Valuentum Securities, Inc. 12/2/2019 Edition 2, Volume 12

HIGH YIELD DIVIDEND NEWSLETTER

Bye Bye AMLP, More T and PM

Latest Changes to High Yield Dividend Newsletter
Previously Removed: 5% in AMLP – November 18
Previously Added: 2.5% to T; 2.5% to PM – November 18

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"WHILE THE 10-YEAR US TREASURY YIELD HAS PERKED UP OVER THE PAST COUPLE OF MONTHS, GROWING MACROECONOMIC HEADWINDS INDICATE INTEREST RATES COULD SHIFT LOWER IF A US-CHINA TRADE DEAL DOESN'T MATERIALIZE."
– CALLUM TURCAN

Image Shown: *We are encouraged by the strong fundamental and technical performance of AT&T and Philip Morris International of late. We recently added to our position in both companies in our High Yield Dividend Newsletter portfolio.*

By Callum Turcan and Brian Nelson, CFA

Please note a version of this article was emailed out to subscribers on November 18.

Dear members,

On November 18, we announced some exciting changes in our High Yield Dividend Newsletter portfolio. So far, we've been very impressed with the performance of AT&T (T) and one of our newest portfolio additions, Philip Morris International (PM). AT&T continues to use "excess" free cash flow (after covering its dividend obligations) to deleverage, which we really appreciate as that behooves its dividend coverage going forward. Recent activist shareholder activity has seen shares of T converge towards our fair value estimate of $40 per share, but we think shares of AT&T could run higher still.

AT&T could trade towards the upper end of our fair value estimate estimate of $48 per share given its strong technical performance this year, especially if the company continues to delever. **As of this writing, shares of T yield a nice 5.5%.**

Philip Morris International has benefited from the removal of the overhang its potential merger with Altria Group (MO) created, with that tie-up no longer being pursued. While we saw plenty of obvious synergies if such a merger were to materialize, it's better to look ahead to the future. Given the problems Altria Group is facing due to its large stake in Juul Labs, Philip Morris International likely dodged a bullet.

As Juul Labs and other flavored tobacco product vaping companies face growing regulatory pressure in the US, Philip Morris International's IQOS offering is well-positioned to take advantage (IQOS only recently launched in the US). The IQOS product has already been approved by the FDA and is similar in aesthetic to traditional cigarettes, putting it in a completely different category than products like Juul that have yet to be approved by the FDA. **Shares of PM yield 5.6% as of this writing** and could test the upper end of our fair value estimate range, which sits at $92 per share.

Image Shown: *Philip Morris International has already reported meaningful growth at its IQOS consumer base.* ***Image Source:*** *Philip Morris International – Third Quarter 2019 Earnings IR Presentation*

Given its lofty yield, the 5.0% weighting in energy infrastructure ETF Alerian MLP (AMLP) had provided the High Yield Dividend Newsletter portfolio with relatively steady income since inception of the newsletter portfolio (inception occurred a couple years after the significant drop in pipeline MLP prices).

However, to no surprise, at least from our perspective, the midstream space continues to face pressure on multiple fronts.

The corporate governance problems created by the midstream industry's now outdated master limited partnership ('MLP') structure, the lack of focus on traditional free cash flows, and the investing community's general dislike of most energy-related equities at this time (due in part to ongoing weakness in raw energy resource prices) has severely limited the potential investor pool in midstream equities. That has led to investor funds flowing elsewhere in a search for yield, depressing midstream equity valuations. Midstream assets remain cash flow cows, but we question the industry's capital allocation priorities.

That said, we continue to like Enterprise Products Partners (EPD)--**6.9% yield**--and Magellan Midstream Partners (MMP)--**6.8% yield**--**as best of breed in the midstream space** but think it's time to move on from AMLP given recent selling pressure and the dour outlook for North American upstream development activity in 2020. **On November 18, we closed out of the HYDN portfolio's 5.0% holding in AMLP.**

With the 5.0% weighting in AMLP removed at that time, we allocated half of that position to each of our existing positions in AT&T and Philip Morris International, meaning 7.5% of the High Yield Dividend Newsletter portfolio now is represented by shares of T (up from 5.0% previously) and 7.5% of the portfolio now is represented by shares of PM (up from 5.0% previously). We are optimistic on the trajectory of AT&T and Philip Morris International, and view the free cash flow profiles of both companies as stellar.

Please note that due to their large debt loads, AT&T and Philip Morris International need to retain access to capital markets, a task made significantly easier after the US Fed cut rates several times this year. We continue to like the other holdings in our High Yield Dividend Newsletter portfolio as well.

Disclosure: *Brian Nelson and Callum Turcan do not own any of the securities mentioned above.*

Magellan Midstream Keeps Growing

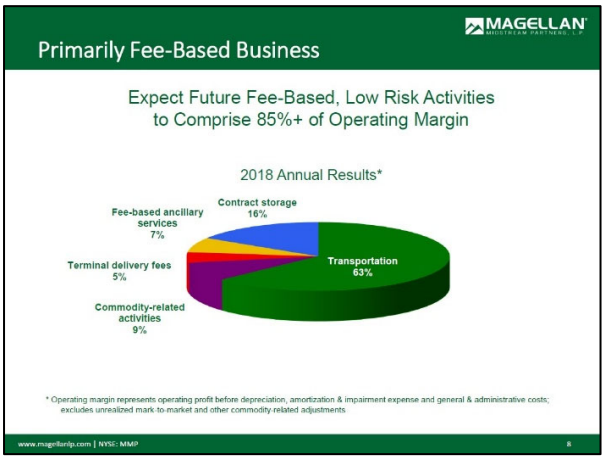


Image Shown: *Magellan Midstream is focusing heavily on growing its fee-based operations, with an eye towards expanding its refined products pipeline segment.* ***Image Source:*** *Magellan Midstream Partners L.P. – August 2019 IR Presentation*

By Callum Turcan

On October 31, Magellan Midstream Partners L.P. (MMP) --- **7.0% yield** --- reported third quarter 2019 earnings. Its quarterly GAAP operating income climbed 8% year-over-year due to a combination of top-line growth (GAAP revenues up 3% year-over-year) and lower operating expenses (GAAP operating expenses down 3% year-over-year).

Cost reductions were largely a function of reduced cost of products sales, meaning Magellan Midstream's marketing division had a decent quarter given the year-over-year growth in products sales revenue. Additionally, Magellan Midstream benefited from a modest reduction in other operating expenses, which was counterbalanced by rising G&A expenses on a year-over-year basis.

Quarterly Overview

Going forward, we like the relatively flat operating expense profile of Magellan Midstream (after removing its more volatile marketing activities, buying/selling third-party volumes, from this picture), especially as the oil and gas infrastructure company continues to grow its core asset base.

When removing changes in cost of product sales, Magellan Midstream's operating expenses were up just a fraction of a percent year-over-year last quarter. When removing products sales revenue growth from Magellan Midstream's third quarter performance, its top-line still grew nicely (transportation and terminals revenues were up 4% year-over-year).

Magellan Midstream's refined products operations saw both higher transportation revenues per barrel shipped and greater shipped volumes in the third quarter on a year-over-year basis, leading to an 12% increase in that segment's operating profit (dubbed operating margin by Magellan Midstream). Rising stored volumes at its marine storage operations helped increase Magellan Midstream's operating margin from that segment on a year-over-year basis. We appreciate that management has been placing a greater focus on growing Magellan Midstream's operations in these areas over the past several years.

Pivoting to Magellan Midstream's crude oil operations, while shipped volumes grew materially in the third quarter allowing for year-over-year increases in the segment's operating margin, we caution that Magellan Midstream's transportation revenues per barrel of crude oil shipped moved meaningfully lower year-over-year. That was partially due to the contract renewals that came into force during the fourth quarter of 2018 locking in significantly lower committed rates along Magellan Midstream's Longhorn Pipeline (a product of rising long-haul pipeline competition in West Texas, and a slowdown in North American drilling and completion activity).

In the past, Magellan Midstream has contemplated selling off a large stake in the Longhorn Pipeline as the company is placing a great emphasis on growing its refined products and marine terminal operations. The Longhorn Pipeline runs for ~450 miles from West Texas (home to the prolific Permian Basin) to Houston, Texas, with the capacity to transport 275,000 barrels of crude oil per day. Reportedly, Magellan Midstream also included some of its storage assets along the Gulf Coast to the divestment package to make the deal more appealing. As an aside, Magellan Midstream sold off part of its interest in in the BridgeTex Pipeline in 2018, retaining a 30% equity stake in the venture.

The graphic down below highlights one of Magellan Midstream's refined products pipeline system expansions set to come online next year.

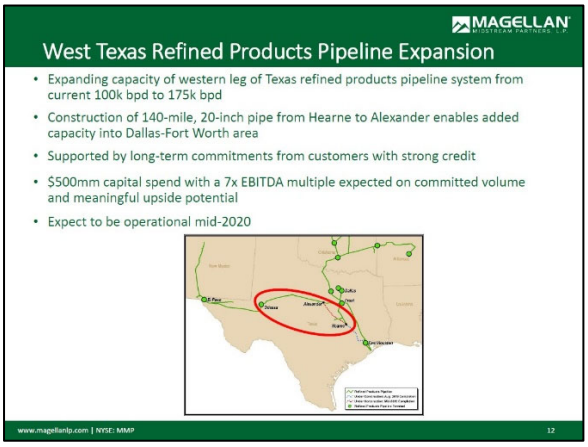


Image Shown: *Magellan Midstream seeks to expand its refined products operations due to stable nature of the cash flow profiles pipeline systems catering towards the space often have.* ***Image Source:*** *Magellan Midstream – August 2019 IR Presentation*

Concluding Thoughts

We continue to like Magellan Midstream as a holding in our High Yield Dividend Newsletter portfolio. **The company's investment grade credit ratings (BBB+/Baa1 as of August 2019) and preference to fund its growth trajectory with debt instead of equity (equity issuances have been very muted since 2010) allows for steady and sustainable increases in the company's per unit distribution.**

Magellan Midstream retains access to capital markets at attractive rates and will likely take advantage of the subdued interest rate environment by refinancing portions of its existing debt load at lower rates when able. Magellan Midstream's quarterly distribution per unit has grown by almost three-fold since the start of 2010, and there's room for additional payout increases over the coming years.

Pivoting towards the marine terminal and refined products space will materially strengthen Magellan Midstream's cash flow profile going forward, in our view.

Disclosure: *Callum Turcan do not own any of the securities mentioned above.*

BP Sees Cash Flow Profile Improvements Ahead

Image Source: *BP plc – Third quarter 2019 earnings infographic*

By Callum Turcan

On October 29, BP plc (BP) reported third-quarter 2019 earnings and shares initially climbed higher due in part to the energy giant's nice cash flow profile. We include BP in our High Yield Dividend Newsletter portfolio as a way to play the raw energy resource market and generate sizable income streams while taking advantage of the protection its large midstream (pipelines, storage facilities, etc.), downstream (refineries and petrochemical plants), and retail (gas stations and convenience stores) operations provide. Additionally, we like BP's growing upstream oil & gas production base, a product of stellar operational execution of late. **Shares of BP yield 6.6% as of this writing.**

Cash Flow and Gearing Update

BP's gearing ratio has moved up over its long-term target of 20%-30%, hitting 31.7% in the third quarter of 2019. **Management expects BP's gearing ratio will come down over time due in part to the expected cash proceeds from BP exiting Alaska.** In August 2019, after operating for sixty years in the state, BP sold its remaining Alaskan assets to privately-held Hilcorp for $5.6 billion in total consideration ($4.0 billion in near-term payables, $1.6 billion in earnouts). The deal is expected to close in 2020 and will help pare down BP's net debt load. Management expects BP will divest $5.0-$10.0 billion worth of assets in 2019 and 2020, with the Alaskan sale representing a large part of that.

In the graphic below, note BP's strong underlying cash flows relative to its dividend payments and organic capital expenditures. Looking ahead, BP's Gulf of Mexico oil spill payments should continue to shift lower once most of the remaining payments are predominantly (if not entirely) from BP's 2015 settlement with the US and five Gulf Coast states. BP paid $2.5 billion towards its spill-related settlements during the first three quarters of 2019 and expects to pay about that amount for the full-year (indicating minimal fourth quarter spill-related payments are expected to be made).

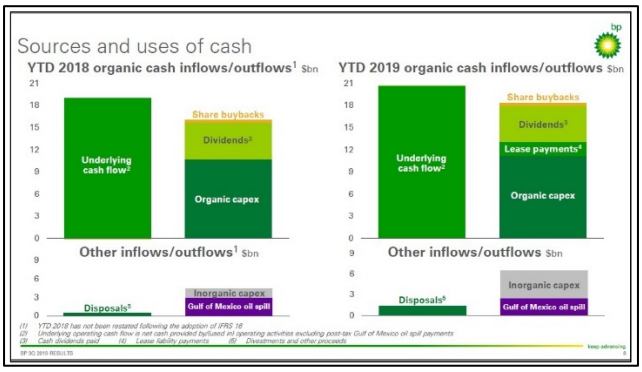


Image Shown: *BP's cash flow profile remains strong.* ***Image Source:*** *BP – Third quarter 2019 earnings presentation*

Within its fourth quarter 2017 earnings report, **BP noted that by 2021, its annual Gulf of Mexico oil spill-related payments would hit ~$1 billion**. That being said, these payments have often exceeded expectations, but the trend still holds (that payments are shifting lower as BP settles the remaining private-party agreements, keeping in mind the company's Gulf of Mexico oil spill-related payments totaled $5.3 billion in 2017). **Reduced oil spill-related payments will go a long way in bolstering BP's cash flow profile.**

Russian Holdings

Please note BP owns just under 20% of Russian energy giant Rosneft's (OJSCY) equity, which is very material given the sheer size of Rosneft's upstream oil and gas output. In the upcoming graphic at the top of this page, BP highlights the significance of its equity stake in Rosneft to its own financials. As an aside, BP has a seat on Rosneft's board (keeping in mind the Russian government generally has an outsized influence on the country's energy policy).

Rosneft is majority-owned by the Russian government. Going forward, Rosneft is investing in building out its own refining capacity while boosting its upstream production levels as best it can given the ongoing OPEC+ production limits in place that are curbing Russian oil output.

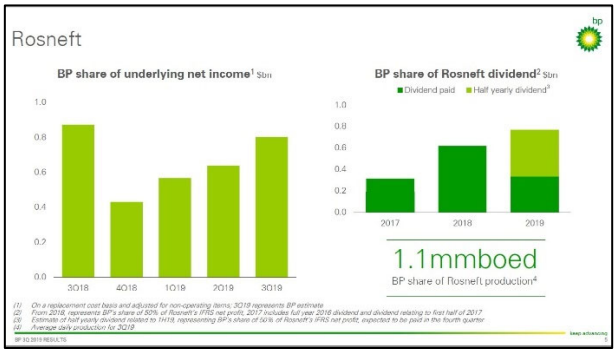


Image Shown: *BP receives a material amount from Rosneft each year in the form of dividends paid to equity holders, a figure that has grown materially since 2017 due largely to oil prices stabilizing relatively speaking.* ***Image Source:*** *BP – Third quarter 2019 earnings presentation*

Looking Ahead

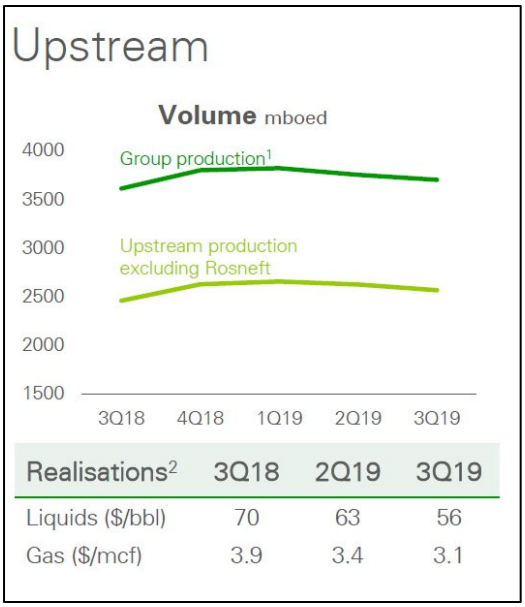
Large energy companies like BP will always be at the mercy of market forces, with pricing for raw energy resources and refined products having an outsized influence on its financial performance regardless of how well its operating performance goes. While its downstream operations, such as its Whiting Refinery in Indiana, Cherry Point Refinery in Washington State, and BP Rotterdam Refinery in the Netherlands, helps mitigate the worst of a crash in raw energy resource prices (refining margins tend to rise when crude oil and natural gas prices fall), **those assets can only do so much when upstream financials falter.**

BP's Whiting Refinery is particularly noteworthy as that facility directly capitalizes on the yawning spread between Brent, the world's international benchmark that sets most gasoline and diesel prices (to a degree), and Western Canadian Select, the benchmark for heavy sour oil supplies namely from Alberta. Management seeks to continue expanding the facility going forward, building on past upgrades that turned out to be huge successes given the economics of refining heavy sour oil supplies in the US Midwest.

Additionally, BP has substantial petrochemical assets in the US, Germany, China, Taiwan, and elsewhere, which produce anything from plastics to lubricants. Those operations also tend to benefit from lower raw energy resource prices.

On the upstream front, BP has brought 23 of 35 planned major developments online since 2016 including; the Juniper project in Trinidad and Tobago (brought online on-time and under budget), Khazzan Phase One project in Oman (brought online ahead of schedule and under budget), the Thunder Horse Northwest Expansion project in the US Gulf of Mexico (brought online ahead of schedule and under budget), and much more.

Looking ahead, BP has upstream endeavors in Oman, the US Gulf of Mexico, Azerbaijan, and elsewhere that are slated to become operational over the coming years. The goal is to bring an additional 900,000 barrels of oil equivalent per day of upstream output online by the end of 2021 (from key projects completed in 2016-2021). **We really appreciate BP's stellar operational execution of late, subdued raw energy resource pricing aside.**



Realisations[2]	3Q18	2Q19	3Q19
Liquids ($/bbl)	70	63	56
Gas ($/mcf)	3.9	3.4	3.1

Image Shown: *BP's realizations have weakened materially over the past year due to raw energy resource prices deteriorating in the face of a tsunami of oil, gas, natural gas liquids, and liquified natural gas supplies coming online in North America, Australia, and elsewhere.* ***Image Source:*** *BP – Third quarter 2019 earnings presentation*

Concluding Thoughts

We continue to like BP as a holding in the High Yield Dividend Newsletter portfolio. **Rising upstream production levels, a quality downstream footprint, and reduced Gulf of Mexico oil spill-related payments will go a long way in enhancing BP's cash flow position.** Raw energy resource prices remained subdued around the globe, but that isn't stopping BP from fully covering its organic capital expenditures and dividend payments with underlying cash flows. We would like to see BP's gearing ratios move lower, which is the stated goal.

Disclosure: *Callum Turcan do not own any of the securities mentioned above.*

Member Question: Reaves Utility Income Fund

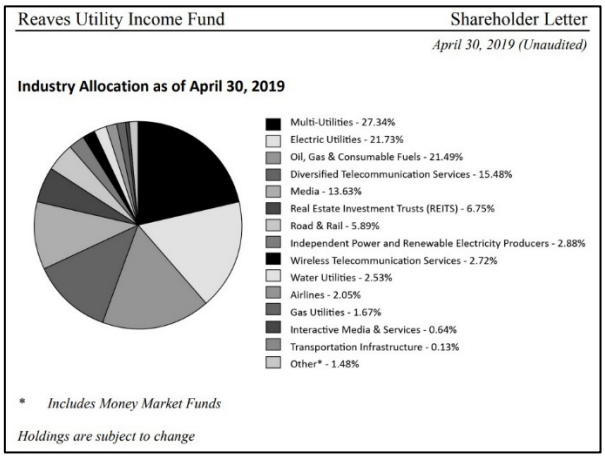


Image Source: *Reaves Utility Income Fund - April 30, 2019*

By Brian Nelson, CFA

Question: Have you ever looked at Reaves Utility Income Fund (UTG)? The fund is a utility fund that uses a little bit (20%) of leverage. I have owned them for a long time and have made a good return, but I wonder going forward if I should keep them in my portfolio? Utilities are popular right now, but popularity worries me.

Answer: For starters, as is the case for financial publishers such as Valuentum, we can't provide any personal advice, as we're not aware of your personal goals and risk tolerances.

Please always contact your personal financial advisor regarding any investment decision. With that said, according to Reaves' website, "the Reaves Utility Income Fund is a closed-end fund. Reaves Asset Management is the Investment Adviser to the Fund. The Fund invests primarily in electric and gas utilities and aims to generate a high level of monthly income for investors." Here is the stated Investment Objective:

> *The Fund's objective is to provide a high level of after-tax total return consisting primarily of tax-advantaged dividend income and capital appreciation. It intends to invest at least 80% of its total assets in dividend-paying common and preferred stocks and debt instruments of companies within the utility industry. The remaining 20% of its assets may be invested in other securities including stocks, money market instruments and debt instruments, as well as certain derivative instruments in the utility industry or other industries.*

There are two things that struck us right away in looking at this closed-end fund. First, the closed-end fund increased its leverage facility to 28.8% in October of last year, up from 19.8% previously, so this change is something to be aware of (leverage stood at 26.5% in April 2019). Second, for the fiscal year ended October 2018, interest paid on loans, investment advisory fees, administration fees and other expenses totaled $29.6 million, or about 1.5% of investments, at value, as of the end of October 2018. While 1.5% isn't too bad of an expense ratio, by our estimates, we'd like to see an expense ratio a bit lower, especially if turnover of this fund is rather low.

The top holdings of this closed-end fund, as of September 30, 2019, are Sempre Energy (SRE), DTE Energy (DTE), Verizon Communications (VZ), NextEra Energy (NEE), BCE Inc. (BCE), Union Pacific (UNP), WEC Energy Group (WEC), Charter Communications (CHTR), ONEOK (OKE), and Royal Dutch Shell (RDS.A). Collectively, the top 10 holdings account for ~43% of the portfolio. What a lot of these companies have in common is rather large net debt positions, and many aren't necessarily attractively priced as many have benefited materially from declining Treasury rates and lower borrowing costs.

Though many of the closed-end fund's top holdings are strong businesses, in the context of the leverage already applied to operate the fund, the Reaves Utility Income Fund becomes one of debt upon debt to eek out a relatively modest net yield. In the fund's April report, it had outstanding borrowings of $445 million at an interest rate of ~3.5%. This Reeve's closed-end fund currently pays out about $0.18 per month in dividends ($2.16 per share on a forward annual basis), so that means its gross yield is about 5.9%. After deducting for its expense ratio of ~1.5%, by our estimates, we're looking at a fairly leveraged closed-end fund on debt-heavy utility equities with **a net yield of about 4.5%.**

There are certainly some interesting attributes of the Reaves Utility Income Fund, including the application of leverage to enhance yield, but most of that yield augmentation is reduced as a result of the expenses of the fund (and of course, the interest paid on the loan to enhance the yield). The closed-end fund offers some diversification across utilities, communications and energy stocks and even, as of April 2019, had exposure to entities such as Delta (DAL), Alphabet (GOOG, GOOGL), Union Pacific, and Annaly Capital (NLY), but we think Valuentum's High Yield Dividend Newsletter portfolio is much better positioned, and it has a higher yield to boot (without the application of leverage).

The Reaves Utility Income Fund has done well in the past (as interest rates have fallen alongside a very strong bull market), but investors are not receiving the full benefit of the leverage that management is applying to already-leveraged entities in the fund. In fact, investors are taking on all the risk. There also doesn't appear to be too-much of a valuation overlay to the portfolio, which could expose investors to overpriced dividend payers, something that many learned the hard way when venturing into the master limited partnership arena. **For those seeking exposure to high-yield dividend considerations with an intrinsic-value-focused overlay, we continue to prefer the High Yield Dividend Newsletter portfolio, which offers a much more diversified basket of high-yield dividend considerations.**

-- THE HIGH YIELD DIVIDEND SPOTLIGHT IS ON THE NEXT PAGE --

High Yield Spotlight: Covering Cardinal Health Inc (CAH), a Healthcare Giant with Strong Free Cash Flows

Cardinal Health (CAH) --- 3.5% yield --- is one of the leading healthcare services and products providers as its operations cater to over 29,000 pharmacies, more than 10,000 specialty physical offices and clinics, over 6,500 laboratories, and almost 90% of US hospitals. Cardinal Health distributes branded and generic pharmaceuticals, radiopharmaceuticals (for imaging and therapeutic purposes), over-the-counter healthcare and consumer products, and provides a whole slate of services (such as pharmacy management and medication therapy management services) under its 'Pharmaceutical Segment' which caters to the US. The company's 'Medical Segment' manufactures, sources, and distributes branded laboratory, medical, and surgical products all over the world, as well as offering various services to its customers (such as supply chain management solutions). For reference, Cardinal Health's fiscal 2019 ended on June 30, 2019.

From fiscal 2017 to fiscal 2019, Cardinal Health's GAAP revenues grew by 12% to $145.5 billion, assisted by very favorable growth in US healthcare spending. CVS Health (CVS) represented 26% of Cardinal Health's fiscal 2019 revenues, with Cardinal Health's five largest customers representing 51% of its revenues that fiscal year. Given the nature of the healthcare landscape, Cardinal Health does come with a good amount of business concentration risk. In May 2019, Cardinal Health's pharmaceutical distribution agreement with CVS was extended through fiscal 2023, removing a large amount of uncertainty in the medium-term. Cardinal Health also recently extended its contract with Kroger (KR). In the pharmaceutical distribution space, Cardinal Health faces competition from McKesson (MCK) and AmerisourceBergen (ABC).

Please note that Cardinal Health's recent contract renewals will put downward pressure on its financial performance in the near-term. Cardinal Health notes that these contract renewals were locked in at lower rates which will pressure its bottom line, offsetting incremental top line improvements at its Pharmaceutical Segment. Additionally, Cardinal Health's margins faced some pressure from fiscal 2017 to fiscal 2019 for a variety of reasons (unfavorable product mix changes, weakness at its generic pharmaceutical distribution business). **Cardinal Health is seeking to offset these headwinds by pursuing incremental cost savings, some of which are due to acquisition synergies.** Here's what Cardinal Health's CEO Mike Kaufmann had to say during the firm's first quarter fiscal 2020 earnings conference call;

> *"We are already leveraging some synergies, but we see a path to capture significantly more. To that end, within the next quarter, we will finalize plans to reduce cost and deliver industry-leading service across our global network. These plans will take some time to execute. So, we have a strong governance structure in place and are committed to diligently managing our costs to realize the greatest long-term benefit. As in Pharma, we're making significant investments across the Medical Segment to improve the customer experience and drive growth in both the products and services spaces."*

On July 2017, Cardinal Health acquired Medtronic's (MDT) 'Patient Care, Deep Vein Thrombosis and Nutritional Insufficiency' operations for $6.1 billion. The business offered almost two dozen product categories under leading industry brands such as Curity, Kendall, Dover, Argyle, and Kangaroo. Management aims for $150 million in annualized synergies by the end of Cardinal Health's fiscal 2020. These savings are expected to improve Cardinal Health's financials over the long-haul as the company begins to put its problems behind it. Cardinal Health aims to realize $130+ million in incremental synergies in fiscal 2020 after locking in $133 million in incremental synergies as you can see in the upcoming graphic at the start of the next page (Page 9).

FY19 highlights

Operating Performance	▪ Exceeded non-GAAP EPS guidance for the year ▪ Delivered double digit revenue and profit growth in strategic growth areas – Specialty, At Home, and Medical Services ▪ Realized cost savings of $133M, which exceeded our target ▪ Renewed contracts with CVS and Kroger for 4+ years
Capital Deployment	▪ Generated $2.7B in operating cash flow ▪ Returned $1.2B to shareholders through dividends and share repurchases ▪ Paid down $1.1B of long-term debt
Portfolio	▪ Completed the acquisitions of Mirixa® and mscripts® ▪ Finalized partnership to accelerate growth of naviHealth

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CardinalHealth

Image Shown: *Cardinal Health is targeting incremental cost savings to improve its financial performance and to offset near-term headwinds.* ***Image Source:*** *Cardinal Health – Annual Shareholder Meeting IR Presentation November 2019*

While Cardinal Health's Pharmaceutical Segment generates ~90% of its revenues, that operation generates ~70% of its segment profit **as its Medical Segment carries much stronger margins**. The acquisition from Medtronic supports Cardinal Health's drive to become a more profitable enterprise. Cardinal Health aims to enhance the margins of its Medical Segment by consolidating two of its California distribution centers into one flagship center. On the revenue side of things, Cardinal Health is shaking up its sales tactics to better incentivize its sales force to sell Cardinal Health-branded products.

Q1 FY20 Medical segment results

	Q1 FY20 ($M)	Q1 FY19 ($M)	YoY change
Revenue	**$3,917**	**$3,801**	**3%**
Segment profit	**$170**	**$135**	**26%**
Segment profit margin	**4.33%**	**3.55%**	**78 bps**

Drivers:

Revenue

+ Products and distribution
+ Cardinal Health at Home
- Divestiture of the naviHealth business

Segment profit

+ Cost savings initiatives
+ Products and distribution
+ Services
+ Cardinal Health at Home
- Divestiture of the naviHealth business

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CardinalHealth

Image Shown: *The driving forces behind the improving financial performance at Cardinal Health's Medical Segment. An expanding segment margin was made possible through revenue growth, incremental cost savings, and strength at its Cardinal Health at Home business.* ***Image Source:*** *Cardinal Health – First Quarter Fiscal 2020 Earnings IR Presentation*

As you can see in the graphic below, **Cardinal Health is expecting decent growth at its Medical Segment in fiscal 2020 on both a top- and bottom-line basis**. Strength at its Cardinal Health at Home business (providing home care and hospice services along with home medical equipment products and related services) will play a key role in growing segment revenue. As Cardinal Health expects its Medical Segment profit growth to outpace its revenue profit, that implies meaningful margin expansion on the segment level. On the other hand, while Cardinal Health's Pharmaceutical Segment is expecting decent sales growth, that segment's profit is expected to decline materially due to the contract renewals with its big pharmacy customers (CVS, Kroger, and others).

FY20 segment outlook

Segment	Revenue	Profit
Pharmaceutical	Mid-single digit percentage growth	High-single to low-double digit percentage decline
Medical	Low-single digit percentage growth	Low-double digit percentage growth

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CardinalHealth™

Image Shown: *Cardinal Health's Medical Segment will help compensate for the near-term headwinds facing its Pharmaceutical Segment.* ***Image Source:*** *Cardinal Health – First Quarter Fiscal 2020 Earnings IR Presentation*

In early-January 2019, Cardinal Health acquired Mirixa (financial terms weren't disclosed) to improve efficiency at its pharmaceutical distribution, documentation, and billing operations. That acquisition was followed up by Cardinal Health acquiring mscripts in April 2019, which will further digitalize and streamline its operations. These deals represent a core part of management's strategy when seeking incremental improvements at Cardinal Health's Pharmaceutical Segment going forward. **Those improvements will help Cardinal Health win over new business, retain current customers, and drive down expenses thus potentially allowing for margin expansion to return.** However, please note that Cardinal Health sold off a large chunk of its naviHealth business (offers post-acute care management services) in August 2018 for ~$0.75 billion in cash. Cardinal Health retains a stake in the venture through a 44% equity stake in the company that owns 100% of naviHealth.

Cardinal Health's cash flow profile held up very well through all of this. From fiscal 2017 to fiscal 2019, Cardinal Health generated $1.9 billion in annual free cash flow on average. Annual dividend obligations averaged $0.6 billion during this period, which were easily covered by free cash flow with room to spare. **Removing its relatively weak fiscal 2017 cash flow performance from the mix, and Cardinal Health generated $2.4 billion in annual free cash flows on average from fiscal 2018 to fiscal 2019.**

Management has been steadily reducing Cardinal Health's outstanding share count over the past few years. The company spent $0.6 billion on average per year from fiscal 2017 to fiscal 2019 buying back its stock, which reduced its weighted-average outstanding diluted share count from 320 million in fiscal 2017 to 301 million in fiscal 2019. Cardinal Health expects to continue buying back its stock in fiscal 2020.

Cardinal Health exited the first quarter of fiscal 2020 (period ended September 30, 2019) with $1.2 billion in cash and cash equivalents on hand versus $8.0 billion in total debt. **Given the strength of its free cash flow profile, this net debt load is quite manageable.** Additionally, Cardinal Health reduced its net debt load from ~$7.3 billion at the end of its fiscal 2018 to ~$6.8 billion by the end of its first quarter of fiscal 2020. **We appreciate management directing free cash flow towards deleveraging activities.**

Please note that like several of its peers, Cardinal Health is contending with numerous opioid crisis-related lawsuits across the US and that has weighed negatively on its stock price as investors worry about the size and scope of its potential liabilities. In October 2019, Cardinal Health took a big step in the right direction (excerpt sourced from its first quarter fiscal 2020 10-Q filing):

> *In October 2019, we agreed in principle to a global settlement framework with a leadership group of four state attorneys general from the multi-state task force that is designed to resolve all pending and future opioid lawsuits and claims by states and political subdivisions, but not private plaintiffs (the "Settlement Framework"). This Settlement Framework is subject to contingencies and uncertainties as to final terms, but is the basis for our negotiation of definitive terms and documentation.*
>
> *The Settlement Framework includes (1) a cash component, pursuant to which we would pay up to $5.56 billion over eighteen years, (2) development and participation in a program for free or rebated distribution of opioid abuse treatment medications for a period of ten years, and (3) industry-wide changes to be specified to controlled substance anti-diversion programs. The Settlement Framework is in its early phases, and there is no assurance that the necessary parties will agree to a definitive settlement agreement or that the contingencies to any agreement will be satisfied. We have included a $5.56 billion accrual related to the Settlement Framework in deferred income taxes and other liabilities in the condensed consolidated balance sheets and litigation (recoveries)/charges, net, in the condensed consolidated statements of earnings.*

The cash component of this agreement is very manageable given that it will be paid out over 18 years, keeping the strength of Cardinal Health's free cash flows in mind. Providing some services for free over a period of ten years is another cost to consider. Cardinal Health took a ~$5.7 billion charge relating to expected litigation (largely from the opioid settlement agreement) expenses during the first quarter of its fiscal 2020. We expect that should this opioid settlement agreement get approved, Cardinal Health would likely slow down or halt its buyback program to cover its legal obligations while still making good on its dividend payments.

Cost savings from incremental synergies and sales growth at its Medical Segment will help support Cardinal Health's financial performance in the near-term to offset headwinds at its Pharmaceutical Segment. Longer term, the portfolio enhancements Cardinal Health has made via acquisitions should allow the company to return to consistent profit growth. **Most importantly, management plans to keep Cardinal Health's capital expenditures contained to allow for ample free cash flows.** Capital investment is expected at $320-$360 million in fiscal 2020, down from the annual average of ~$366 million in the fiscal 2017 to fiscal 2019 period.

Cardinal Health's fiscal 2020 will be a bumpy ride, but the healthcare company's outlook is getting brighter and brighter. Ongoing strength at its Medical Segment with an eye towards its Cardinal Health at Home operations, recent acquisitions that could support various administrative and logistical operations for clients of its Pharmaceutical Segment, incremental cost savings across the board, past deleveraging efforts, and its strong free cash flow profile should allow for Cardinal Health to power past near-term headwinds. Should a resolution be reached over the opioid crisis America, building on the framework already in place, a lot of uncertainty clouding over Cardinal Health's outlook would abate.

Management remains committed to maintaining Cardinal Health's investment grade credit ratings, and recent deleveraging efforts are a testament to that commitment. **We are confident that the strength of Cardinal Health's free cash flow profile should allow for the company to keep making good on its future dividend obligations, while providing room for payout growth upside over time.**

Consolidated Statements of Cash Flows

(in millions)	2019	2018	2017
Cash flows from operating activities:			
Net earnings	$ 1,365	$ 259	$ 1,294
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	1,000	1,032	717
Impairments and loss on sale of other investments	3	6	4
Impairments and loss/(gain) on disposal of assets, net	(488)	1,417	18
Share-based compensation	82	85	96
Provision for/(benefit from) deferred income taxes	(83)	(1,012)	291
Provision for bad debts	88	74	36
Change in fair value of contingent consideration obligation	—	(2)	(5)
Change in operating assets and liabilities, net of effects from acquisitions and divestitures:			
Increase in trade receivables	(751)	(871)	(665)
Increase in inventories	(551)	(1,211)	(673)
Increase in accounts payable	1,864	2,574	564
Other accrued liabilities and operating items, net	193	417	(493)
Net cash provided by operating activities	2,722	2,768	1,184
Cash flows from investing activities:			
Acquisition of subsidiaries, net of cash acquired	(82)	(6,142)	(132)
Additions to property and equipment	(328)	(384)	(387)
Purchase of available-for-sale securities and other investments	(18)	(9)	(194)
Proceeds from sale of available-for-sale securities and other investments	3	65	228
Proceeds from maturities of available-for-sale securities	—	—	77
Proceeds from divestitures, net of cash sold, and disposal of property and equipment	763	862	3
Net cash provided by/(used in) investing activities	338	(5,608)	(405)
Cash flows from financing activities:			
Payment of contingent consideration obligation	—	(35)	(3)
Net change in short-term borrowings	—	(50)	3
Purchase of noncontrolling interests	—	(106)	(12)
Proceeds from interest rate swap terminations	—	—	14
Proceeds from long-term obligations, net of issuance costs	—	3	5,171
Reduction of long-term obligations	(1,102)	(954)	(310)
Net tax proceeds/(withholding) from share-based compensation	(14)	(3)	26
Excess tax benefits from share-based compensation	—	—	34
Dividends on common shares	(577)	(581)	(577)
Purchase of treasury shares	(600)	(550)	(600)
Net cash provided by/(used in) financing activities	(2,293)	(2,276)	3,746
Effect of exchange rates changes on cash and equivalents	1	4	(2)
Cash reclassified to assets held for sale	—	(4)	—
Net increase/(decrease) in cash and equivalents	768	(5,116)	4,523
Cash and equivalents at beginning of period	1,763	6,879	2,356
Cash and equivalents at end of period	$ 2,531	$ 1,763	$ 6,879

Image Shown: *Cardinal Health's free cash flow profile is quite strong.* ***Image Source:*** *Cardinal Health – Fiscal 2019 Annual Report*

Disclosure: *Callum Turcan does not own any of the securities mentioned above.*

Shares of HP Converge Towards Intrinsic Value After Xerox Move

Image Shown: *Shares of HP Inc leapt higher after news broke that Xerox Holdings Corporation had made a cash-and-stock buyout offer to take control of the printing and PC behemoth.*

By Callum Turcan

Shares of printing and PC behemoth HP (HPQ) --- 3.5% yield --- have begun to converge towards our fair value estimate of $25 after recently receiving an unsolicited cash-and-stock buyout offer from copying and printing giant Xerox Holdings (XRX) --- 2.6% yield --- worth ~$22 per share at the time ($17 per share in cash and 0.137 shares of Xerox). **HP's management forcefully rejected the offer in November and the company's board of directors unanimously voted down the proposal, going as far as to criticize the trajectory of Xerox's revenues and question of elevated debt load such an entity would carry on a pro forma basis.** Xerox's management team is now taking the unsolicited offer straight to HP's shareholders, and in their November 26 letter to HP, Xerox made it clear that they aren't giving up without a fight.

Overview

During the first nine months of 2019, Xerox's GAAP revenues came in at $6.7 billion, down from $7.3 billion in the same period last year. However, Xerox cut its total costs and expenses this period by ~10% year-over-year, cushioning itself from the blow of sharply lower sales figures. HP's GAAP revenues fared better during the its fiscal 2019 (fiscal year ended October 31, 2019), hitting $58.8 billion, with its sales up marginally during this period versus the same period last fiscal year. Strength at HP's PC business (segment revenue was up 3% year-over-year) offset the decline at its printing business (segment revenue was down 4% year-over-year), but company-wide sales growth still remains elusive (up just a fraction of a percent year-over-year). HP's total costs and expenses grew modestly year-over-year, in contrast to Xerox's sharp costs reductions.

Carl Icahn has gotten involved, reportedly buying up a stake in both companies and pushing for a merger. The general idea here is that while both HP and Xerox face major structural hurdles in the printing space, by joining forces the combined company's costs could be substantially reduced (in part due to ever greater economies of scale, but more so due to the ability to shrink the size of their workforce). **However, HP is already in the process of a major corporate restructuring.** In early-October 2019, HP announced plans to cut 7,000 – 9,000 jobs over the coming years in a move that's expected to save ~$1.0 billion on an annualized basis by the end of HP's fiscal 2022.

Part of the reason behind HP rebuffing Xerox's buyout offer likely stems from management believing that HP would be worth considerably more after its restructuring process is complete (meaning the future estimated free cash flow potential of HP should be substantially enhanced in the event operating costs fall significantly over the coming years). HP has already embarked on one restructuring program after separating from Hewlett Packard Enterprise (HPE) in 2015, but management is recognizing that there's still a lot of work to be done.

HP's printing business is in decline (potentially terminal decline), and while its PC business is doing better, there's not much the company can do when one of its core operations is facing such serious headwinds. Consumers don't need to print the same amount that they used to, and neither do businesses or even governments given the rise of digital technology and other societal advancements.

Combining the operations of HP and Xerox would largely be a defensive maneuver, not an offense one, as the goal isn't to drive revenue growth but to create a situation that allows for serious cost reductions. There's a possibility that such a merger would smooth out the combined company's revenue streams by offering a wider slate of products, but that doesn't really fix the core problems HP and Xerox are facing in the printing space.

Valuation Analysis

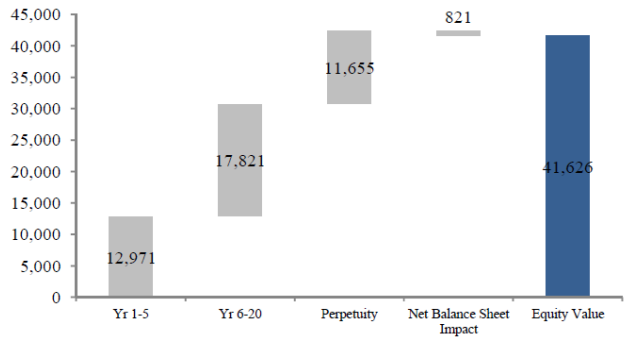
In the graphic below, from our 16-page Stock Report covering HP, we highlight the valuation assumptions we used in our base case scenario when arriving at a fair value estimate of $25 per share of HPQ. We modeled continued top line pressure over the next five full fiscal years that ultimately feeds down into expectations that HP's free cash flow to the firm performance will weaken considerably during this period, before covering modestly during the mid-cycle and perpetuity part of HP's business cycle.

Valuation Assumptions

In Millions of USD (except for per share items)	5-year Projections	
Revenue CAGR %	-0.3%	
Avg. EBIT Margin %	7.8%	
Avg. Cash Tax Rate %	16.0%	
Earnings Before Interest CAGR %	-2.9%	
Earnings Per Share CAGR %	-6.2%	
Free Cash Flow to the Firm CAGR %	-4.5%	
Earnings before interest = Net operating profits less adjusted taxes	Long-term Projections	
Phase II --> III FCFF CAGR %	1.3% (II)	3% (III)
Cost of Equity %	10.2%	
After-tax Cost of Debt %	4.6%	
Discount Rate (WACC) %	9.2%	
Synthetic credit spread = 1.18%	Results	
Phase I Present Value	12,971	
Phase II Present Value	17,821	
Phase III Present Value	11,655	
Total Firm Value	42,447	
Net Balance Sheet Impact	-821	
Total Equity Value	41,626	
Diluted Shares Outstanding	1,634.0	
Fair Value per Share	$25.00	

Valuation Breakdown

In the chart below, we show the build up to our estimate of total enterprise value for Hewlett-Packard and the break down to the firm's total equity value, which we estimate to be about 41.63USD billion. The present value of the enterprise free cash flows generated during each phase of our model and the net balance sheet impact is displayed. We divide total equity value by diluted shares outstanding to arrive at our $25 per share fair value estimate.



In Millions of USD

Image Shown: *Under our base case scenario, our fair value estimate for HP stands at $25 per share of HPQ.*

Revenue headwinds aside, HP's free cash flows remain strong. During its fiscal 2019, HP generated $4.0 billion in free cash flows due to its capital expenditure light business model. $1.0 billion in dividends were paid during this period, on top of $2.4 billion in share repurchases, all of which were easily covered by free cash flows. There's plenty of room for HP to push through future dividend increases, and please note the company just raised its per share payout by ~10% sequentially this November. HP exited October 2019 with $4.5 billion in cash and cash equivalents on hand versus $0.4 billion in short-term debt and $4.8 billion in long-term debt. HP's modest net debt position combined with its strong free cash flow profile is why we give the firm a Dividend Cushion ratio of 2.9x, earning HP an EXCELLENT Dividend Safety rating. Additionally, we give HP an EXCELLENT Dividend Growth rating given the promising outlook for meaningful payout increases going forward, keeping structural headwinds in mind.

Pushing Back

On November 17, HP published a letter it sent to Xerox after HP's board of directors unanimously rejected Xerox's buyout proposal. Here's a choice excerpt from HP's management:

> *"We recognize the potential benefits of consolidation, and we are open to exploring whether there is value to be created for HP shareholders through a potential combination with Xerox. However, as we have previously shared in connection with our prior requests for diligence, we have fundamental questions that need to be addressed in our diligence of Xerox. We note the decline of Xerox's revenue from $10.2 billion to $9.2 billion (on a trailing 12-month basis) since June 2018, which raises significant questions for us regarding the trajectory of your business and future prospects."*

That was followed up by another letter HP sent Xerox, which was published on November 24. Here are some more choice quotes from HP's management team (emphasis added):

> *"We reiterate that we reject Xerox's proposal as it significantly undervalues HP. Additionally, it is highly conditional and uncertain. In particular, there continues to be uncertainty regarding Xerox's ability to raise the cash portion of the proposed consideration and concerns regarding the prudence of the resulting outsized debt burden on the value of the combined company's stock even if the financing were obtained. Consequently, your proposal does not constitute a basis for due diligence or negotiation. We believe it is important to emphasize that we are not dependent on a Xerox combination. We have great confidence in our strategy and the numerous opportunities available to HP to drive sustainable long-term value, including the deployment of our strong balance sheet for increased share repurchases of our significantly undervalued stock and for value-creating M&A."*

HP is communicating that the company plans to utilize its strong balance sheet to try and revive its growth outlook, whether that be on a total or per share basis. As HPQ is trading at a meaningful discount to the midpoint of our intrinsic value estimate, share buybacks are a good use of capital here. However, Xerox is still pursuing the company and plans to take its offer straight to HP's shareholders.

Concluding Thoughts

Shares of HPQ are converging towards their intrinsic value as the market begins to factor in its strong free cash flow profile, quality balance sheet (minimal net debt position), and ability to augment its future free cash flows via cost cuts. Management seems to think that by going it alone, HP will be a stronger entity than it if joins forces with Xerox (which effectively locks HP into the printing business for good). The printing business is tough, and most see it only getting tougher given ongoing trends (i.e. the digitalization of everything, cost saving initiatives at the firm level, need to reduce waste/footprint, etc.). Cost cutting initiatives could improve HP's medium-term outlook, but over the long haul, the company is going to need to find a way to either revive its printing business (moving into new areas such as 3D printing), materially increase growth at its PC business (a very cyclical operation), or consider a future when HP's printing operations are no longer a part of the company (divesting the business).

Disclosure: *Callum Turcan does not own any of the securities mentioned above.*

Evaluating Global X SuperDividend ETF (SDIV)

Global X SuperDividend® ETF

Ticker: SDIV Exchange: NYSE Arca, Inc.

INVESTMENT OBJECTIVE

The Global X SuperDividend® ETF ("Fund") seeks investment results that correspond generally to the price and yield performance, before fees and expenses, of the Solactive Global SuperDividend® Index ("Underlying Index").

Image Source: *GlobalXETFs – Fund Website*

By Matthew Warren

Summary

The Global X SuperDividend ETF (SDIV) --- **10.0% yield (on a 30-day SEC basis)** --- is a very high yielding, very well diversified ETF. This is accomplished by fishing for the very highest yielding equity securities around the entire world. The ETF is highly concentrated in three financial sectors of mortgage REITs, REITs, and financials. While historical performance has not been very good relative to the MSCI ACWI or on an absolute total return basis, the Global X SuperDividend ETF provides any portfolio with extensive diversification and an absolutely high yield to boot. We include the SDIV ETF in our High Yield Dividend Newsletter portfolio largely for those two reasons.

The Global X SuperDividend is a passive ETF that does its best to replicate the performance of the Solactive Global SuperDividend Index. Essentially, what this index does is after screening for minimum market capitalization, liquidity, and yield requirements, it ranks stocks by yield and selects the top 100 in equal allocations. Every quarter the companies in the index are screened for dividend cuts or negative outlook regarding the dividend policy. Otherwise, the components are rebalanced annually (recent portfolio turnover was nearly 60%), all of which is described in the below graphic.

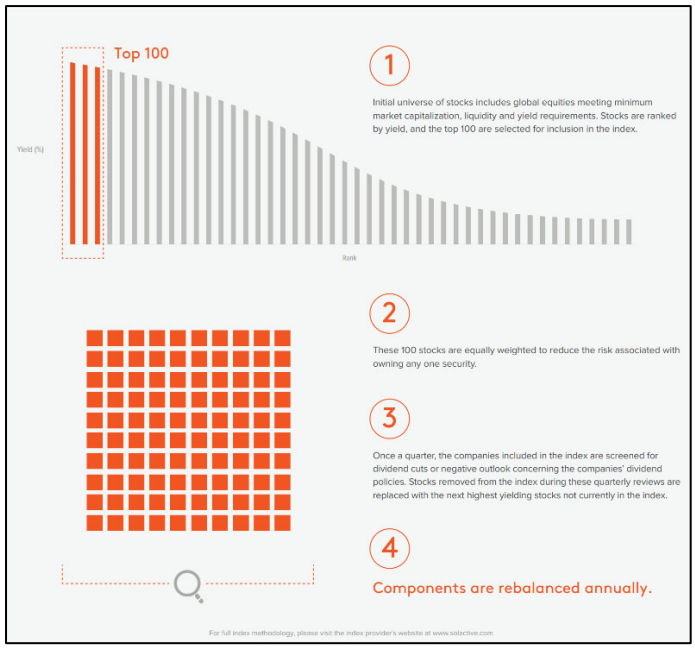


Image Source: *GlobalXETFs – Fund Website*

Fund Details

In the graphic below, you will find the relevant fund information required on how to find this ETF as well as some of the high-level fund details. Please note the ETF's double-digit yield on a 30-day SEC basis is extremely high in the current market. Needless to say, yields like this are very hard to come by, especially across such a diversified portfolio.

FUND DETAILS

As of 11/27/19

Key Facts

Ticker	SDIV
Inception Date	6/8/11
CUSIP	37950E549
ISIN	US37950E5490
Bloomberg Index Ticker	SOLSDIV
Primary Exchange	NYSE Arca

Stats & Fees

Net Assets	$932,084,766
NAV	$17.17
Shares Outstanding	54,300,000
Total Expense Ratio ?	0.58%

Distributions

30-Day SEC Yield ?	10.01%
12-Month Dividend Yield ?	9.55%
Distribution Yield ?	8.38%
Distribution Frequency	Monthly

Image Source: *GlobalXETFs – Fund Website*

ETF Holdings

In the below graphic, you will see the SDIV ETF's top ten holdings out of 100 positions. As you can see, the stocks that have appreciated the most since the last rebalancing have come to represent quite a bit more than the original ~1.0% allocation to each position of the overall fund.

TOP 10 HOLDINGS As of 11/27/19 FULL HOLDINGS (.CSV)

NET ASSETS %	NAME	MARKET PRICE ($)	SHARES HELD	MARKET VALUE ($)
1.70	COSTAMARE INC	8.12	1,956,694	15,888,355.28
1.54	GENWORTH MORTGAG	2.47	5,825,881	14,379,916.62
1.36	PATTERN ENER -A	27.80	456,577	12,692,840.60
1.34	VECTOR GROUP LTD	13.35	933,913	12,467,738.55
1.32	BPOST SA	11.65	1,056,907	12,317,192.99
1.31	KITE REALTY GROUP TRUST	19.38	630,941	12,227,636.58
1.31	SABRA HEALTH CAR	22.38	543,629	12,166,417.02
1.30	MARSTON'S PLC	1.69	7,185,015	12,157,291.86
1.27	SUPER RETAIL GROUP LTD	6.77	1,752,794	11,861,914.63
1.27	ARBOR REALTY TRUST INC	15.12	780,133	11,795,610.96

Holdings are subject to change. Cash, where shown, includes other assets and liabilities, such as payables and receivables.

Image Source: *GlobalXETFs – Fund Website*

Concentration Risk in Sectors and Countries

As you can see in the upcoming graphic, this ETF features substantial concentration in mortgage REITs, REITs, and financials (approximately 54% of the ETF's holdings), all of which are highly interest rate sensitive. In a world like today's where rates seem to be lower for longer and considering we have been in a multi-decade bond market bull market, the risk of higher interest rates seems like a distant memory. But it's important to point out that this ETF would suffer in a period of rapidly rising interest rates, however unlikely that might be.

Given the tremendous amount of leverage out there in the world and the fact that higher rates almost act like a governor on economic activity all by itself, we view rapidly higher rates as an unlikely scenario at this stage. The other thing to point out is that all three of these concentrated sectors use a lot of financial leverage within the company itself. This means that if any individual company overextends itself relative to its own economic prospects or in the event of a substantial economic downturn, these companies could easily run into financial distress. While there is some country concentration risk involved in the ETF (heavily focused on US, Australia, and the UK), we will stress here that the ETF is well diversified across geographies. This means that the interest rate and currency risks are spread out across several different geographies, ameliorating some of the risk of investing in a single country and currency. The only way this strategy can backfire is if US markets and the USD substantially outperform the rest of the world. It also matters which benchmark you are using for your portfolio? Is it US centric or does it reflect global returns?

INDUSTRY BREAKDOWN (%)

Mortgage REITs	21.12%
REITs	17.17%
Financials	16.30%
Communication Services	8.03%
Materials	7.95%
Energy	7.92%
Industrials	7.58%
Consumer Discretionary	6.40%
Utilities	4.67%
Others*	2.87%

* Real Estate 1.66%, Consumer Staples 1.21%

COUNTRY BREAKDOWN (%)

United States	43.39%
Australia	15.54%
Britain	7.40%
Russia	3.45%
Brazil	3.02%
Netherlands	2.94%
South Africa	2.56%
China	2.38%
Canada	2.33%
Others**	16.99%

** Norway 2.10%, Monaco 2.05%, Thailand 1.22%, Belgium 1.21%, New Zealand 1.17%, Mexico 1.14%, Singapore 1.07%, Czech 0.99%, Hong Kong 0.90%, Turkey 0.85%, Spain 0.84%, Germany 0.78%, Nigeria 0.76%, Italy 0.74%, Indonesia 0.61%, Poland 0.55%

Image Source: *GlobalXETFs – Fund Website*

ETF Past Performance

In the below graphic, you can see that the trading price of the ETF tracks closely with the ETF's net asset value (NAV). This suggests that the bankers responsible for creating ETF units have been doing a good job of arbitraging any spreads and keeping any differences between the ETF's NAV and the shares trading price to a minimum. Additionally, the managers of the ETF have actually been able to outperform the underlying index by a small margin, which is very satisfactory, and hard to do considering trading costs and the management fee of 58 basis points—a level we don't find excessive given the nature of the ETF.

PERFORMANCE HISTORY

PREMIUM DISCOUNT CHART

Cumulative % Data as of month end (10/31/19)	FUND NAV	CLOSING PRICE	INDEX
1 Month	2.28%	2.28%	2.03%
3 Months	3.07%	3.56%	2.81%
6 Months	1.45%	1.11%	1.31%
Since Inception	28.15%	28.00%	25.39%
Avg Annualized % Data as of month end (10/31/19)	**FUND NAV**	**CLOSING PRICE**	**INDEX**
1 Year	-1.02%	-1.23%	-1.09%
3 Years	2.08%	2.02%	2.33%
5 Years	0.56%	0.47%	0.48%
Since Inception	3.00%	2.98%	2.73%
Avg Annualized % Data as of quarter end (9/30/19)	**FUND NAV**	**CLOSING PRICE**	**INDEX**
1 Year	-8.97%	-9.03%	-8.87%
3 Years	-0.07%	-0.20%	0.20%
5 Years	0.39%	0.40%	0.38%
Since Inception	2.75%	2.73%	2.51%

Cumulative return is the aggregate amount that an investment has gained or lost over time. Annualized Return is the average return gained or lost by an investment each year over a given time period.

The performance data quoted represents past performance. Past performance does not guarantee future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when sold or redeemed, may be worth more or less than their original cost and current performance may be lower or higher than the performance quoted.

Image Source: *GlobalXETFs – Fund Website*

The less exciting thing to report is that the overall strategy's past performance comes into question when comparing to the MSCI ACWI Index to date. While this might not be the most perfect index to compare against, it does show that the SDIV has underperformed substantially since inception. Is pursuing high dividend yields blindly the best way to achieve total returns? This is why only ~5% of the High Yield Dividend Newsletter portfolio is allocated to the ETF, again largely for diversification and income generating purposes.

Average Annual Total Returns (for the Periods Ended December 31, 2018)

	One Year Ended December 31, 2018	Five Years Ended December 31, 2018	Since Inception (06/08/2011)
Global X SuperDividend® ETF:			
·Return before taxes	-14.71%	0.82%	2.38%
·Return after taxes on distributions[1]	-16.57%	-1.29%	0.28%
·Return after taxes on distributions and sale of Fund Shares[1]	-8.89%	-0.16%	1.09%
Solactive Global SuperDividend® Index (net) (Index returns reflect invested dividends net of withholding taxes, but reflects no deduction for fees, expenses, or other taxes)	-14.65%	0.70%	2.06%
MSCI ACWI Index (net) (Index returns reflect invested dividends net of withholding taxes, but reflects no deduction for fees, expenses, or other taxes)	-9.41%	4.26%	6.29%

[1] *After-tax returns are calculated using the historical highest individual U.S. federal marginal income tax rates and do not reflect the impact of state and local taxes. Your actual after-tax returns will depend on your specific tax situation and may differ from those shown above. After-tax returns are not relevant to investors who hold Shares of the Fund through tax-deferred arrangements, such as 401(k) plans or individual retirement accounts (IRAs).*

Image Source: *GlobalXETFs – Fund Website*

The Crux of the Matter

The crux of the matter is whether the strategy of this ETF makes sense for investors. This question can be answered in many different ways. First of all, when sorting for high dividend yields, you are almost by definition also seeking financial leverage and/or fundamental risk, as evidenced by the outsized yield that the market might be calling into question. A lot of these company's dividends probably require ongoing market funding and/or improvement in fundamentals to be sustainable. Companies that cut their dividends are shuffled out of the portfolio, most probably after a large capital loss. It takes a lot of de-leveraging or fundamental improvement stories to make up for these losers.

Absolute and relative total returns are not the end all and be all when it comes to investing, however. There are practical concerns. Some investors count on dividends to fund their retirement, which cannot be ignored. **For those investors that need a substantial yield to fund their living expenses, they might well consider this highly diversified ETF as one small part of their overall portfolio.** It will act as a boost to the yield of most any portfolio.

PERFORMANCE (%)

	Current Quarter	Year to Date	One Year	Five Year	Since Inception
SDIV at NAV	1.06%	4.91%	-8.97%	0.39%	2.75%
SDIV at Market Price	0.88%	5.21%	-9.03%	0.40%	2.73%
Solactive Global SuperDividend® Index	1.04%	5.30%	-8.87%	0.38%	2.51%

TOP 10 HOLDINGS (%) *Holdings Subject to Change*

Genworth Mortgage Insurance	1.46%	Harvey Norman Holdings Ltd	1.27%
Sabra Health Care REIT Inc	1.36%	Chemtrade Logistics Income Fund	1.26%
Pattern Energy Group Inc	1.34%	Ship Finance International Ltd	1.26%
Costamare Inc	1.30%	SemGroup Corp	1.23%
Super Retail Group Ltd	1.28%	Jasmine International PCL	1.22%

Image Source: *GlobalXETFs – Fund Website*

Disclosure: *Matthew Warren does not own any of the securities mentioned above.*

Primer on the Banking Sector: Where Are We in the Cycle?

Image Source: *JPMorgan Chase & Co – 2019 Investor Day IR Presentation*

By Matthew Warren

Please note that a version of this article was emailed out to subscribers on November 25.

Three of our favorite banks are JPMorgan Chase, Bank of America, and US Bancorp. These are three very high-quality institutions which are also very well managed. They all benefit from cultures that encourage the right kind of risk/reward thinking. If these equities start to trade at a meaningful discount to our fair value estimates, they may be are worth considering as long-term investments, in our view.

Summary

We'll talk about how banks make money, and the three most important costs of running a bank.

The Great Financial Crisis revealed the tremendous risks of banking equities, and we'll walk through these in depth.

We'll discuss how to conceptualize where we are in the banking cycle, and how that helps inform our valuation process for banks, which is different than traditional operating entities.

The stress tests have helped many of the big banks from pursuing hazardous endeavors during the past decade, and we'll go into how to think about the yield curve in the context of banks.

Investors should expect ongoing digitization of banks and increased M&A as the competitive environment only intensifies.

Three of our favorite banks are JPMorgan Chase, Bank of America, and US Bancorp, and we'll be looking to consider adding any of these to the Best Ideas Newsletter portfolio or Dividend Growth Newsletter portfolio at the right price.

How Do Banks Make Money?

In order to understand where the big banks stand right now, it might be helpful to start at the very beginning. How do banks make money? Banks essentially make money on money. They collect money mostly in the form of deposits, often at a very low cost--such as zero interest checking accounts. Certificates of deposit (CDs) and corporate deposits cost more than nothing and borrowing in the bond market costs even more than that. Even when no interest is paid on transactional accounts, there remains a cost to these funds as services are being offered to those clients "for free."

While banks have a cost of funds, they then turn around and lend out some, all, or more than their deposits to the public whether in the form of credit cards to retail clients, small business loans, construction finance loans, or loans to giant multi-national corporations. The spread between the revenue earned lending and the cost of those funds is called the net interest margin ('NIM'), which is often about 200-300 basis points for a large bank, depending on the mix of business. Banks also earn non-interest revenue in the form of banking fees, commissions, and the like. Adding net interest income to the non-interest revenue arrives at the net revenue of the bank; subtracting non-interest expenses (starting with bad credit costs) from this, one gets down to the pre-tax income line.

Three Key Costs of Running a Bank

This quick introduction to banking makes it clear the three key areas where banks must control their costs, especially given that US banking is largely a commodified industry. In a commodified industry, it is the sustainable low-cost leaders that can eek out returns above the cost of capital.

One, the cost of deposits is the first key cost to control. Banks with large, low cost deposit bases such as JPMorgan Chase (JPM), Bank of America (BAC), and Wells Fargo (WFC) enjoy the leading US deposit franchises.

Two, the cost of credit is the next key cost to control. Over the course of time, banks that are lending in the exact same space such as auto lending can experience wildly different credit costs. While some of this can be due to the risk/reward tradeoff being pursued by management, it can also reflect the success or failure of underwriting each individual loan, which ultimately creates the aggregate loss experience.

Underwriting quality stems from the underwriting culture of the bank, which starts right at the top with the CEO steering the ship. Is risk or reward being emphasized to middle managers and the rank and file? What kind of targets are financial incentives and promotions based upon? How is risk versus reward talked about inside the bank? Underwriting culture is driven by all layers of management and is not quick or easy to change on a dime. It is more like turning a large ship. It is individual human decisions that we are talking about after all and old habits die hard.

Not only is there an underwriting culture that drives credit costs (bad debt expenses), but it is also a bank's culture that drives the **third** major cost center, which is operating costs, as measured by the all-important efficiency ratio--operating costs over net revenue. The efficiency ratio is also very much affected by business mix. Stock brokerage comes with very high efficiency ratios as does high service commercial banking relationships, while mass market retail banking comes with much lower efficiency ratios. That said, if business mixes are similar, the bank with the lower efficiency ratio is the one that is accomplishing the same revenue dollar with less cost associated.

The Risks of Running a Bank

The risks of running a bank are many-fold. The first and most important thing a bank CEO can get wrong is the culture of the bank. Culture touches everything from how a bank operates, to the ultimate fundamental results, and even the valuation analysts and investors are willing to place on the firm. Wells Fargo used to trade at a premium and now trades at a discount to peers, and questions around the culture are a key element in that change.

Every bank management team wants revenue growth. The question is how do you get there? Are you willing to sacrifice near term earnings trajectory as you invest in new markets and new salespeople? Or does your growth come simply by taking more risk for the same level of reward? The former is a tough decision for public bank managers to take as it can negatively affect the share price and management options in the short run. The latter is like a siren song. If you get the same reward for riskier new business, the near-term financials show faster growth with similar credit costs in the short run. In time, however, perhaps even as late as the next recession, the greater risk being taken ultimately will show up in the credit cost line on the profit and loss statement.

The run up to the Great Financial Crisis ('GFC') provides the perfect example of bank culture and risk versus reward. While massive home price appreciation was allowing folks to use their home as an ATM and paper over any income deficiencies, it seemed most all banks could do no wrong. Revenue growth was stronger than usual and credit costs were largely benign. A key hint for those paying attention was the subtle but not insignificant differences between credit losses for those banks operating with similar business mixes.

As it turned out, the banks growing the fastest on the back of subprime mortgages and subprime mortgage-backed collateralized debt obligations ('CDOs'), which were starting to show slightly larger losses even prior to the peak, were the first banks to get blown away when the housing market melted down from excesses boiling over. What might have seemed like minor differences at the time, turned out to measure the difference between failure or tough times--before a full rebound to health. Amongst the money center banks, JPMorgan turned out to be sitting on a lot less risk than Bear Stearns, Lehman, or Citigroup (C).

This brings us to another risk of investing in bank stocks. **Bank balance sheets can be appropriately characterized as somewhat opaque.** Loan books are broken down by industry and by credit quality as determined by the bank, but that doesn't mean that a large bank cannot hide a busted deal on their balance sheet without anyone really knowing. If a deal was originated with intent to distribute, but it ultimately falls through--for example because the cycle is changing on a dime—there is nothing to stop the bank from parking this loan on the balance sheet.

In fact, this is exactly what happened with busted collateralized debt obligations and commercial real estate deals back when the GFC hit. The amount of speculation about the big banks opaque balance sheets came to a fevered pitch. **Banks didn't trust each other**, and investors lost faith in what was contained on balance sheet. This fed the fear in the marketplace and increased counterparty risk. This caused banks to stop lending as much to each other and further fed the liquidity crisis that was taking place at the time, forcing the Federal Reserve to step in and help with bank funding. Trust matters in banking, and if investors and counterparties come to think a bank is hiding things on its balance sheet, real trouble can ensue.

Speaking of counterparty risk, another key risk of running and investing in banks is the counterparty risk that comes from large, opaque derivative books. Notional exposure amounts are disclosed, and the banks will tell you that exposures to any particular bank are kept to reasonable levels. That said, if there is a global run on banks like was starting to take place in the GFC, the risk of several banks failing all at once can emerge. **Derivative books make banks more intertwined and increases the knock-on effect of bank failures.** If hedges fall away, banks must scramble to put those hedges back in place. It can create chaos in the derivatives market, and it can certainly create doubt about the efficiency and effectiveness of the hedging programs that banks have in place.

The Risk of Outsized Growth

Growth is good, right? Usually the answer to this is a simple yes. When it comes to banks, however, the answer becomes a bit more nuanced. Sustainable growth is good. Growth that the market allows for is good. Organic growth from adding productive geographies and salespeople and products is good. **However, loosening underwriting standards to hit a revenue growth target that management has foolishly sold to Wall Street can lead to a full blown disaster.** It is up to management to lead the bank in the right direction and communicate appropriately to employees and other stakeholders. Beware of growth hype from management when it comes to a bank.

It is up to the analyst to judge the quality of growth that they are witnessing at a particular bank. Sometimes, it is the bank that is leaving growth on the table that will outperform in the coming downturn. Other times, banks can be left behind when management is afraid of its own collective shadow and is not willing to grow with the market. The bottom line here is that these are judgment calls. Look for logical descriptions of where the growth is coming from. Watch the bank's key metrics to make sure they are not giving up NIMs or credit costs in order to achieve growth. Watch for the warning signs and retain a healthy skepticism.

Where are We in the Cycle?

This is a question that every bank manager, analyst, and investor must ask and answer for themselves, even if the answer is: I'm not sure. When bank performance is suffering from the downcycle and results are accelerating to the downside, it can be a scary time to invest in banks. The best thing to do is to try to make judgments about how much bad credit is contained on a given banks balance sheet and whether earnings and capital can offset these pressures to get through to the other side. If in the case of the GFC where the downside is large and unknown, it is often best to stick to top quality banks with the strongest balance sheets and earnings power. Don't worry about finding opportunities as these banks have probably sold off, too. Top quality banks are more likely to be "double down" stocks, which is a rare thing among banks.

If the worst of the cycle has been left behind, the question then becomes: where are we relative to the next downcycle? Are current earnings reflective of what can be characterized as mid-cycle or normalized earnings? If so, putting an appropriate valuation on those results will lead to better outcomes. Are earnings outsized because revenues are benefitting from good times and credit costs are abnormally low or even near zero? If so, it is important to scale back to mid-cycle revenue trends and margins before fully valuing an earnings stream into perpetuity.

Another question to ask is: where are the excesses that are building up and how bad are they? How much loss content is being stored up for the next downturn? A prime example is the GFC when subprime mortgages were being written very rapidly and turned into CDOs, which were highly rated but ultimately completely suspect. The larger these revenue streams became and the larger these positions became on bank balance sheets, the more danger was lurking for when the the cycle turned, and losses showed up in rapid fashion as folks could not afford the homes that they had stretched for without proper income and/or documentation. The ratings on the flood of Wall Street paper quickly downgraded to junk.

A current example would be collateralized loan obligations ('CLOs'). These are levered loans where companies are borrowing substantial sums of money where debt is a large multiple of EBITDA (cash flow before several important costs) and interest payments are a large part of cash flow. These CLOs have grown substantially in size and are largely held outside of the banking system. However, if the music stopped quickly, the banks that are underwriting these loans could easily get stuck with inventory. It is a risk to watch.

Sometimes, the question of where we are in the cycle will give no definitive answers, which may be informative, nonetheless. It may indicate that the industry is not at the trough and probably not at the peak of the cycle. It suggests that the industry may not see any large piles of old or new risks that can hit the P&L in a material way. It indicates that the revenue and earnings stream is more likely to be close to mid-cycle margins, deserving of a full valuation.

So, where are we right now? As mentioned, we see risk in the CLO space. We also see risk in the commercial construction cycle and commercial property loans. WeWork has exposed a structural weakness and represents a very large weak commercial real estate player out there in many key cities. Credit losses look abnormally low across the banking system, but especially in credit cards given the currently very strong consumer. Revenue growth has not been out of control, which is a good sign of moderation. As of this writing, we are 11 years into a bull cycle, and it will ultimately turn down due to one cause or another. Therefore, we think it makes sense to scale back the earnings power when valuing a bank's equity at this stage in the cycle, which is exactly what we do here at Valuentum.

Stress Tests

Since the GFC, systemically important (large and interconnected) banks have been forced to go through annual stress tests, where sizable losses are hypothetically run through each bank's P&L to see what impact there would be on capital levels.

The idea is to determine what would happen to each bank in a recession and a more severe recession scenario. Would they still have the required capital after eating up the assumed losses against earnings and existing capital levels? **This process has forced a certain discipline on banks these past ten years, and we would argue it has largely kept them in line from doing anything particularly reckless in the meantime.** These banks must get their capital plans approved also, so they must stay in line if they want to pay out their dividends and perform the planned share buybacks to reward shareholders during this last decade of relatively slow revenue growth.

Interest Rates, the Yield Curve, and Net Interest Margins

Some but not all bank loans are tied to benchmark interest rates plus a margin. Therefore, in the short run, the amount they can charge customers varies accordingly with short rates. Another key factor is that zero rate deposits don't tend to move much when rates change (endowment effect). Therefore, higher rates mean higher net interest margins on these deposits. These two factors mean that higher rates tend to mean higher net interest margins and vice versa. The banks disclose how much higher and lower rates will affect revenues and the profit impact can be imputed.

That said, we think these short-term impacts can be overblown by the media and even analysts and investors at times. The reality is that the margin or spread changes with competition over a longer period of time. So, if rates are lower for longer, the banks can simply mark up the margin they charge over these lower rates and cycle through the book to better economics.

Given that the overall industry tends to produce cost-of-capital returns on average over time, it suggests a competitive landscape and one that can adjust the levers of profitability to match the exogenous or uncontrollable factors like short-term rates and the shape of the yield curve. Therefore, beware when you hear oversimplifications in the media that banks borrow short and lend long and are simply price takers on both sides according to the whims of the yield curve. We would beg to differ, and we think results will prove out over time.

Digitalization of Banking

The digitalization that is taking place across so many industries has certainly been taking place in banking over the past decade. Think about how advanced mobile banking apps are now compared to where things stood a decade ago, when most people were in the branch or at the ATM. Digitalization is also simplifying processes in the back office, taking out people, making things more scalable and repeatable. **The biggest banks with the most scale and the largest revenue streams can afford to easily stay on top of this trend while many small scale banks and credit unions are stuck in the past shuffling paper around, assisted only by an unsophisticated mobile app (or no mobile app at all).** Therefore, this trend plays right into the hands of the biggest banks in the country. It helps them hold onto clients and win new clients and market share. It helps them deliver a better experience and free up branches for sales, while streamlining the back-office cost structure. This is a key trend that will help large banks and drive consolidation of market share within the industry

Mergers & Acquisitions

As of this writing, BB&T (BBT) is on track to acquire SunTrust (STI) and we don't think this will be the last merger. Given the digitalization of the banking industry, scale matters even more than it already did. Retail banking, especially, is a scale game. Running large credit card operations is a mass marketing game and the back office certainly benefits from scale. **Smaller banks have largely ceded this market to the larger banks already. With the digitalization trend pouring fuel on this fire, we expect M&A to continue apace.** Since banks are not really undervalued as a whole, mergers of equals might be an essential tool for (relatively) smaller banks as they seek out the scale required so they can play with the big boys.

Business Mix

Having mentioned the upside of being a big bank, let's also talk about a more questionable characteristic of most of the largest banks. Most of these institutions have large investment banking and trading operations. While this clearly is a benefit when it comes time to win over the largest corporate clients, as they can be a full one-stop shop for all of the client's needs, it also introduces a volatile and low return on capital earnings stream to the overall earnings mix. For the big money center banks, it is the bread and butter banking unit (especially retail banking) where the highest returns on capital are made and generally with the smoothest earnings streams (setting aside the GFC). **Simply said, large scale retail banking operations deserve higher valuations.** This can also be true of asset management and payment processing units for those banks that benefit from material operations on these fronts.

Valuation

Banking valuations can be very bi-polar throughout the market cycle. At the trough of the GFC, banks were being priced as if they were going out of business. Some in fact did. Therefore, it was no shock that most banks traded at a discount to tangible net asset value. The banks were being priced as if they would be wound down or as if there was a probability of survival and a probability of failure or permanent capital impairment. These weightings would change from day to day along with the macro assumptions about the magnitude and duration of the banking crisis and substantial economic downturn.

Just before the GFC hit, analysts and investors were arguing that banks shouldn't suffer from price-to-earnings (PE) multiples below the overall market. The case was being made that big earnings cycles were a thing of the past, these were growth stocks, and so, there should be no P/E discount. This was extremely flawed logic, which was quickly proven as things swung to the opposite extreme. And yet, we are hearing this case being made again today by some in the media.

The right answer to us is that banks--that do not face the risk of permanent capital impairment--should be valued based on the premium or discount that they are able to earn relative to book value. It should be based on mid-cycle revenue and margin trends. If a bank does face the risk of permanent capital impairment, at the very least one must introduce a probability-of-zero value into the overall value. More realistically, if this risk is material, the stock is simply un-investible as no one ever truly knows the magnitude and duration of any particular downturn in the banking cycle. **Fragile banks can tumble like dominoes when things get bad enough.**

Bank Panics

The problem with banks as opposed to operating companies is that very few (if any) are true "double down" opportunities regardless of the macro environment. In a bank panic or depression, it is extremely hard to tell which banks will suffer a crisis of confidence and a run on the bank by its various stakeholders. The GFC is the most recent example of this, but a down cycle or panic can in fact come in worse than that.

Banks operate with significant financial leverage by their very business model. They borrow money to lend money. Most banks are levered approximately 10 times to 1. If the loss content in the assets becomes large enough, and the revenues come under enough pressure, it's like everything is going wrong at once. This is especially true for banks that are only marginal during the good times. They are simply closer to the tipping point in terms of failure.

The other undeniable fact is that perception can become reality. Banks need their depositors to keep their funds in place. Banks need to rollover their market funding. If these conditions don't hold, then a bank can face a liquidity crisis. Once a crisis of confidence starts, it is hard to arrest. As we've said in the past, banking is a game of confidence.

In fact, without help from the US Treasury and regulators, the GFC could have led to many, many more bank failures and a full-blown depression. So, investors at that time were left guessing what the next regulatory response would be and whether the medicine would be strong enough to turn around the systemic infection.

It is hard to double down on even the strongest bank stocks in an environment like that and one could even argue that it is not as logical as doubling down on strong operating companies with rock-solid balance sheets where permanent capital impairment was essentially non-existent. The exception is for a player like Warren Buffett who by investing enough capital and committing to invest more can almost guarantee a bank's survival.

Regulatory Risk on Both Sides

Regulatory risk could bite the banking industry from both sides. If de-regulation goes too far and the stress tests are thrown out, excesses could easily build up again in the banking industry, cowboy capitalism could ensure, and the next bank panic could follow. On the other side of the coin, some of the most progressive political candidates seem to still be gunning for the banking and investment banking world in the aftermath of the GFC and the consequences visited upon society. These risks bear watching but neither one seems imminent.

Contagion from Offshore

The biggest systemic risk that we see is contagion from offshore and specifically from Europe as these large banks are indeed interconnected with large US banks. If deflation or depression-like environments take hold in Europe (and to a lesser extent Japan), sovereign defaults and domino bank failures could cause severe stress on the global banking system. This kind of stress would certainly spill into the US market and economy. This risk is not easy to handicap but bears watching.

Our Favorite Banks

Three of our favorite banks are JPMorgan Chase, Bank of America, and US Bancorp (USB). These are three very high-quality institutions which are also very well managed. They all benefit from cultures that encourage the right kind of risk/reward thinking. If these equities start to trade at a meaningful discount to our fair value estimates, they may be are worth considering as long-term investments, in our view.

Disclosure: *Matthew Warren does not own any of the securities mentioned above.*

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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'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 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			
Global X SuperDividend ETF	SDIV	5.0%	9.18%
Global X SuperIncome Preferred ETF	SPFF	10.0%	6.31%
iShares International Select Dividend ETF	IDV	5.0%	5.69%
iShares MSCI Australia ETF	EWA	5.0%	5.26%
iShares U.S. Preferred Stock ETF	PFF	5.0%	5.56%
PowerShares Senior Loan Portfolio	BKLN	5.0%	5.18%
ProShares High Yield—Interest Rate Hedged	HYHG	5.0%	6.33%
Utilities Select Sector SPDR	XLU	5.0%	2.91%
Vanguard Real Estate ETF	VNQ	10.0%	3.09%
EQUITY			
AT&T ***weighting change***	T	7.5%	5.46%
BP PLC	BP	5.0%	6.57%
CubeSmart	CUBE	5.0%	4.15%
Digital Realty Trust	DLR	5.0%	3.57%
Enterprise Products Partners	EPD	5.0%	6.72%
Magellan Midstream Partners	MMP	5.0%	6.98%
Philip Morris ***weighting change***	PM	7.5%	5.64%
Public Storage	PSA	5.0%	3.80%
Cash*	-	0.0%	1.75%
		100.0%	**5.37%**

This is not a real money portfolio. Inception 1/1/2018. Data as of 12/2/2019. Est. Div. Yield retrieved from YahooFinance.

** Reflects high end of federal funds rate range*

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.*

Company Name	Symbol	Sector	Div Yield	Economic Castl	Multiplier
General Motors	GM	Consumer Discretionary	4.1%	Attractive	14.13
Honda	HMC	Consumer Discretionary	3.9%	Neutral	13.94
Gilead Sciences	GILD	Health Care	3.9%	Very Attractive	12.17
Fluor	FLR	Industrials	2.9%	Attractive	11.79
Guess	GES	Consumer Discretionary	2.7%	Attractive	11.33
Lear Corp	LEA	Consumer Discretionary	2.8%	Attractive	10.98
Hewlett-Packard	HPQ	Information Technology	3.7%	Attractive	10.84
Automatic Data Processing	ADP	Information Technology	2.1%	Very Attractive	10.36
Bristol-Myers Squibb	BMY	Health Care	2.9%	Very Attractive	10.29
Gap	GPS	Consumer Discretionary	6.0%	Attractive	10.25
Ralph Lauren	RL	Consumer Discretionary	2.8%	Attractive	10.08
Tapestry	TPR	Consumer Discretionary	5.2%	Attractive	9.95
Methode Electronics	MEI	Information Technology	1.6%	Attractive	9.75
Cheesecake Factory	CAKE	Consumer Discretionary	3.7%	Attractive	8.52
Total	TOT	Energy	5.1%	Neutral	8.27
Huntsman	HUN	Materials	2.7%	Attractive	8.25
Ethan Allen	ETH	Consumer Discretionary	4.9%	Unattractive	8.21
Dick's Sporting	DKS	Consumer Discretionary	3.0%	Attractive	7.96
QUALCOMM	QCOM	Information Technology	3.6%	Very Attractive	7.71
H&R Block	HRB	Consumer Discretionary	3.7%	Very Attractive	7.67
Walgreens Boots Alliance	WBA	Consumer Staples	3.3%	Attractive	7.64
AVX Corp	AVX	Information Technology	2.5%	Attractive	7.50
Manpower	MAN	Information Technology	2.4%	Attractive	7.47
Ford	F	Consumer Discretionary	6.5%	Neutral	7.47
Archer-Daniels-Midland	ADM	Consumer Staples	3.5%	Attractive	7.40
Novartis	NVS	Health Care	3.1%	Attractive	7.27
Cisco	CSCO	Information Technology	2.6%	Very Attractive	7.17
MKS Instruments	MKSI	Information Technology	0.8%	Attractive	7.15
Caterpillar	CAT	Industrials	2.9%	Very Attractive	7.14
McKesson	MCK	Health Care	1.2%	Very Attractive	7.07
Applied Materials	AMAT	Information Technology	2.0%	Very Attractive	7.01
Harley-Davidson	HOG	Consumer Discretionary	4.2%	Attractive	6.97
Cardinal Health	CAH	Health Care	4.2%	Attractive	6.95
AmerisourceBergen	ABC	Health Care	2.0%	Very Attractive	6.92
Paychex	PAYX	Information Technology	2.8%	Very Attractive	6.92
Apple	AAPL	Information Technology	1.3%	Highest Rated	6.91
Altria Group	MO	Consumer Staples	6.7%	Very Attractive	6.78
Amgen	AMGN	Health Care	2.6%	Very Attractive	6.74
Pfizer	PFE	Health Care	3.9%	Attractive	6.71
KLA-Tencor	KLAC	Information Technology	2.4%	Very Attractive	6.69
Xerox	XRX	Industrials	3.2%	Attractive	6.69
Williams-Sonoma	WSM	Consumer Discretionary	3.4%	Attractive	6.69
Robert Half	RHI	Information Technology	1.9%	Very Attractive	6.66
Expeditors Intl	EXPD	Industrials	1.4%	Very Attractive	6.63
Garmin	GRMN	Industrials	2.9%	Attractive	6.59
Johnson & Johnson	JNJ	Consumer Staples	2.8%	Attractive	6.54
Best Buy	BBY	Consumer Discretionary	2.7%	Very Attractive	6.53
British American	BTI	Consumer Staples	6.6%	Unattractive	6.53
Hillenbrand	HI	Consumer Discretionary	2.5%	Attractive	6.52
Taiwan Semiconductor	TSM	Information Technology	3.2%	Attractive	6.48

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.

For example, there may be stocks that are dealing with a secular shift toward digital consumption or navigating changing consumer preferences as millennials seek 'experiences' not 'things' (e.g. fashion). These may not be the best dividend growth stocks to consider. The Dividend Cushion is only one factor that we use in assessing the overall health of a company's dividend.

DIVIDEND REPORT PAGE 2 – GAP INC (GPS)

Gap GPS UNDERVALUED 10.7%

Buying Index™ 3 **Value Rating** ✓

Economic Castle	Stock Fair Value Range	Dividend Track Record	Dividend Safety / Cushion™	Div Growth Potential	Dividend Yield
Attractive	$18.00 - $33.00	HEALTHY	GOOD / 1.7	GOOD	5.97%

Assessment of Company Dividend Strategy

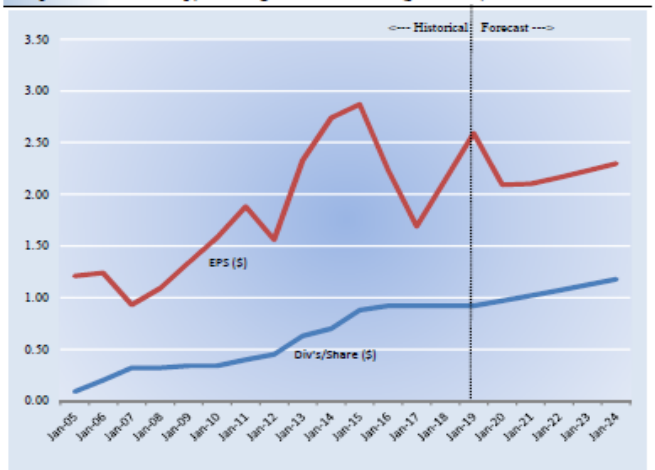
Key Strengths

Gap offers apparel and accessories under a number of compelling brand names, and its Dividend Cushion ratio and dividend yield offer an interesting consideration. The firm's balance sheet is healthy as it holds a net cash position of $120 million as of the end of fiscal 2018. Free cash flow generation averaged more than $840 million over the past three fiscal years (ended January 2017-2019), which covers annual run rate cash dividend obligations of ~$373 million multiple times over. Though the firm remains tied to uncertain trends, we're anticipating future growth in the dividend. Overall growth prospects could be more compelling, and management has yet to release a dividend policy for the company post-split.

Potential Weaknesses

Gap's success is dependent on its ability to accurately predict and take advantage of changing consumer taste trends, which is inherently difficult. We're not fans of its business model. The overall retail operating environment has been a difficult one in recent quarters, and competition and promotional activity from rivals will inevitably continue, if not worsen. Competing capital allocation options have the potential to impact the pace of dividend expansion moving forward, particularly in the form of share repurchases, and share repurchases came in at nearly $400 million in fiscal 2018. We view the company's dividend as being on solid ground for the time being, and management is high on the potentially renewed focus of the to-be-separated entities.

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. Gap'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.

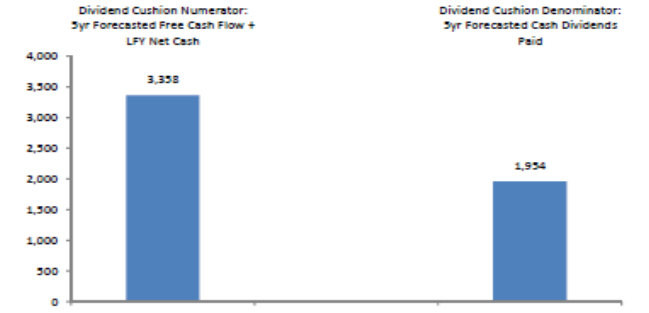
Dividend Cushion Cash Flow Bridge

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, Gap'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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