--- 4.8% yield ---** is a power generation and natural gas distribution company that operates six regulated utilities which serve 9 million customers in nine states, with a major presence in Southeastern America. The firm also owns a growing power generation company, nuclear power plants, a fiber optics business, natural gas storage assets, and a mobile communications business. **For 71 consecutive years, Southern has paid out 285 quarterly dividends that have either been equal to or greater than the previous payout. That's a track-record to be proud of.** Southern Company just recently raised its quarterly payout by 3% to 62 cents per share or $2.48 per share per year.

Over the past few years, the company sold off several large assets to help pay down debt and fund its growth trajectory including Gulf Power, Florida City Gas, equity stakes in SP Wind and SP Solar, and various other assets. Going forward, the company is in the process of divesting its entire equity interest in the Mankato Energy Center for roughly $0.65 billion to Xcel Energy Inc (XEL) in a deal that is expected to close by the middle of 2019.

We like Southern's investment grade credit ratings and active financing management schemes. Moody's Corporation (MCO) confirmed Southern Company's Baa2 unsecured investment grade credit rating back in September 2018 with a stable outlook, a significant improvement from August 2018 when Moody's had Southern's credit rating at a negative outlook. S&P gives Southern Company an A- investment grade credit rating with a negative outlook, and Fitch gives the utility a BBB+ investment grade credit rating with a negative outlook. As noted previously, divestment proceeds have been steadily chipping away at Southern's debt load. From the end of 2017 to the end of 2018, the firm's total long-term debt load dropped by $3.1 billion while its cash pile dipped by $0.7 billion, good for a $2.4 billion reduction in its net debt burden. Over time, that may help improve its credit rating if this progress is maintained.

Divestment Program Funds Long-Term Growth

At the beginning of 2019, Southern completed the all-cash sale of its Gulf Power asset to NextEra Energy Inc (NEE) for $5.8 billion less $1.3 billion in indebtedness assumed (subject to working capital adjustments). Those proceeds combined with the Mankato Energy Center sale (assuming that transaction gets completed) will give Southern plenty of financial firepower, reducing its need to issue equity to fund its five-year capital expenditure program while strengthening the balance sheet. Here is a statement from Southern's CEO, President, and Chairman Thomas Fanning (from the firm's 2018 annual report);

> *"We have successfully completed more than $11 billion in strategic, value-accretive transactions, including the divestitures of Elizabethtown Gas, Elkton Gas, Florida City Gas, Pivotal Home Solutions and other assets. In December, Southern Power entered into a partnership with three of the largest tax equity partners in the U.S. – Bank of America, JP Morgan and Wells Fargo – for an interest in substantially all of its operating wind portfolio. And on January 1, 2019, we closed on the sale of Gulf Power.* ***These decisive actions served to strengthen our balance sheet, substantially reduce our projected equity needs and remove significant risk from our financing plans. We believe these transactions also position our company for future growth.****"*

Excluding special items, Southern's EPS has grown from $2.80 in 2014 to $3.07 in 2018 as its annual dividend per share rose from $2.08 to $2.38 during that period. While Southern's adjusted EPS is expected to come in at $2.98 - $3.10 this year, or $3.04 at the midpoint (implying a slight year-over-year decline), management expects the utility to generate 4 – 6% long-term EPS growth. That trajectory supports Southern's plan for annual $0.08 per share dividend increases, equal to 2 - 3% annual payout growth going forward.

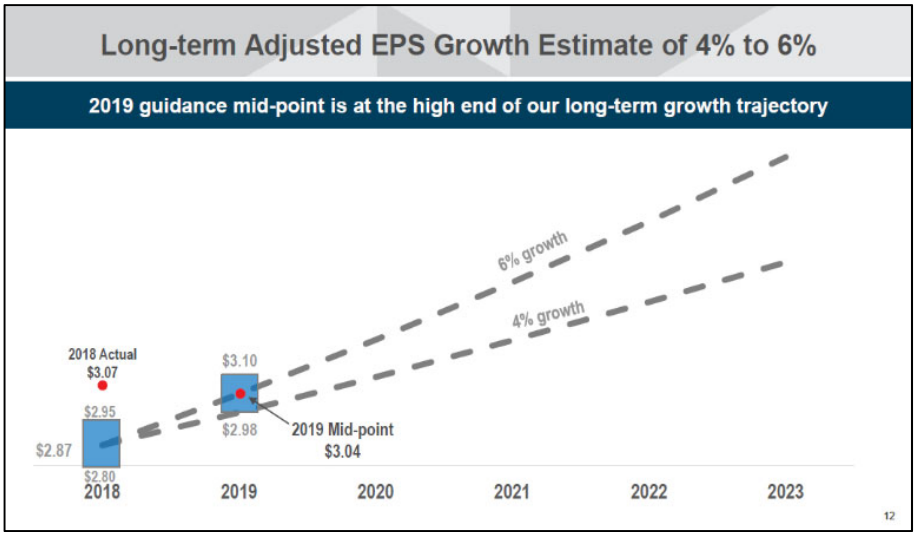


Image Shown: *Southern is targeting mid-single digit EPS growth on an annual basis through the mid-2020s.* ***Image Source:*** *Southern Company – Fourth quarter 2018 earnings presentation*

Growth will largely be driven by increases in Southern's rate base as the company has its eyes set on $38.1 billion in total capital expenditures from 2019 – 2023. As Southern has raised a lot of funds via divestments, the company projects that it will only need to issue out $2.5 – 3.0 billion in equity over the next five years to cover its spending plans. That figure may change depending on the progress of its divestment program. In April 2019, Southern's announced it was selling the Nacogdoches Generating Facility for $0.5 billion in a deal expected to close in the middle of this year.

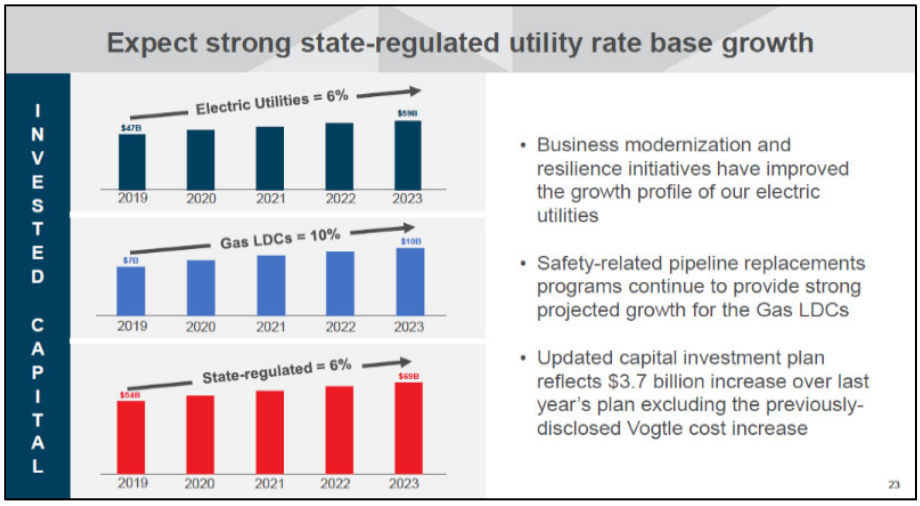


Image Shown: *Southern expects significant rate base growth due to its ongoing capital investment program than spans across its asset base.* ***Image Source:*** *Southern Company – Fourth quarter 2018 earnings presentation*

Southern's capital expenditures are primarily weighted towards its electric and power generation operations, with a decent portion allocated towards its natural gas pipelines business. The vast majority of these expenditures are going towards state-regulated capital investment projects that usually generate very stable income streams. For that reason, most utilities are able to take on significantly more debt than other publicly traded companies as the stable nature of their projected cash flow generation keeps their cost of capital down. However, if a utility's cost of capital begins to rise, that can be cause for concern. This is why Southern paid down some of its debt and made sure to have additional funds on hand as its current five-year capital expenditure program is frontloaded.

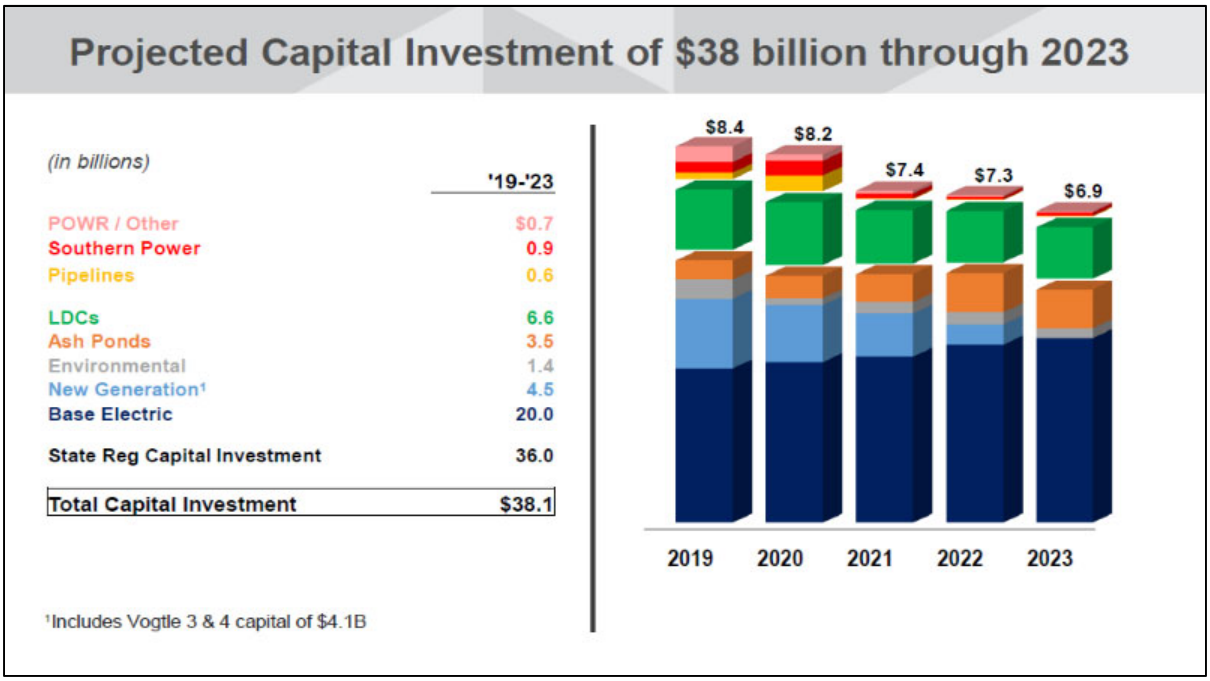


Image Shown: *Southern forecasts it will allocate $38.1 billion towards capital expenditures from 2019 to 2023, enabling significant growth in its rate base than in turn will enable EPS and ultimately dividend growth.* ***Image Source:*** *Southern Company – Fourth quarter 2018 earnings presentation*

In 2018, Southern generated $6.9 billion in net operating cash flow and spent $8.0 billion on capital expenditures (defined as property additions). Cash outlays for its common stock dividends came in at $2.4 billion last year. This outspend is primarily why Southern issued $1.1 billion in common stock last year, as the company needed to supplement divestment proceeds and net operating cash flow in order to cover its outlays without eating into its entire cash pile. At the end of 2018, Southern had $1.4 billion in cash on hand.

One Risk Gone but Nuclear Headaches Remain

Southern's Nicor Gas, a natural gas distribution company that operates in northern Illinois, replaced its last cast iron mainline natural gas pipeline in 2018. Management noted that *"today, Nicor Gas has no known low pressure cast iron in its system, helping to ensure the long-term safety and reliability of natural gas service for its customers"* in Southern's latest annual report.

This is more important than it appears. Cast iron pipelines are a relic from over sixty years ago and are prone to problems due to the degrading nature of iron alloys (on top of general wear and tear over time). America has made great progress in upgrading its natural gas pipeline network, with 97% of America's natural gas distribution pipelines comprised of steel or plastic by the end of 2017 according to the Pipeline and Hazardous Materials Safety Administration, an agency of the U.S. Department of Transportation. The remaining 3% is mostly iron, and the owners of those pipelines could be exposed to extensive legal liabilities in the event something goes wrong.

On the other hand, Southern is exposed to risks involved with the Vogtle nuclear power plant development in Georgia, the only nuclear power plant project currently under construction in America. The original two units came online back in the 1980s, with the development of the third and fourth units sanctioned back in 2009. Cost overruns have been onerous to say the least (Westinghouse went bankrupt due to this project), and Southern isn't certain will be able to recover all of its capital investment. Southern recorded a pre-tax charge of $1.1 billion during the second quarter of last year to take additional cost overruns into account.

Georgia Power, owned by Southern, owns just under 46% of those two units and took over construction activities after Westinghouse filed for bankruptcy. From Southern's 2018 annual report;

> *"In 2009, the Georgia PSC certified construction of Plant Vogtle Units 3 and 4 (with electric generating capacity of approximately 1,100 MWs each). Georgia Power holds a 45.7% ownership interest in Plant Vogtle Units 3 and 4. In March 2017, the EPC Contractor filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code. In December 2017, the Georgia PSC approved Georgia Power's recommendation to continue construction. The current expected in-service dates remain November 2021 for Unit 3 and November 2022 for Unit 4."*

Going forward, Southern expects to spend $4.1 billion on capital expenditures through 2022 completing this project. That's up by $1.1 billion from Southern's expectations when it reported its fourth quarter 2017 earnings due to another cost increase, which resulted in the aforementioned charge. From Southern's 2018 annual report;

> *"In the second quarter 2018, Georgia Power revised its base capital cost forecast and estimated contingency to complete construction and start-up of Plant Vogtle Units 3 and 4 to $8.0 billion and $0.4 billion, respectively, for a total project capital cost forecast of $8.4 billion (net of $1.7 billion received under the Guarantee Settlement Agreement and approximately $188 million in related Customer Refunds), with respect to Georgia Power's ownership interest."*

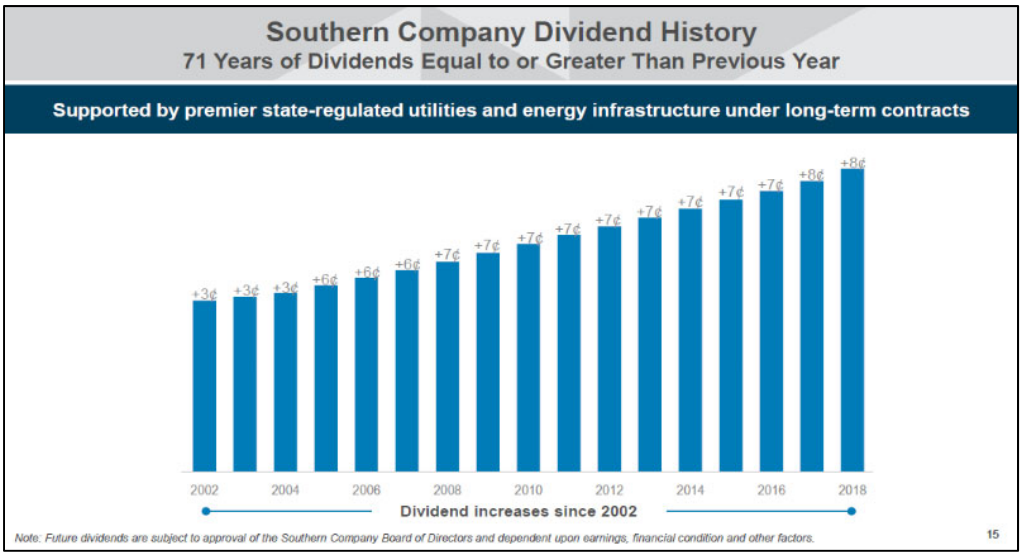
Now that Southern is in charge of development activities, the company has better control over one of its largest operational liabilities. Southern expects both units will be operational by 2022 but note that the risk of construction delays and non-recoverable cost overruns remain. The Vogtle development has received substantial loan guarantees from the federal government, including an additional $1.7 billion from the Department of Energy that closed in March 2019 (which was on top of an existing $3.5 billion in loan guarantees), to help ensure these units get turned online. Aided by strong backing from both the state of Georgia and the US federal government, Southern has a good chance of getting across the finish line.

When Southern took over from Westinghouse, the utility was able to win approval from regulators (specifically, the Georgia Public Service Commission) to recover an additional $7.3 billion from ratepayers in order to get this project completed (effectively, Southern was able to pass on the expected development cost increases, or at least most of them, to its customers). The firm didn't attempt to recover the more recent cost overruns of $1.1 billion from ratepayers, instead opting to take a loss. Southern's argument was that it's best to move onward after already securing a big win from regulators.

Part of that calculation had to do with the political risk Southern could incur by seeking yet another rate hike so soon, and due to the federal government offering additional help via the loan guarantees and public support from key officials, including U.S. Energy Secretary Rick Perry (who reportedly plans on leaving office soon) and U.S. Agricultural Secretary Sonny Perdue (who used to represent Georgia as the state's governor).

Concluding Thoughts

Southern Company is a Dividend Aristocrat with a nice 4.8% yield, a payout that is expected to grow modestly over the coming years due to its promising long-term growth trajectory, investment grade credit rating, and recent clarity on how the Vogtle project will proceed. Management's past focus on paring down Southern's debt load combined with the company ensuring it will have the necessary funds to cover its five-year capital expenditure program without relying heavily on equity issuances going forward is the right call in our view.



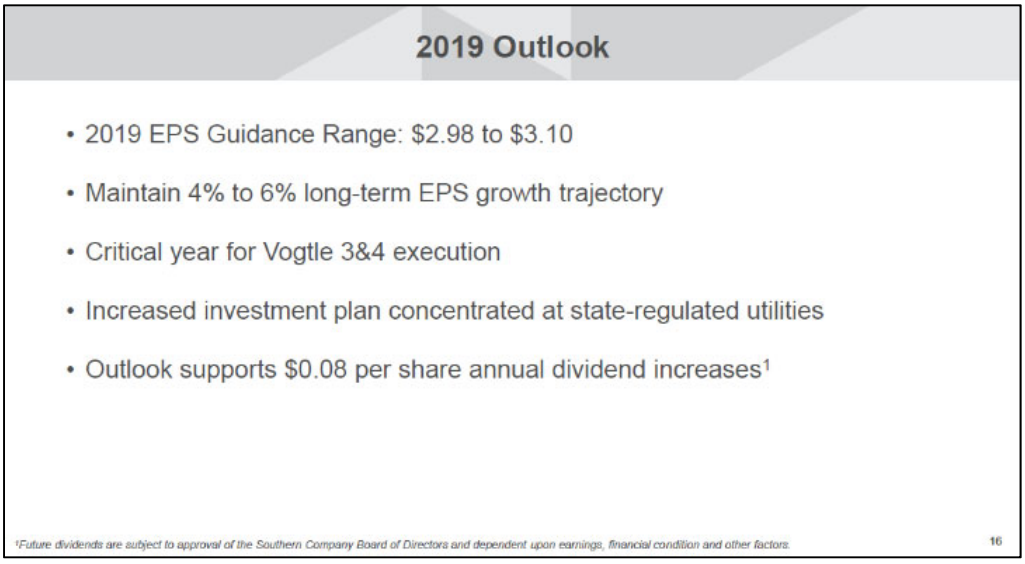


Image Source: *Southern Company – Fourth quarter 2018 earnings presentation*

Disclosure: *The author of this piece, Callum Turcan, does not own any of the companies mentioned above.*

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Brian M Nelson

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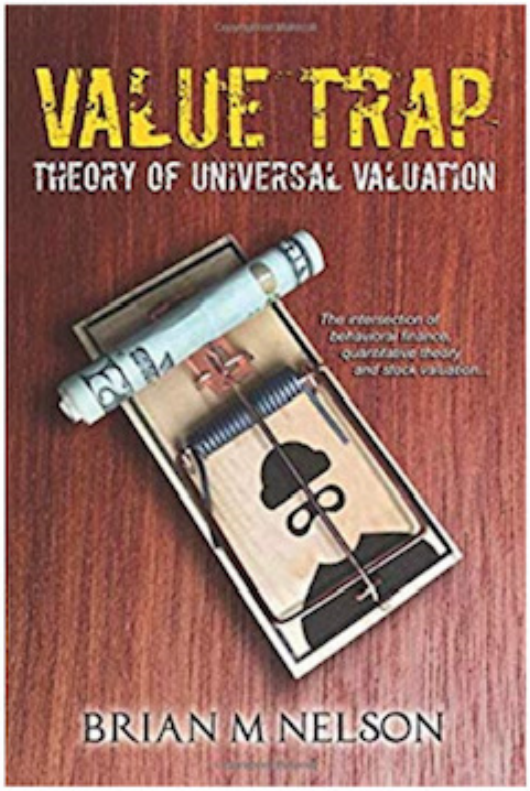

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Surveying the Big Banks

J.P. Morgan Kicks Off Earnings of the Banks

By Matthew Warren

J.P. Morgan has a major advantage when it comes to crown jewel consumer banking. The company is a powerhouse.

On April 12, J.P. Morgan (JPM) reported first quarter earnings of $2.65 per share, fully 30 cents per share ahead of Wall Street estimates, and well ahead of $2.37 in the strong year-ago quarter. Managed revenue was up $1.3 billion over last year's first quarter to $29.9 billion. Return on equity was 16% in the quarter versus 15% last year and return on tangible common equity was 19%--just as in last year's quarters. These return on capital metrics, if broadly sustainable, fully justify the firm's shares trading at 1.5 times book and 1.9 times tangible book equity. Capital levels are very strong with a common equity tier 1 ratio of 12.1%, despite the bank paying out 93% of earnings over the last 12 months, highlighting the lack of reinvestment required to support these impressive fundamentals.

Lest we not forget that banks are cyclical and have enjoyed a decade of mostly benign credit conditions following the Great Financial Crisis. When the next downturn eventually begins, revenues and therefore efficiency ratios will come under pressure, as will net charge offs, all of which will drag on earnings. That said, this bank has impressive earnings power, a strong balance sheet, solid efficiency ratings, low cost of funds, and ample liquidity, all of which suggests this bank is capable of withstanding the next downturn when it does come.

One main point that one should think about when considering J.P. Morgan is that its Consumer and Community bank is an absolute crown jewel with a 30% return on equity in the quarter. Consumer banking is most definitely a business that benefits from scale in this age of increasing digitalization. J.P. Morgan is talking about $11.5 billion of technology spend a year with half spent on improving the bank and the other half maintaining the bank, better than the 60% maintaining the bank last year. Fifty percent of $11.5 billion or $5.75 billion is more than the total expense line of thousands of banks in the United States, and the bank expects to be able to keep this spending flat even as revenues grow.

Smaller banks cannot afford to spend on digitalization in the same way that J.P. Morgan and the other large banks such as Bank of America (BAC) and Wells Fargo (WFC) can. Smaller banks have inferior websites and mobile apps, increasing the difficulty in walking down the cost efficiency curve resulting from digitalization of processes. This is a major advantage for the big banks when it comes to consumer banking, the reason why they have so much market share and why the thousands of smaller US banks will continue to be market share donors in years to come. J.P. Morgan is a powerhouse, but then that is reflected in the share price, which was up another nearly 5% on Friday following the earnings report. Our fair value estimate is $104, and the shares were trading around $116 on Tuesday, April 30.

Wells Fargo's Net Interest Income Guidance Disappoints

Wells has a solid franchise, which we expect to bounce back once these troubles are squarely in the rear-view mirror, but the timing and magnitude of decline and then ultimate improvement are anyone's guess at this tender stage of regulatory reproach and perspective client disillusionment. Our fair value estimate remains $52 per share.

On April 12, Wells Fargo (WFC) reported first-quarter 2019 results that showed revenue falling $300 million from last year's first quarter, to $21.6 billion this year. Net income was $5.9 billion or $1.20 per share, up from $5.1 billion and $0.96 per share last year, respectively. Wells posted a 12.7% return on equity and 15.2% return on tangible common equity in the quarter, better than the cost of capital. This reflects the firm's competitive advantages as one of the largest scale consumer banks in the country--a business where scale matters, especially against the backdrop of digitalization of both front-end consumer engagement with websites and mobile apps, but also the digitalization of backroom processes which support the business.

The bank is well-capitalized with a common equity tier 1 ratio of 11.9%, above the regulatory minimum of 9% and current internal target of 10%. This is after returning $6.0 billion to shareholder in the first quarter

of 2019, just a touch more than the firm earned in the quarter. This reflects Wells' lack of reinvestment needs required to produce the current earnings stream. In fact, Wells' share count is down 7% from last year due to ongoing share repurchases over and above the money returned to shareholders via dividends. Given the company's well-capitalized position, we're not too concerned with the bank's buyback program.

During its earnings call April 12, Wells Fargo's CFO lowered its net interest income guidance for the year from the range of -2%-2% to the range of -2%-5%, which had the shares reversing and trading lower immediately upon this revelation. The bank's own actions caused its reputation to be dragged through the mud the past three years. Internal incentives to drive "cross-selling" ended up instead driving misbehavior with bank employees opening customer accounts without their permission. This major scandal combined with some additional SNAFUs that have come to light since have really dinged the bank's reputation. Banking is built on trust and therefore reputation.

The regulators have gotten involved, forcing changes at the bank including an asset cap of $1.93 trillion in place since February 2, 2018 which limits growth, especially compared to peers, contributing to market share losses - above and beyond the difficulty of attracting new customers given the reputational problems. The bank has also beefed up its compliance and operational staff, brought in outside hires and now is looking to replace the recently-departed CEO, the second departure since the scandal broke. It is unclear how long-lasting this damage will be, but you can clearly see the pressure in the current results with revenue down while more successful peers are growing nicely.

Wells also has lower return on capital metrics than the likes of J.P. Morgan (JPM), despite (very slightly) lower Tier 1 common equity capital levels. Wells has a solid franchise, which I expect to bounce back once these troubles are squarely in the rear-view mirror, but the timing and magnitude of decline and then ultimate improvement are anyone's guess at this tender stage of regulatory reproach and perspective client disillusionment. Our fair value estimate remains $52 per share.

Citigroup Remains a Sub-scale US Bank

Even if Citigroup achieves improved return-on-capital targets, it would remain a sub-scale US bank from a nationwide perspective, and it remains overly reliant on Corporate and Investment banking, which is an overtraded and competitive field globally.

Citigroup (C) reported middling first-quarter results April 15, with revenues down 2% versus last year, to $18.6 billion. Thanks to strong operating expense control (-3%), lower taxes, and a 9% lower share count, earnings per share advanced 11%, however. With a common equity tier 1 ratio of 11.9%, Citigroup was able to return over $5 billion to shareholders in the quarter. The bank reported a 11.9% return on tangible equity in the quarter, barely better than the cost of capital, and this without including goodwill and intangibles in the equation.

On the earnings call, CFO Mark Mason confirmed that the bank is targeting 12% return on tangible common equity in 2019 and 13.5% or greater in 2020. Citigroup is hoping to reduce its common equity tier 1 ratio to 11.5% from the current 11.9% (requires regulatory approval), but the rest of the improvement would largely come from reducing the efficiency ratio from current levels, which the bank has been doing for the past several quarters. The CFO also seemed to indicate on the earnings call that it considers current loan losses to be mid-cycle or normalized, which is highly questionable in my opinion, giving the extremely benign economic conditions that the US economy has been enjoying for some time.

More realistically, Citigroup's earnings could come under substantial pressure in an environment of considerable job losses. Even if the bank hits these improved return-on-capital targets, Citigroup would remain a sub-scale US bank from a nationwide perspective, and it remains overly reliant on Corporate and Investment banking, which is an overtraded and competitive field globally. There are simply too many players and some of them are national champions in Europe, where overcapacity is pronounced. Many of those banks are operating with limited earnings power, yet they continue to fight for market share. Our fair value estimate remains $71 per share.

Raising Our Fair Value Estimate for Bank of America

The only thing not to like with Bank of America is that banks are cyclical and the economy is overdue for a downturn. Everything else is going right at Bank of America. We have raised our fair value estimate for Bank of America to $35 per share.

Bank of America (BAC) reported first-quarter 2019 results April 16, with revenue stable at $ 23 billion, pre-tax income up 4% to $8.8 billion, and thanks to 7% fewer shares outstanding, earnings-per-share was up 13% versus last year's first quarter. It was again the crown jewel consumer banking segment that led with 25% growth in earnings. Unsurprisingly, Global Markets, where there is simply too much global competition and market-related volatility, was the laggard.

Bank of America's return on equity was up 57 basis points, to 11.42%, while return on tangible common equity was up 75 basis points, to 16.1%. The bank is very well capitalized with a common equity Tier 1 ratio of 11.6%. The bank repurchased $6.3 billion of shares on top of $1.5 billion of common dividends, returning more than 100% of earnings to shareholders in the period.

Impressively, the bank also extended its streak to 17 quarters of positive operating leverage. When you consider that revenue was up in only 11 of those quarters and down as much as 7% back in the first quarter of 2015, it is all the more impressive that the bank has been able to manage its cost structure in such a consistent manner. Over the past year, the bank's efficiency ratio improved substantially from 59.5% to 57%. On the earnings call, CFO Paul Donofrio stated that costs will hold flat for this year and next, so as long as revenues are up, the positive operating leverage will continue apace.

Much of this success in expense control is driven by digitalization of both the (a) front end consumer experience with websites and mobile apps becoming more capable and more utilized versus more traditional interfaces like the branch and even ATMs, but also the (b) back-end processes being streamlined via greater use of technology. The bank has been spending $3 billion annually on technology for many years now, but plans to increase that by 10% in 2019, even as it continues to benefit from positive operating leverage. Consumers want to go digital and Bank of America is a resounding success story of facilitating that demand as you can see below.

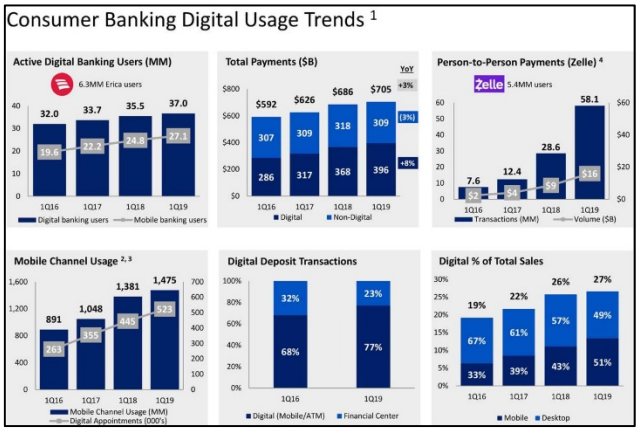

Image Source: *Bank of America First-Quarter Presentation*

Regarding guidance, the bank expects net interest income to grow at half of 2018's pace of 6%, reflecting a slower growing economy, lack of further rate hikes, and the flat yield curve. While not particularly exciting, this is much better than what peer Wells Fargo (WFC) is projecting and should also allow for decent (probably double digit) earnings growth given positive operating leverage and share buybacks. Despite the positive outlook, it is best to keep in mind the cyclical nature of banks along with the overdue economic downturn. Everything else is going right at Bank of America. We have raised our fair value estimate for Bank of America to $35 per share.

Taking a Fresh Look at Goldman Sachs

After taking a fresh look at our valuation assumptions in the context that Goldman hasn't really proven that it can earn above the cost of capital through the economic cycle, we have lowered our fair value estimate to $200 per share.

Goldman Sachs (GS) reported first-quarter 2019 results April 15 with revenue down 13%, to $8.8 billion, and diluted earnings per share down 18%, to $5.71. Return on equity was a middling 11.1% and return on tangible common equity was 11.7%. The bank's standardized common equity Tier 1 ratio is 13.7%, well above large

bank peers. This makes sense as Goldman holds substantial investment positions such as private equity holdings on its balance sheet, which have the potential for considerable volatility compared to the likes of customer loans or government securities.

The declines in revenue and earnings reflect the vagaries of Goldman's market-oriented businesses, and the less-than-exciting return on capital metrics reflect the very competitive nature of the firm's investment banking and trading operations. As you can see in the graphic below, the vast bulk of the firm's earnings are directly tied to market levels and/or market activity. While Goldman is a global leader in some of its businesses, the field is extremely crowded and includes firms in Europe that are desperately seeking to scratch out cost of capital returns in order that their shares to trade closer to book value.

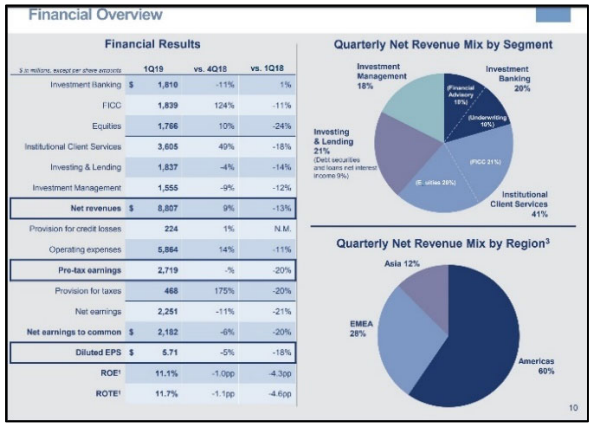

Image Source: *Goldman Sachs 1Q19 Earnings Slides*

Not only did Goldman have a problem with negative growth and volatility of revenue in the most recently-completed quarter, but the bank also faced a worsening efficiency ratio as a result, as you can see below:

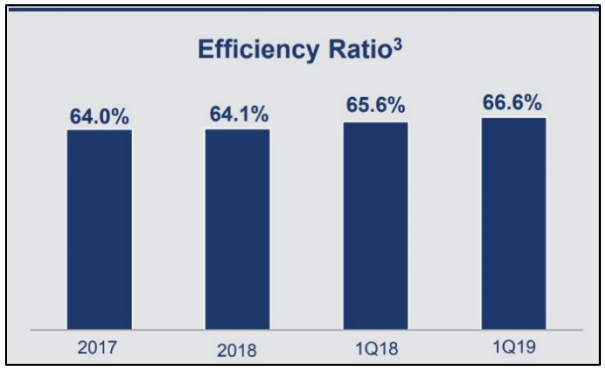

Image Source: *Goldman Sachs 1Q19 Earnings Slides*

Since late last year and through to next year this time, Goldman's management team is undergoing a front-to-back review, searching for ways to increase revenue with new and existing clients as well as using digitalization, platforms, and simple cost cutting to improve its cost structure and return on capital metrics. It is seeking deposit growth via its Marcus platform and wants to better serve mass-wealth clients overall. While we appreciate the argument that Goldman Sachs is creating new digital platforms to enable opportunities, we think it will be difficult to pry clients away from existing banking relationships. That said, the bank has significantly grown its deposits in recent years. After taking a fresh look at our valuation assumptions in the context that Goldman hasn't really proven that it can earn above the cost of capital through the economic cycle, we have lowered our fair value estimate to $200 per share.

Morgan Stanley's Lumpy Performance Calls Into Question Durability of Earnings Stream

If Morgan Stanley's activities can collapse that quickly, as they did during the fourth-quarter of 2018 when the market swooned, it really calls into question the durability of the earnings stream for all of the global players.

Morgan Stanley (MS) reported first-quarter 2019 results April 17 with net revenues down 7%, earnings down 9%, and diluted earnings per share down 4%. Return on equity was 13.1% versus 14.9% last year. The firm's efficiency ratio was 71% versus 69% in last year's first quarter. The bank is well-capitalized with a common equity Tier 1 ratio of 16.5%, which is necessary considering the riskier nature of Morgan Stanley's balance sheet compared to a universal bank like JP Morgan (JPM). While results were down from last year, they were a substantial improvement over the abysmal fourth quarter.

That's the rub though; last quarter is very recent evidence that Morgan Stanley is unlikely to earn above the cost of capital through the entire cycle. Morgan Stanley is a mixed bag. The wealth management unit is the crown jewel. It is a scale business, and Morgan Stanley certainly benefits from this scale. The bank has a critical mass of advisers covering the country, and all of this activity rests on a platform of both technology and

processes. This drives cost competitiveness, and also therefore revenue opportunities. While the investment business isn't the largest in the world, it is certainly large enough, and we suspect the economics are good. It also enjoys synergies with the wealth business.

It is the institutional securities business that is overtraded globally and highly cyclical, dependent on market levels and activities. If you think about it, the fourth quarter of 2018 was only a hiccup after a huge run up in market levels. If Morgan Stanley's activities can collapse that quickly, it really calls into question the durability of the earnings stream for all of the global players. The extensive industry capacity is there whether the client activities are or not. When activity dries up, earnings and returns on capital head south in a hurry. We're simply not big fans of investment banking and trading businesses, no matter how they are labeled by a particular bank, or even how high a firm sits in the ranking tables. We are maintaining our $50 fair value estimate.

improve its return on capital and stock rating assigned by the market. As long as revenues grow even slightly, we expect this to be the case.

Wells Fargo has a good balance of business and historically outperformed its peers, but it is currently facing fallout from several scandals, the largest one being the opening of client accounts without their approval or knowledge. It seems Wells is struggling to gain new customers after all of the bad press and its decreased guidance for lower net interest income stands out to the downside compared to peers.

The negative trends in trading and investment banking simply highlight how overly competitive and commoditized these businesses are and how wildly cyclical these earnings streams can be. The simple truth is that a hedge fund can choose from an astounding number of firms to trade with just as a CFO can easily invite a dozen investment banks in for a dog and pony show before deciding who gets IPO or advisory business.

Earnings Summary

($ millions)		1Q2019 Net Revenue	1Q2018 Net Revenue	% Change	1Q2019 Net Income	1Q2018 Net Income	% Change	1Q2019 ROE%	1Q2018 ROE%
JP Morgan	JPM	29,851	28,520	4.7%	9,179	8,712	5.4%	16.0%	15.0%
Bank of America	BAC	23,000	23,100	-0.4%	7,300	6,900	5.8%	11.4%	10.9%
Citigroup	C	18,576	18,872	-1.6%	4,710	4,620	1.9%	10.2%	9.7%
Wells Fargo	WFC	21,600	21,900	-1.4%	5,860	5,140	14.0%	12.7%	10.6%
Goldman Sachs	GS	8,807	10,080	-12.6%	2,182	2,737	-20.3%	11.1%	15.4%
Morgan Stanley	MS	10,286	11,077	-7.1%	2,429	2,668	-9.0%	13.1%	14.9%
Total (ROE AVG)		**112,120**	**113,549**	**-1.3%**	**31,660**	**30,777**	**2.9%**	**12.4%**	**12.7%**

Image Source: *Compilation from first quarter earnings releases*

In an environment where the big six banks overall revenues were down slightly and trading and investment banking revenues--in particular--were down substantially, JP Morgan stood out with its nearly 5% net revenue growth this quarter. The bank also stands out with the highest return on capital amongst its large bank peers and it would be hard to argue that JP Morgan is not best in class. Of course, the market broadly reflects this reality with the shares trading at the top end of our range of fair value estimates.

We are also impressed by Bank of America's 17 consecutive quarters of positive operating leverage. If they can keep up this trend, the bank will continue to

Consumer and small business banking, on the other hand, is a business where massive scale matters. JP Morgan, Bank of America, and Wells Fargo all benefit from scale and it shows in their relative strength and stability compared to more investment banking and trading oriented firms like Goldman, Morgan, and Citigroup. For the universal banks, these more cyclical business are much more a means to the end of serving as a one-stop shop for corporate and commercial customers. We prefer this more diversified mix of business and the diversity of income streams.

Disclosure: *The author of this piece, Matthew Warren, does not own shares in any of the securities mentioned above. Contact Valuentum for more information about its editorial policies.*

Meet Brian Nelson in Silicon Valley!

2. Value Trap: Theory of Universal Valuation

Brian Nelson will cover the pitfalls of valuation multiples [e.g., price-earnings (P/E) ratio, price-to-sales (P/S) ratio], traditional quantitative analysis (e.g., value factor, size factor) and the great contradiction between factor investing and the efficient markets hypothesis. He will show how enterprise valuation rests at the intersection of behavioral economics, quantitative theory, equity valuation and, therefore, finance itself. Nelson will talk about how enterprise valuation can be used to identify bubbles and mispricings and how it's valuable to dividend growth and income. Receive a free paperback copy of Brian's new book, Value Trap: Theory of Universal Valuation! Limited to the first 75 attendees.

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Discussed by:
Brian Nelson , CFA President of Equity Research, Valuentum Securities

Brian Nelson, CFA, is the president of equity research and exchangetraded fund (ETF) analysis at Valuentum Securities. Before founding Valuentum in early 2011, he worked as a director at Morningstar, where he developed their discounted cash flow model used to derive the fair value estimates for the company's entire equity coverage universe. He earned an MBA from the University of Chicago Booth School of Business.

Meeting Details:

- **Date:**
  - Saturday, May 11th, 2019
- **Location:**
  - Shoup Park Garden House
  - 400 University Avenue
  - Los Altos, CA 94022

8:30 A.M. Registration / Social / Book Swap

- 8:30 A.M : Chapter announcements
- 9:00 A.M : Presentation Starts
- 10:15 A.M : Break
- 10:30 A.M : Presentation Resumes
- 11:30 A.M : Q&A

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Disclosure: Brian Nelson, Callum Turcan, and Matthew Warren do not own any shares of any securities mentioned in their authored articles.

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THE SIMULATED HIGH YIELD DIVIDEND NEWSLETTER PORTFOLIO

We can't begin to tell you how excited we are about the high yield space during 2019. We think we did pretty good during 2018 given the uncertainty regarding Fed policy, but as you've noticed since the December 2018 bottom in the market, high yield dividend equities have come roaring back!

We think this is the beginning of what could be a nice run in the space given a more "dovish" stance by Fed policy. We also think the High Yield Dividend Newsletter portfolio positions us fairly well for whatever the market may throw at us. We're pretty well-diversified, and we've started to identify some pretty good individual equity ideas of late.

The high yield dividend equity arena trades a lot like junk bonds, meaning that interest rates play a key role in how equities will perform. As interest rates fall, high yield stays in vogue, but as interest rates rise, many look elsewhere. This impacts pricing greatly.

We know there's a lot of competition in this area, but we're laser focused on identifying high yielding stocks that have sustainable yields, and if the income stream becomes threatened, we won't hesitate to say goodbye to a name. The simulated High Yield Dividend Newsletter portfolio is presented each month in similar fashion (list and weightings) as that of the first edition.

If you have any questions, comments, or concerns, please be sure to let us know at info@valuentum.com.

Idea	Symbol	Weighting	Est Div Yield
CORE			
Alerian MLP ETF	AMLP	5.0%	7.96%
Global X SuperDividend ETF	SDIV	5.0%	8.82%
Global X SuperIncome Preferred ETF	SPFF	10.0%	7.02%
iShares International Select Dividend ETF	IDV	5.0%	5.67%
iShares MSCI Australia ETF	EWA	5.0%	5.49%
iShares U.S. Preferred Stock ETF	PFF	5.0%	5.89%
PowerShares Senior Loan Portfolio	BKLN	5.0%	4.60%
ProShares High Yield—Interest Rate Hedged	HYHG	5.0%	6.13%
Vanguard Real Estate ETF	VNQ	10.0%	3.96%
EQUITY			
AT&T	T	5.0%	6.51%
BP PLC	BP	5.0%	5.63%
Digital Realty Trust	DLR	5.0%	3.63%
Enterprise Products Partners	EPD	5.0%	5.98%
Iron Mountain	IRM	5.0%	6.89%
Magellan Midstream Partners	MMP	5.0%	6.58%
Public Storage	PSA	5.0%	3.67%
Schlumberger	SLB	5.0%	4.59%
Tallgrass Energy LP	TGE	5.0%	8.90%
		100.0%	**5.95%**

This is not a real money portfolio. Inception 1/1/2018. Data as of 5/1/2019. Est. Div. Yield retrieved from YahooFinance.

SCREEN OF THE MONTH – THE FINANCIALLY-HEALTHIEST DIVIDEND PAYERS YIELDING OVER 2%

The following is a list of stocks that have the highest multiplicative combination of their dividend yield and Dividend Cushion ratio, per our estimates. We exclude the business models of master limited partnerships and real estate investment trusts in this screen and focus exclusively on corporates. We also make a few other tweaks with respect to business model risk considerations.

Income investors have a lot to choose from, and this screen is one of our favorites -- it focuses on identifying the financially-healthiest dividend-payers with yields over 2%. We've overlaid the screen with an Economic Castle assessment to consider business-model risk, too!

Note: *The 'Multiple' in this list considers a company's dividend yield and Dividend Cushion ratio as a multiplicative combination. Though it is a robust and largely objective measure, there could be exogenous or secular dynamics that could impact the business, where a dividend may not be as strong as the financials indicate. This screen was included in the May edition of the Dividend Growth Newsletter.*

Company Name	Symbol	Est Div Yield	Div Cushion	Economic Castl	Multiplie
GameStop	GME	17.3%	1.8	Attractive	31.29
General Motors	GM	3.8%	3.6	Attractive	13.82
Chico's FAS	CHS	5.9%	2.3	Attractive	13.74
Honda	HMC	3.6%	3.7	Neutral	12.98
Gilead Sciences	GILD	3.9%	3.1	Very Attractive	12.17
Chicago Rivet	CVR	3.0%	3.9	Neutral	11.78
Guess	GES	2.7%	3.9	Attractive	10.48
Automatic Data Processing	ADP	2.1%	5.0	Very Attractive	10.36
Abercrombie & Fitch	ANF	3.1%	3.3	Attractive	10.17
Cooper Tire & Rubber	CTB	1.2%	8.1	Neutral	9.96
Methode Electronics	MEI	1.6%	6.0	Attractive	9.75
Hewlett-Packard	HPQ	3.1%	3.1	Attractive	9.74
Bristol-Myers Squibb	BMY	3.4%	2.7	Very Attractive	9.29
Western Union	WU	4.5%	2.1	Neutral	9.22
American Eagle	AEO	2.6%	3.5	Attractive	9.19
Gap	GPS	3.6%	2.3	Attractive	8.46
Gentex	GNTX	1.9%	4.4	Attractive	8.37
Total	TOT	5.1%	1.6	Neutral	8.27
Huntsman	HUN	2.7%	3.0	Attractive	8.25
Ralph Lauren	RL	1.9%	4.3	Attractive	8.19
Omnicom	OMC	3.5%	2.3	Unattractive	8.01
Dick's Sporting	DKS	3.0%	2.6	Attractive	7.96
Cummins	CMI	3.1%	2.6	Attractive	7.94
Tapestry	TPR	4.1%	1.9	Attractive	7.93
Fluor	FLR	1.8%	4.4	Attractive	7.87
H&R Block	HRB	3.7%	2.1	Very Attractive	7.84
Walgreens Boots Alliance	WBA	3.2%	2.4	Attractive	7.80
Foot Locker	FL	2.3%	3.3	Attractive	7.74
Apple	AAPL	1.4%	5.5	Very Attractive	7.69
Archer-Daniels-Midland	ADM	3.3%	2.3	Attractive	7.66
Graham Holdings Co	GHC	0.8%	9.1	Attractive	7.50
AVX Corp	AVX	2.5%	2.9	Attractive	7.50
Manpower	MAN	2.4%	3.1	Attractive	7.47
Lear Corp	LEA	1.8%	4.1	Attractive	7.45
McKesson	MCK	1.2%	6.0	Very Attractive	7.45
Newmont Mining	NEM	1.8%	4.1	Neutral	7.40
Granite Construction	GVA	1.1%	6.8	Attractive	7.37
Amgen	AMGN	3.1%	2.4	Very Attractive	7.37
Ethan Allen	ETH	4.0%	1.8	Unattractive	7.31
Cisco	CSCO	2.5%	2.9	Very Attractive	7.29

DIVIDEND REPORT PAGE 2 – LOCKHEED MARTIN (LMT)

Lockheed Martin LMT FAIRLY VALUED

Buying Index™ 6 **Value Rating**

Economic Castle	Stock Fair Value Range	Dividend Track Record	Dividend Safety / Cushion™	Div Growth Potential	Dividend Yield
Attractive	$236.00 - $374.00	HEALTHY	GOOD / 1.6	GOOD	2.68%

Assessment of Company Dividend Strategy

Key Strengths

Lockheed's free cash flow generating capacity is strong, and by comparison, it runs a rather capital-light operation. Changes in US government funding and the integration of Sikorsky will impact reported results, but we remain impressed by Lockheed's cash-generating prowess. The company's backlog recently surpassed the $100 billion mark for the first time. The firm's deal with Leidos has resulted in the separation of its lagging Information Systems & Government Systems business, as well as receipt of $1.8 billion in cash, used to repay debt and return to shareholders. We'll be watching Lockheed's Dividend Cushion ratio closely in light of recent M&A activity, however, which we see as the biggest threat to its dividend health at this point in time.

Potential Weaknesses

A former unit of United Technologies, Sikorsky Aircraft, is now a part of Lockheed Martin, and while we like the transaction, credit metrics will face pressure as a result of the incremental debt on the books. Management is still buying back stock, despite the increase in leverage, and we're not sure this is a great move, particularly in light of our estimate of the company's intrinsic value. Share repurchases averaged ~$1.9 billion annually from 2016-2018, capital we think could have been more prudently used in shoring up the balance sheet. The firm is directly tied to US government spending levels and is dependent on continuing to win new contracts. Any swings in the national budget could impact results. Financial leverage should be monitored.

Graphical Relationship, Earnings and Dividends (per share)

The graph above shows the relationship between a firm's earnings per share and its dividends per share.

Dividend Cushion Cash Flow Bridge Evaluation

The Dividend Cushion Cash Flow Bridge, shown in the image to the right, illustrates the components of the Dividend Cushion ratio and highlights in detail the many drivers behind it. Lockheed Martin's Dividend Cushion Cash Flow Bridge reveals that the sum of the company's 5-year cumulative free cash flow generation, as measured by cash flow from operations less all capital spending, plus its net cash/debt position on the balance sheet, as of the last fiscal year, is greater than the sum of the next 5 years of expected cash dividends paid. Because the Dividend Cushion ratio is forward-looking and captures the trajectory of the company's free cash flow generation and dividend growth, it reveals whether there will be a cash surplus or a cash shortfall at the end of the 5-year period, taking into consideration the leverage on the balance sheet, a key source of risk. On a fundamental basis, we believe companies that have a strong net cash position on the balance sheet and are generating a significant amount of free cash flow are better able to pay and grow their dividend over time. Firms that are buried under a mountain of debt and do not sufficiently cover their dividend with free cash flow are more at risk of a dividend cut or a suspension of growth, all else equal, in our opinion. Generally speaking, the greater the 'blue bar' to the right is in the positive, the more durable a company's dividend, and the greater the 'blue bar' to the right is in the negative, the less durable a company's dividend.

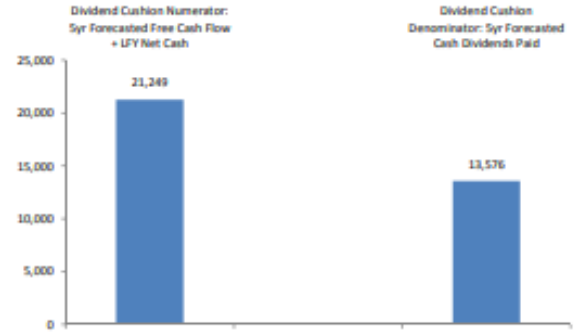
Dividend Cushion Cash Flow Bridge

Source: Company Filings, Valuentum Projections

Dividend Cushion Ratio Evaluation

The Dividend Cushion Ratio Deconstruction, shown in the image to the right, reveals the numerator and denominator of the Dividend Cushion ratio. At the core, the larger the numerator, or the healthier a company's balance sheet and future free cash flow generation, relative to the denominator, or a company's cash dividend obligations, the more durable the dividend. In the context of the Dividend Cushion ratio, Lockheed Martin's numerator is larger than its denominator suggesting strong dividend coverage in the future. The Dividend Cushion Ratio Deconstruction image puts sources of free cash in the context of financial obligations next to expected cash dividend payments over the next 5 years on a side-by-side comparison. Because the Dividend Cushion ratio and many of its components are forward-looking, our dividend evaluation may change upon subsequent updates as future forecasts are altered to reflect new information.

Dividend Cushion Ratio Deconstruction



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DEFINITIONS

ValueCreation. This is a proprietary Valuentum measure. ValueCreation indicates the firm's historical track record in creating economic value for shareholders, taking the average difference between ROIC (without goodwill) and the firm's estimated WACC during the past three years. The firm's performance is measured along the scale of EXCELLENT, GOOD, POOR, and VERY POOR. Those firms with EXCELLENT ratings have a demonstrated track record of creating economic value, while those that register a VERY POOR mark have been destroying economic value.

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).

ValueTrend. This is a proprietary Valuentum measure. ValueTrend indicates the trajectory of the firm's return on invested capital (ROIC). Firms that earned an ROIC last year that was greater than the 3-year average of the measure earn a POSITIVE rating. Firms that earned an ROIC last year that was less than the 3-year average of the measure earn a NEGATIVE rating.

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