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HIGH YIELD DIVIDEND NEWSLETTER

Let's Discuss Recent Economic Events

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

INSIDE THIS ISSUE

1 Let's Discuss Recent Economic Events
5 AT&T Continues to Follow Through With Its Mission
9 The Great Guyanese Oil Boom
13 **Spotlight: *NEW* MSC Industrial Direct Co Inc (MSM) Has a Great Free Cash Flow Profile and Strategic Turnaround in the Works**
18 Bank Earnings Roundup
26 The High Yield Dividend Newsletter Portfolio
27 Screen of the Month – The Financially-Healthiest Dividend Payers Yielding Over 2%
28 Dividend Report Page 2 – Broadcom Inc (AVGO)

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"THE ONGOING CORONAVIRUS OUTBREAK IN CHINA WILL LIKELY WEIGH ON NEAR- AND MEDIUM-TERM ECONOMIC ACTIVITY IN BOTH THE MIDDLE KINGDOM AND THE GLOBAL ECONOMY AT-LARGE."
– CALLUM TURCAN

Image Shown: *Shares of High Yield Dividend Newsletter portfolio holding iShares MSCI Australia Index Fund (EWA) have performed well over the past six months.*

By Valuentum Team

Dear members,

Bloomberg recently reported that U.S. banks' record-breaking earnings have likely peaked for this cycle. Let's get the team's thoughts on this, and we'll also cover views on the corporate credit cycle, China GDP, and the US election cycle. We don't think the US-China Phase One deal amounts to much, other than removing the uncertainty that it, itself, created.

Let's kick things off with our views on a recent Bloomberg piece, U.S. Banks' Record-Breaking Earnings Streak Has Probably Peaked, "which notes that "global interest rates remain stubbornly low and geopolitical tensions (remain) high."

Matt Warren is Valuentum's Independent Bank and Economic contributor, and we'll start there.

Matthew Warren: The views expressed in the article seem a bit overly bearish assuming the economy continues growing at 2% or so. Net interest margins ('NIM') will continue to be under pressure but the banks should lap that pressure in a couple quarters (assuming rates don't continue lower). Balance sheet growth has been decent. Investment banking and trading is always a wild card. The fourth quarter is an easy comp, and then it gets a little tougher but not that tough. Share buybacks are amplifying what modest growth there is. If the economy turns down, then I would expect earnings to also be down.

Callum Turcan: Tying this in with the latest US employment report covering December 2019, the one real risk to the US economy, in my view, is a weakening manufacturing sector spreading to the rest of the economy. Manufacturing employment grew just ~46,000 in December 2019 versus December 2018 levels. The US Labor Department noted that the US shed 12,000 manufacturing jobs in December 2019, indicating softness as we head into 2020. While economists and financiers note there are plenty of job openings in the manufacturing sector and the US economy at-large, what isn't noted in a lot or any of these discussions is that many of those job openings come with low starting wages and lackluster benefits.

Often, a lot of the new manufacturing jobs in the US aren't what one would consider "traditional" manufacturing jobs in terms of offering a salary that's comparable to the national median average (around ~$62,000 per year according to the US Census, as of 2018). The Bureau of Labor Statistics notes that as of May 2018, the mean and median annual salary for 'Production Occupations' (a definition that covered 9.1 million US employees at the time) was $39,190 and $35,070, respectively.

Reductions in US auto manufacturing output and problems at Boeing's (BA) 737 MAX airplane take away the kind of manufacturing jobs with higher pay that lead to more dynamic positive effects on the economy (which goes away when those jobs are lost and vis-versa when those jobs are created).

Brian Nelson: Since the beginning of 2019, as measured by the Select Sector SPDR Trust (XLF) the largest banking stocks have lagged the broader stock market be a few percentage points. Since 2011, that spread of underperformance expanded to about 25-30 percentage points, so owning banks through this upswing hasn't been a great proposition. An investor almost had to call the exact March 2009 bottom to have generated outperformance relative to the broader S&P 500 with diversified banking entities.

It's hard to believe that banking stocks haven't bounced back as much as they probably should have – for example, on a price-only basis, the XLF is about back to its highs set in May 2007 before the Great Financial Crisis, while the broader stock market has more than doubled since then. Investing in banks hasn't been rewarding this past decade, but we still think some exposure makes sense. One of our favorite banks is Bank of America (BAC), which we include in the Dividend Growth Newsletter portfolio.

I came across a rather interesting piece from Moody's of late, "Overvalued Equities Increase Corporate Credit's Downside Risk."

In the book, *Value Trap*, I talk a lot about how equity analysis and credit analysis are inherently linked, and also how many income-oriented equities are capital-market dependent, meaning that they are reliant on external capital to support the payout.

Here is an excerpt from the Moody's piece:

> *An overvalued equity market increases the risk of a deep sell-off of equities that will damage corporate credit. Ironically, corporate credit may eventually suffer to the degree that debt-funded equity buybacks and dividends lifted equity values up to unsustainable heights.*
>
> *A sinking equity market also increases the cost of corporate debt by making it much costlier, if not impossible, to replace debt capital with equity capital. Moreover, equity weakness reduces the amount of cash that can be raised via the sale of business assets.*
>
> *All else the same, a broadly distributed equity price plunge lowers the market value of the business assets that collateralize outstanding corporate debt.*

> *The consequent drop in the market value of the net worth of businesses and a likely increase in the volatility in the market value of business assets will increase the likelihood of default.*

It should not be a surprise that any sort of dislocation in the equity markets could make things bad on the credit side, and Moody's may have it right that when this bull market and stock market party is over, we could have one very, very bad hangover. We're definitely keeping an eye on some of our leveraged ideas in the newsletter portfolios. What do you think Callum?

Callum Turcan: Good piece, and it ties into why we like AT&T Inc (T) and Philip Morris International Inc (PM) in the High Yield Dividend Newsletter portfolio. Both companies have a substantial amount of debt (and as such need to retain access to capital markets to refinance that debt), but their strong investment grade credit ratings and stellar free cash flow profiles enable both companies to pay juicy yields without being dependent on equity markets in a meaningful way.

AT&T is in the process of buying back its stock, and Philip Morris International doesn't issue equity outside of any share-based compensation (dilution historically has been minimal/non-existent). As of this writing, Philip Morris International is breaking out towards the high end of our fair value range estimate, a trajectory supported by its strong technicals and positive fundamentals (such as the recent launch of its IQOS product in the US supporting its free cash flow outlook).

Back to the Moody's piece--what I found particularly striking was by just how much the yield spread for investment grade and high yield bonds grew when US equity markets dipped significantly lower from May 2015 to February 2016. High yield bond spreads jumped over 85% while investment grade bond spreads jumped over 45% in the matter of less than a year, according to the piece. The surge in the expected default frequency rate and high yield bond spread during this period indicates just how dangerous some of these low quality high yielding companies are out there for investors.

Sure, a double-digit yield might sound tempting, but not if that yield comes with the risk of (and oftentimes, eventual) material capital depreciation.

Capital depreciation could be caused by bankruptcies in the events credit markets seize up on low quality firms that are dependent on capital markets for refinancing needs (usually this decimates equity holders), or serious capital depreciation can be the result of dividend cuts/suspensions as dividend obligations weren't properly funded by free cash flows (future payouts required the company to maintain access to capital markets for funds).

Corporates that find themselves overly reliant on equity markets are not in a good position this late in the business cycle, as things can turn south quick in this environment.

Matthew Warren: It does seem to me like many bond investors are "picking up nickels in front of a steamroller." There just isn't much yield or sound covenants on some of the issuance, particularly as it relates to junk issuance and levered loans. I think it will end very badly for some of these investors when the next downturn comes. Of course, one could have been saying that for 11 years now.

Switching gears a bit--what do we think about the comeback in GE? The stock is still down considerably since late 2016, but it has come roaring back off the bottom.

Callum Turcan: GE's (GE) problems still look tough to navigate given its exposure to the natural gas power generation space (a market that has really cooled off in the US, Europe, and elsewhere) and the 737 MAX debacle (given GE is a partner in a JV that makes the LEAP engine). While there are ways for GE to navigate some of these problems, such as growing its wind turbine business and pivoting away from the 737 MAX towards other airplane models (GE and its JV partner did a deal with Airbus (EADSY) recently to increase shipments to the European aerospace giant), I'm still concerned with its large net debt load, weak outlook, and need to divest assets to cover its deleveraging plans.

Brian Nelson: I generally agree. While GE could bounce back to the teens, the move is still within the wide range of fair value outcomes for a company that has endured so much the past decade or so, not the least of which are three dividend cuts.

One can probably count out income or dividend growth investors as those interested in GE, and for those looking for industrial exposure, Honeywell (HON) may be a better fit, a stock that has a lot less "hair" on it. Shares of Honeywell are a bit pricey, but its Dividend Cushion ratio of 2.5x speaks to considerable strength in the payout. Honeywell yields about 2% at the moment.

What does the team think about developments in China (FXI, MCHI)?

Callum Turcan: As it concerns the ongoing coronavirus epidemic that's centered in China (there are also a growing number of cases internationally), the situation appears worse than is being reported. Russia, a close geopolitical and economic ally of China, closed its land border with its southern neighbor to prevent the outbreak from spreading. The Chinese city Wuhan, the epicenter of the epidemic, has been effectively quarantined and this is a city with a population that's much larger than New York City's. Economic activity in China is likely slowing down, which could have massive implications for the global economy.

Pivoting to historical economic news, China's preliminary assessment of its GDP growth in the fourth quarter of 2019 indicates the Middle Kingdom's economy grew by 6.0% in the quarter, allowing for full year GDP growth of 6.1% which was below 2018 levels of 6.6%. While there are plenty of questions concerning just how "managed" these figures are, what matters most is Chinese authorities are communicating to businesses and investors that Beijing will accept a slower rate of growth than the historical norm. Considering the hurdles posed by the ongoing coronavirus epidemic, there doesn't appear much authorities can do at this point but accept a slower rate of economic growth in the medium-term.

The country did enact stimulus efforts to offset the US-China trade war. For instance, China cut its reserve requirement ratio ('RRR') in a bid to boost lending by allowing domestic banks to hold less cash in reserve relatively speaking, with the RRR last cut by 50 basis points at the end of 2019, bringing it down to 12.5% (a move that was made effective January 6, 2020). China had cut its RRR a few months prior in September 2019, also by 50 basis points (which at the time brought the RRR down to 13.0%).

Other stimulus measures include allowing local governments to boost their bond issuances to fund ambitious infrastructure programs and rolling back environmental targets in certain areas (particularly as it relates to thermal coal mines and power plants).

Adding on to the thermal coal related subject, China's central government has not been pushing natural gas as hard as it has been in the recent past. That's largely because China imports a lot of its natural gas supplies, either by pipeline from Russia, Turkmenistan, and elsewhere, or through liquefied natural gas re-gasification import terminals (those supplies can come from such sources as Qatar, Australia, Russia, and elsewhere, even the US if tariffs on US LNG supplies are scrapped as potentially planned). When times get tougher (i.e. US-China trade war), priorities change.

Now that the US and China have signed their "Phase One" trade accord, which effectively is a partial trade war truce, it will be interesting to see if China pivots back to focusing on keeping debt levels contained. On the other hand, if the US-China trade war flares up again, Beijing likely still retains the ability to launch even more aggressive stimulus packages, but that will severely stress its debt levels.

Brian Nelson: It seems like the US-China trade war has been more of a superficial economic peace treaty between two superpowers. I think it was to be expected that we'd get some kind of deal before the Trump administration hits the campaign trail, and I'm hard pressed to believe Phase One really changes much. Here is what our team said in September, months before the signing of the Phase One pact:

> *I think Trump is going to do whatever he can to cut a deal soon. It may not be exactly what the US is looking for, but I think whatever the deal will be, he will "declare victory" as he builds talking points for the upcoming debates. I think he knows China can just wait him out, so I expect a much more amenable President Trump at the next round of talks.*

While others find this Presidential administration to be unpredictable, it seems that the moves are somewhat predictable as each move seems very politically motivated, in my view, almost entirely focused on getting re-elected in 2020.

Perhaps this may be the case with each first-term President, but it seems so obvious to me the past few years: The Trump administration has a political playbook to get reelected in 2020, and that playbook is what we're going to see.

That means that I doubt we see much movement on Phase Two at all because the political talking points have already been achieved in landing a Phase One accord. Same with Iran. It doesn't seem like the Democrats are making the assassination and the downing of passenger airplane in Iran a big deal on the campaign trail (I don't even think it has come up in the Democratic debates of late), so we might see ongoing easing of tensions in the Middle East. The impeachment process continues, but it is almost expected that Congressional authorities won't cross party lines.

Though China's economic growth is slowing, that it handled a "trade war" with the US and is still growing at a 6% clip is noteworthy. In some ways, this is a big win for China, and I doubt that the US will be able to press as hard as it did to achieve much more. Though there was a celebration at the signing of Phase One, again, it's largely superficial, in my view, and China's economy continues to hum along at a breakneck pace, even if that pace may be slowing. Trump continues to show both economic and military restraint in his international dealings, even as he comes close to tipping over the global economy and sparking increased tensions in the Middle East.

Matthew Warren: While I think that the Phase One deal does cool tensions a bit and prevents further escalation of the trade war for now, it seems like a shaky truce, with the tariffs still in place and the US demanding more than it is willing to give.

At some point, isn't this likely to come back to a boil, even if it is after the 2020 US general elections?

In the meantime, I think we will see a further balkanization of economies and technology ecosystems. It has all the makings of a cold war, where you have two powers competing and trying to pull other countries into their orbits. Some countries will choose a leader, while many will simply try to play both sides. I think what is lost is a lot of growth opportunities for companies trying to grow their sales into China.

Further, I remain a long term (and unrequited) bear on China. I simply don't believe that centralized management of a large economy works. It's been proven otherwise several times in history. I think the state-owned companies are my case in point. They are bloated organs of the state, with too much debt, and extremely political mandates. One day, there will be a lot of bad debt as a result. There is simply too much leverage and real estate speculation in the system. That will also come home to roost.

It's funny, I think people believe in the party's ability to manage economic outcomes just like the West believes in the Federal Reserve, European Central Bank, and Bank of Japan. These forces are indeed extremely powerful in the short run and you can lose your career by betting against them. Longer term, it is more like the Wizard of Oz. Printing money or building new ghost towns in central China are simply not long term fundamental growth drivers. Please don't ask me when these will flip over, because your guess is as good as mine.

AT&T Continues to Follow Through With Its Mission

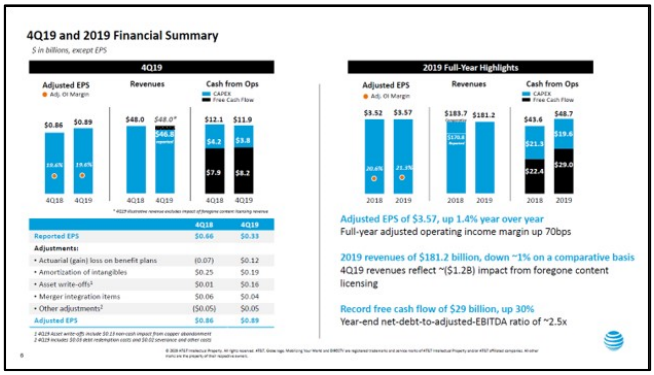


Image Source: *AT&T Inc – Fourth Quarter and Full-Year Earnings Presentation*

By Callum Turcan

One of our holdings in the High Yield Dividend Newsletter portfolio, AT&T Inc (T), reported full-year and fourth quarter results for 2019 on January 29. Shares of T sold off modestly on the mixed report (adjusted non-GAAP EPS beat consensus estimates but revenues fell short of expectations), **and now shares of T yield ~5.5% as of this writing.**

We continue to like what we see in AT&T as management is delivering on major value creating initiatives: deleveraging, margin expansion, and ultimately free cash flow growth.

Free Cash Flow Giant

AT&T generated almost $48.7 billion in net operating cash flow and spent over $19.6 billion in capital expenditures in 2019, allowing for ~$29.0 billion in free cash flow. Management was guiding for ~$26 billion in free cash flow for 2019, and AT&T easily beat that target which we appreciate. **Please note that above all else, the sheer size and resilience of AT&T's free cash flow profile is why we like the firm as a top quality high yield play.** In 2018, AT&T generated $43.6 billion in net operating cash flow and $22.4 billion in free cash flow.

In 2019, AT&T spent $14.9 billion on its dividend obligations and another $2.4 billion repurchasing its common stock (most of which was spent during the fourth quarter). Management directed most of the remaining free cash flow towards deleveraging activities and debt reduction efforts were assisted by divestment proceeds of $4.7 billion in 2019 (acquisitions consumed $1.8 billion net of cash acquired last year).

AT&T plans to continue monetizing part of its asset base going forward, and additionally, the company intends on increasing preferred equity as part of its capital stack. Please note AT&T issued out $1.2 billion in preferred equity during the fourth quarter of 2019.

Deleveraging Activities Continue

The upcoming graphic provides an overview of where management would like to take AT&T's capital stack going forward. Since closing on the big Time Warner deal last year, the company has reduced its net debt load by roughly $29-$30 billion, which dropped its net debt load to ~$151 billion at the end of 2019 (we'll have more to say on AT&T's financial status when it publishes its annual report for 2019).

That in turn helped reduce its leverage ratio, defined as net debt to adjusted EBITDA, from 3.0x at the time of the Time Warner deal closing to ~2.5x at the end of 2019.

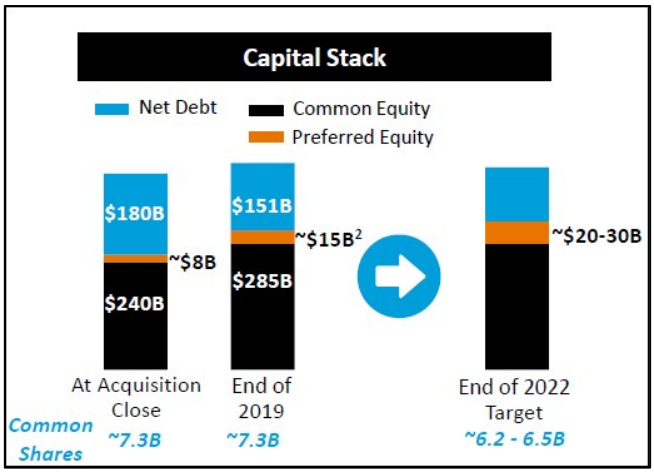


Image Shown: *AT&T plans to issue preferred equity, sell off additional assets, and leverage its strong free cash flow profile to materially reduce its net debt load and outstanding common share count through the end of 2022 while still making good on its hefty dividend obligations.* ***Image Source:*** *AT&T – Fourth Quarter and Full-Year 2019 Earnings Presentation*

Going forward, management intends on reducing AT&T's net debt load down further to $130-$140 billion by the end of 2022, which will see its leverage ratio drop down to 2.0-2.25x if everything goes as planned. During this period, management also intends on allocating a material amount towards share repurchases, which will see AT&T's outstanding share count drop by roughly 1 billion shares at the midpoint according to guidance. We caution that meaningful per share payout growth will likely have to wait until after these programs are completed.

Looking Ahead

In the near term, AT&T was happy to report that 56 million common shares were retired in 2019 and that under an accelerated share repurchase program, an additional 85 million were retired in January 2020. AT&T plans to retire at least 250 million common shares this year.

Given that shares of AT&T are trading below our fair value estimate of $40 per share, and that the company's intrinsic value is likely increasing over time, we see share buybacks as a good use of capital. For 2020, AT&T aims to generate ~$28 billion in free cash flow, revenue growth of 1-2% and non-GAAP adjusted EPS of $3.60-$3.70.

In 2019, AT&T generated non-GAAP adjusted EPS of $3.57 (up 1% year-over-year) and its non-GAAP adjusted revenue (taking the Time Warner deal into account) slipped by 1% year-over-year (this was due in part to AT&T willingly sacrificing some revenue from selling the rights to its TV shows, which we'll cover later on in this article). **Cost synergies are going to play an essential role in augmenting AT&T's future free cash flows.**

The firm secured $0.7 billion in annualized synergies in 2019, and management is angling for material labor synergies (~$1.5 billion) to be locked in this year. Furthermore, cost savings will come from simplifying its portfolio (divestments are part of this strategy), rationalizing its call center operations and using technology to enhance customer service operations (allowing for headcount reductions while still being able to offer quality customer service across its business portfolio), cost procurement savings (leveraging its ever-growing scale to drive down third-party rates), and simplifying its offerings in certain areas to reduce complexity.

AT&T's long-term goals remain the same. By 2022, AT&T wants to grow its adjusted EBITDA margin by 200 basis points while generating modest revenue growth each year, which is expected to add ~$6 billion in incremental annual adjusted EBITDA generation to its financials.

Management forecasts AT&T will generate $4.50-$4.80 in adjusted non-GAAP EPS in 2022, up sharply from 2019 levels. Most importantly, AT&T is targeting $30-$32 billion in free cash flow in 2022, with its dividend payout ratio (defined here as annual dividend obligations divided by free cash flow) moving below 50% by then (from 51% in 2019). We appreciate that AT&T's dividend payout ratio came in at *just* 51% in 2019, versus guidance calling for a payout ratio around the high 50's% range last year.

Operational Commentary

Management was happy to report during AT&T's fourth quarter conference call with investors that the firm's Mexican operations experienced a nice turnaround last quarter on the back of meaningful margin expansion.

Here's what AT&T had to say on the issue (emphasis added):

> *"The big news in our Latin American operations is Mexico turning EBITDA positive in the quarter. The team has done an excellent job of reducing costs and growing revenue in a challenging environment. Fourth quarter Mexico EBITDA improved nearly $200 million year-over-year and improved by more than $300 million for the full year.*
>
> ***We continue to press for further gains**. A new wholesale agreement with Telefónica (TEF) will **add to both revenues and EBITDA**. Going forward we expect continued improvement. Vrio continues to work against economic and foreign exchange headwinds. But even in this environment, it continues to be profitable and generate positive cash flows."*

The agreement with Telefonica was signed during the fourth quarter of 2019 and should provide a nice uplift to AT&T's financial and operational performance going forward. From the fourth quarter of 2018 to the fourth quarter of 2019, AT&T's Latin American business unit saw its revenue came in flat at $1.8 billion however, **its segment EBITDA grew more than five-fold due to margin expansion.**

Where AT&T will experience some volatility comes down to the success of its HBO Max streaming service which is set to launch in May 2020. The firm plans to leverage its current subscriber base at HBO to jump-start its streaming growth ambitions, and it appears that there are over 10 million HBO subscribers currently according to the company's IR presentation. We caution that the firm is making material original content investments to support the upcoming launch of HBO Max, which will pressure its financial performance on the margins until the service takes off.

Please note that AT&T intends on offering HBO Max at a "reduced" rate meaning that it will be priced the same as HBO for starters (at ~$15 per month), a price point that will likely be increased in the near-future to support the cost of the additional content within HBO Max. The ability to push through future price increases while maintaining its subscriber base will be a tricky task, but one that AT&T has a lot of experience in given its enormous 'Communications' business segment.

That segment includes its wireless telecommunications and wired internet provider services, along with its embattled DirecTV business.

The next big opportunity for AT&T is 5G. By the middle of 2020, AT&T hopes to rollout nationwide 5G service in the US. What 5G offers for a telecommunications giant like AT&T is the ability to sell higher priced data packages and to upsell customers on wireless plans in general, as unlimited data packages for the whole family is a more enticing proposition when considering what 5G offers (i.e. the ability to quickly download apps, games, TV/movie entertainment, music, and more).

Heading into the launch of 5G services, AT&T's wireless business has been performing well as the firm continues to grow its subscriber base. Here's what management had to say during the firm's fourth quarter conference call:

> *"In our Communications segment, mobility continues to build momentum and deliver solid results. Service revenue grew by about 2% in the quarter and for the year. EBITDA grew both in the quarter and for the year.* ***And EBITDA margins expanded by 40 basis points for the year****, while service margins were stable even with a heavily promotional fourth quarter.*
>
> *Postpaid phone growth was solid adding 229,000 in the quarter.* ***For the year, we had about one million phone net adds both postpaid and prepaid.*** *This strong performance was driven by our industry-leading network and came even while postpaid phone churn was up as competitors ramped up promotional efforts. You should note total churn postpaid and prepaid combined improved year-over-year by 12 basis points."*

Turning now to AT&T's fiber and "premium video" businesses. On the fiber internet front, this segment has seen nice growth in the recent past as high-speed internet services are still in demand. However, please note that AT&T's DirecTV subscriber base has been withering away due to structural changes in the way consumers watch TV entertainment (namely the pivot towards streaming services). The firm lost 945,000 net premium video subscribers in 2019.

Here's what management had to say during AT&T's latest quarterly conference call (emphasis added):

> *"Long-term customer value continues to be our focus as we head into 2020. That focus has helped drive growth in video and IP broadband ARPUs.* ***AT&T Fiber continues to grow adding nearly 200,000 customers.*** *That brings us to nearly four million AT&T Fiber customers and we have lots of room left to grow.* ***Premium video net losses improved sequentially by more than 200,000 subscribers, but video losses continue to impact our broadband numbers, especially our bundled customers.*** *Our new simplified video offerings position us for the long term and our subscriber trends are improving."*

There's not much AT&T can do about premium video losses as it relates to that segment's performance, but its upcoming HBO Max launch in many ways is the firm's way of dealing with the issue. If AT&T can't see any reasonable way to turn that segment around in terms of subscribers, the company will instead find subscriber growth elsewhere. Here's what management had to say about some of the content and financial decisions concerning HBO Max during AT&T's latest quarterly conference call:

> *"We made the strategic decision to give HBO Max exclusive streaming rights for top programs including Friends, Big Bang Theory and other popular shows. In the past, we would have sold these externally."*

Initially, that will further pressure AT&T's financial performance on the margins as the company is giving up a source a revenue (selling the streaming rights to its top performing TV shows), but in the long run this could give HBO Max the competitive edge needed to stay ahead of its many competitors. Please note that one of the reasons AT&T's revenues didn't perform quite as well as expected during the fourth quarter of 2019 was due to the company's decision to not sell the rights to these aforementioned TV shows. Excluding that impact, AT&T's 'WarnerMedia' segment would have seen its revenues grow by 10% organically during the quarter on a year-over-year basis and its segment EBITDA would have grown by 11%. Instead, the segment's revenues and EBITDA both shrunk on a year-over-year basis.

Concluding Thoughts

AT&T continues to follow through with its long-term strategy of **modest top-line growth** (which is set to return this year, aided by the launch of HBO Max and the rollout of nationwide 5G services in the US), **meaningful margin expansion** (due to synergies and efficiency-led cost savings), and **material deleveraging** (made possible primarily through the sheer size of AT&T's impressive free cash flows). Share buybacks and activist activity from some big fund managers (including Elliott Management, founded by Paul Singer) could help shares of T converge towards their fair value estimate in the foreseeable future. We continue to like AT&T as a top quality high yield name.

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

The Great Guyanese Oil Boom

Image Shown: *A drill ship floating in open waters.* ***Image Source:*** *Exxon Mobil Corporation – 2019 IR Presentation*

By Callum Turcan

We're going to get into the potential opportunity for energy producers in Guyana, but first, one thing that often gets lost in the noise surrounding press releases and presentations announcing new upstream projects coming online is that Exxon Mobil Corp (XOM) --- **5.6% yield** --- and its peers are contending with serious base decline rates.

Decline rates are around 3-5% per year for conventional fields depending on the level of investment made in base maintenance (along with recovery rates and the quality of the rock), which includes such things as gas/water injection projects (this entails drilling injection wells to maintain reservoir pressure and often involves drilling new producing wells) and what's known as acidizing (which entails cleaning the well with hydrochloric acid mixtures and/or injecting a solution into the formation itself depending on the situation).

Should Exxon Mobil or any other company with upstream operations (the production of raw energy resources like oil and natural gas) not make these types of investments, the natural rate of decline is higher at 5-7% per year (additionally, the rate of decline is higher for oil than natural gas).

Please note that Exxon Mobil estimates "without investments, we estimate the supply of existing oil naturally declines at a rate of approximately 7 percent per year" and furthermore, that "the imperative for investment in natural gas is similar to oil, with the annual decline of natural gas from existing supplies at approximately 5 percent". This was from Exxon Mobil's 2018 Financial and Operating Review.

For a company that produced 2.3 million barrels of liquids and 9.4 billion cubic feet of natural gas per day in 2018, equal to 3.8 million barrels of oil equivalent per day ('BOE/d'), **Exxon Mobil's annual upstream production base (before taking its push into shale into account) is shrinking by approximately 200,000 – 300,000 BOE/d every single year from its existing operations.**

Add in its growing unconventional Permian output which has much sharper decline rates (wells that are hydraulically fractured, like those seen across the US, have first year decline rates that range from 45-80% which requires new wells to be constantly turned online to maintain output), and one gets a better idea of why **Exxon Mobil's new projects haven't yielded upstream growth in the recent past**.

In 2011, Exxon Mobil's upstream production came in at 2.3 million barrels of liquids and 13.2 billion cubic feet of natural gas per day, equal to 4.5 million BOE/d.

Since then, Exxon Mobil's upstream production has fallen to ~4.0 million BOE/d as of 2019, which was up from ~3.8 million BOE/d in 2018 but still down sharply over the course of eight years. Having a large and mature upstream asset base is a tough proposition.

The Great Guyana Oil Boom

With this in mind, let's look at Exxon Mobil's impressive Guyana operations. Since striking liquid gold (namely crude oil) back in 2015, the Exxon Mobil-led venture has made 16 successful discoveries in the country. Those discoveries uncovered 8 billion barrels of recoverable oil equivalent, namely crude oil, and given that these are substantial conventional resources, this region is expected to be very competitive on the global cost of supply curve.

By the end of 2019, Exxon Mobil and its partners Hess Corporation (HES) and CNOOC Ltd (CEO), who each own 45%, 30%, and 25%, respectively, of the 6.6 million square acre Stabroek Block in offshore Guyana that houses these resources, had achieved first-oil at the block.

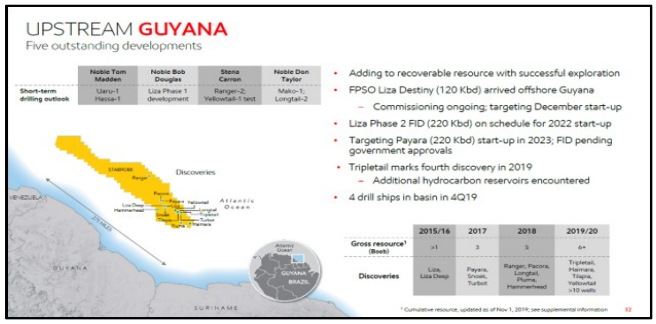


Image Shown: *A look at the Stabroek Block off the coast of Guyana, a small country in the northern portion of South America, where Exxon Mobil and its partners have found an enormous amount of recoverable low-cost conventional oil resources.* ***Image Source:*** *Exxon Mobil – 2019 IR Presentation*

The consortium decided to develop the Liza oil field first given its immense size. By turning the Liza Phase One project online, which entailed developing a series of producing wells supported by a floating production storage and offloading ('FPSO') vessel, the Exxon Mobil-led group will soon be able to pump out 120,000 barrels of crude oil per day on a gross basis from the region.

That FPSO is known as the 'Lisa Destiny' vessel. Another FPSO, 'Lisa Unity', is under construction and set to come online in the middle of 2022. Once operational, Lisa Unity will have the capacity to produce up to 220,000 barrels of crude oil per day and like the Liza Phase One project, this Liza Phase Two endeavor is developing the Liza oil field.

Image Shown: *A look at the project timetables for the consortium in terms of existing and future developments.* ***Image Source:*** *Exxon Mobil – 2019 IR Presentation*

Furthermore, the consortium envisions possibly adding a third FPSO to the region, tentatively dubbed 'Prosperity', to develop the Payara oil field.

More broadly, Exxon Mobil and its partners have their eyes set on having five FPSO vessels that will collectively produce ~750,000 barrels of crude oil per day in the region on a gross basis by 2025. As things stand today, all of those volumes will be exported given that Guyana does not possess an oil refinery or any meaningful domestic refining capacity.

There are currently four drill ships operating in the Stabroek Block with another slated to join the group later this year. For a country that just five years ago didn't even have a hydrocarbon sector to speak of (at least not one of this caliber), that's quite the change in scenery.

Exxon Mobil and its partners are thought to be in a position to earn a very economical return on their investment, short of oil prices crashing to the floor and staying there, given the relatively favorably tax regime the consortium is operating in.

Compared to other oil-rich nations, such as an Iraq (where foreign oil companies are generally sub-contractors and earn a paltry return) or Brazil (where taxes and regulations are quite onerous, however, the current administration has been more amenable to the industry) for example, the contracts and tax regimes aren't always conducive to foreign companies seeking to earn a decent return on investment as compared to the US, Canada, or now Guyana (at the right raw energy resource price point of course, no private firm makes good money in a price taking business when prices are low).

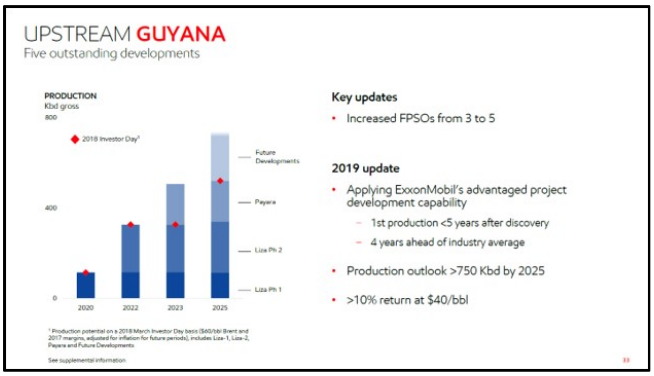


Image Shown: *A look at the upstream growth trajectory of the Exxon Mobil-led Guyana consortium, with an eye towards the very economical nature of these types of large conventional oil projects.* ***Image Source:*** *Exxon Mobil – 2019 IR Presentation*

As Guyana's crude oil production has access to every major oil demand center in the world, the consortium will be able to fetch Brent-linked prices for these upstream volumes. Brent trades at a premium to WTI, which is very important to note when comparing these assets to that of say, an onshore oil field in the US that doesn't have easy access to the US Gulf Coast region. Exxon Mobil estimates these projects will earn a return north of 10% in a ~$40 Brent world, and the venture should be quite economical in a $60 Brent world.

Concluding Thoughts

Guyana's economy of ~780,000 people is about to experience the oil boom bonanza of a lifetime, even in the relatively subdued oil price environment Exxon Mobil is currently operating in, as substantial royalties and taxes are set to fill the government's coffers. Those funds will allow for major public investments in healthcare, education, infrastructure, and so much more. Given the relatively small size of Guyana's population, there will be a lot of new funds to go around.

For Exxon Mobil and its partners, turning ~750,000 barrels of gross daily crude oil production capacity online by 2025 would be quite the achievement. **In less than five years, the consortium went from hitting it big on the exploration side to reaching first-oil, and in ten years, the group plans on turning Guyana into one of the world's largest oil exporters on a net basis.** However, please keep in mind that big projects like these are contending with material mature field declines across Exxon Mobil's upstream portfolio. Guyana is just part of the puzzle for Exxon Mobil.

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

[Please see next page for a summary of portfolio activity during2019.]

Tracking the High Yield Dividend Newsletter	Price -- 12/31/2018 or at open*	Interim Dividends	Price -- 12/31/2019 or at close**
CORE			
Alerian MLP ETF (AMLP) -- *removed* November 18	8.73	0.78	7.83
Added 2.5pts of AT&T (T) -- November 18	*39.21*	-	39.08
Added 2.5pts of Philip Morris (PM) -- November 18	*84.57*	1.17	85.09
Global X SuperDividend ETF (SDIV)	17.10	1.54	17.69
Global X SuperIncome Preferred ETF (SPFF)	11.03	0.71	11.74
iShares International Select Dividend ETF (IDV)	28.71	1.73	33.57
iShares MSCI Australia ETF (EWA)	19.25	0.90	22.64
iShares U.S. Preferred Stock ETF (PFF)	34.23	2.00	37.59
Invesco Senior Loan Portfolio (BKLN)	21.78	1.11	22.82
ProShares High Yield -- Interest Rate Hedged (HYHG)	62.09	3.97	65.44
Utilities Select Sector SPDR (XLU) -- *added August 22*	*61.61*	0.99	64.62
Vanguard Real Estate ETF (VNQ) - *added April 1*	*85.91*	2.53	92.79
EQUITY			
AT&T (T)	28.54	2.04	39.08
BP PLC (BP)	37.92	2.46	37.74
CubeSmart (CUBE) -- *added August 22*	*35.13*	0.65	31.48
Digital Realty Trust (DLR)	106.55	4.32	119.74
Enterprise Products Partners (EPD)	24.59	1.76	28.16
Iron Mountain (IRM) -- *removed August 1*	32.41	1.22	29.97
Magellan Midstram Partners (MMP)	57.06	4.04	62.87
Omega Healthcare Investors (OHI) -- *removed March 1*	35.15	0.66	34.72
Philip Morris (PM) -- *added August 1*	*82.41*	2.34	85.09
Public Storage (PSA)	202.41	8.00	212.96
Schlumberger*, added January 18, removed August 1*	*43.00*	1.00	38.07
Realty Income Corporation (O) -- *removed April 1*	63.04	0.68	72.03
Tallgrass Energy LP (TGE) -- *removed August 1*	24.34	1.59	18.25

* As shown in the January 2019 edition of the High Yield Dividend Newsletter, or price at entry point

** Price as of December 31, 2019, or price at close

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

High Yield Spotlight: MSC Industrial Direct Co Inc (MSM) Has a Great Free Cash Flow Profile and Strategic Turnaround in the Works

Our **February 2020 High Yield Dividend Newsletter Spotlight** is industrial equipment supplier MSC Industrial Direct Co Inc (MSM) --- **4.4% yield** --- which is a leading North American distributor of metalworking, maintenance, repair, and operations products and services (for reference, the industry is abbreviated as 'MRO' according to the company). What makes MSC Industrial an attractive high yield opportunity is that the firm is very light on capital expenditures, **allowing for material free cash flows in various macroeconomic environments**, and its sales are overwhelmingly conducted in the US (~96% of its sales). For reference, please note that MSC Industrial's fiscal 2019 ended on August 31, 2019.

The Company's net sales originating from the following geographic areas were as follows for the year ended August 31, 2019:

	For the Fiscal Year Ended August 31, 2019 (52 weeks)	
United States	$ 3,243,026	96%
U.K.	56,506	2%
Canada	41,126	1%
Mexico	23,159	1%
Total net sales	$ 3,363,817	100%

Image Shown: *The vast majority of MSC Industrial's sales comes from the US, with only a marginal amount of international sales.* ***Image Source:*** *MSC Industrial – Fiscal 2019 Annual Report*

Most of MSC Industrial's sales are conducted with firms operating in the manufacturing sector (~70% of its sales), **meaning the firm is tied to highly cyclical industries**. We caution that exogenous forces have an outsized role to play as it concerns MSC Industrial's financial performance, which is why its capital expenditure light business model is so important.

	For the Fiscal Year Ended August 31, 2019 (52 weeks)
Manufacturing Heavy	48%
Manufacturing Light	22%
Government	8%
Retail/Wholesale	6%
Commercial Services	4%
Other (1)	12%
Total net sales	100%

(1) The other category primarily includes individual customer and small business net sales not assigned to a specific industry classification.

Image Shown: *MSC Industrial is heavily tied towards the state of the manufacturing sector in the US.* ***Image Source:*** *MSC Industrial – Fiscal 2019 Annual Report*

As you can see in the upcoming graphic down below, MSC Industrial generated $257 million in annual free cash flow on average from fiscal 2017 to fiscal 2019. Dividend obligations averaged $124 million per year during this period, with the remainder of MSC Industrial's free cash flow directed towards share repurchases (which averaged $72 million per year during this period) and acquisitions (we'll go into more detail on that in a moment). From fiscal 2017 to fiscal 2019, MSC Industrial's weighted average diluted outstanding share count fell from ~57 million to ~55.5 million and continued to fall during the first quarter of fiscal 2020.

MSC INDUSTRIAL DIRECT CO., INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE FISCAL YEARS ENDED AUGUST 31, 2019, SEPTEMBER 1, 2018, AND SEPTEMBER 2, 2017
(In thousands)

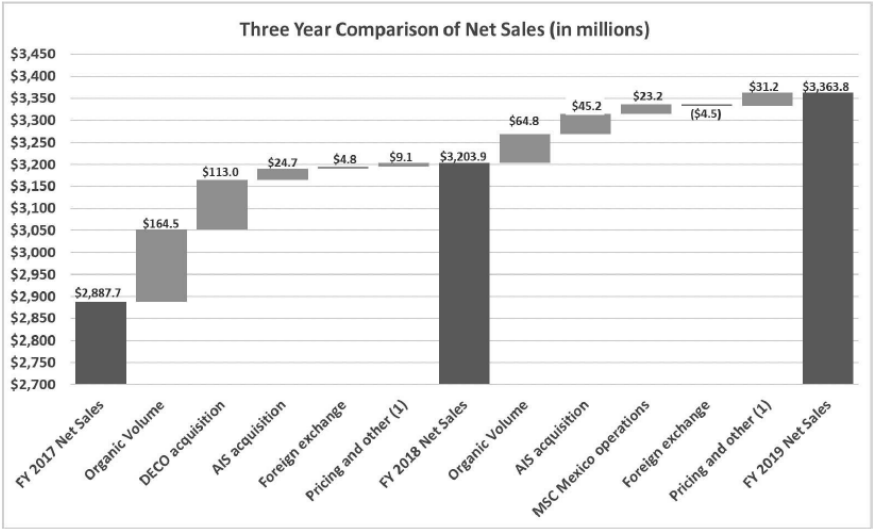
	For the Fiscal Years Ended		
	August 31, 2019 (52 weeks)	September 1, 2018 (52 weeks)	September 2, 2017 (52 weeks)
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 288,797	$ 329,223	$ 231,431
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	65,377	63,154	62,980
Stock-based compensation	16,283	14,934	13,925
Loss on disposal of property, plant, and equipment	416	479	678
Provision for doubtful accounts	10,763	6,938	7,048
Deferred income taxes and tax uncertainties	14,297	(19,577)	13,482
Write-off of deferred financing costs on previous credit facility	—	—	94
Changes in operating assets and liabilities, net of amounts associated with business acquired:			
Accounts receivable	(26,948)	(49,827)	(72,230)
Inventories	(32,528)	(33,235)	(15,871)
Prepaid expenses and other current assets	(8,316)	(4,865)	(7,428)
Other assets	(2,064)	1,094	548
Accounts payable and accrued liabilities	2,349	31,340	12,184
Total adjustments	39,629	10,435	15,410
Net cash provided by operating activities	328,426	339,658	246,841
CASH FLOWS FROM INVESTING ACTIVITIES:			
Expenditures for property, plant and equipment	(51,773)	(44,919)	(46,548)
Proceeds from sale of available for sale securities	27,025	—	—
Cash used in business acquisitions, net of cash acquired	(11,625)	(87,000)	(42,345)
Net cash used in investing activities	(36,373)	(131,919)	(88,893)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Repurchases of common stock	(84,611)	(82,369)	(49,182)
Payments of cash dividends	(145,709)	(125,430)	(102,216)
Proceeds from sale of Class A common stock in connection with associate stock purchase plan	4,600	4,461	4,243
Proceeds from exercise of Class A common stock options	15,640	24,243	26,887
Borrowings under the revolving credit facilities	382,000	242,000	546,000
Payments under the revolving credit facilities	(451,000)	(350,000)	(618,500)
Contributions from noncontrolling interest	918	—	—
Proceeds from long-term debt	—	110,000	—
Payments on capital lease and financing obligations	(28,370)	(1,066)	(1,175)
Other, net	903	575	(803)
Net cash used in financing activities	(305,629)	(177,586)	(194,746)
Effect of foreign exchange rate changes on cash and cash equivalents	(355)	(19)	(9)
Net increase (decrease) in cash and cash equivalents	(13,931)	30,134	(36,807)
CASH AND CASH EQUIVALENTS, beginning of the year	46,217	16,083	52,890
CASH AND CASH EQUIVALENTS, end of the year	$ 32,286	$ 46,217	$ 16,083
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:			
Cash paid for income taxes	$ 79,334	$ 100,504	$ 121,691
Cash paid for interest	$ 16,648	$ 13,448	$ 11,695

See accompanying notes to consolidated financial statements.

Image Shown: *MSC Industrial has historically been very free cash flow positive, and we expect that to continue going forward.* ***Image Source:*** *MSC Industrial – Fiscal 2019 Annual Report*

To support its revenue growth trajectory, **MSC Industrial has pursued some acquisitions over the years** (along with modest divestments) including the purchase of Iowa-based industrial supplier DECO Tool Supply Co. for $44 million net in cash back in calendar year 2017. That was followed up by the acquisition of Wisconsin-based All Integrated Solutions Inc for $89 million net in cash in calendar year 2018, which was a value-added distributor of industrial fasteners and components, MRO supplies and assembly tools. In calendar year 2019, MSC Industrial bought certain assets from TAC Insumos Industriales in a deal that cost $14 million net in cash. Dubbed the 'TAC' deal, this purchase gave MSC Industrial a bigger footprint in Mexico to support growth in non-US market (keeping in mind MSC Industrial is still heavily focused on the US).

The chart below displays a three-year comparison of our net sales from fiscal 2017 through fiscal 2019:



(1) Pricing and other is comprised of changes in customer and product mix, discounting and other items.

Image Shown: *A look at MSC Industrial's rising revenues over the past few fiscal years.* ***Image Source:*** *MSC Industrial – Fiscal 2019 Annual Report*

From fiscal 2017 to fiscal 2019, MSC Industrial's GAAP revenues grew by over 16% while its GAAP operating income grew by almost 6% during this period. The contraction in MSC Industrial's GAAP gross margin and rising operating expenses were largely responsible for the decline in its GAAP operating margin as the firm integrated new assets into company-wide operations. Additionally, increased product costs and unfavorable product mix changes further pressured its margins. Management expects the firm will face some headwinds on the sales and margins front in fiscal 2020, however, the US-China Phase One trade deal should offer some relief to MSC Industrial's clients.

Management embarked on a strategy to stabilize MSC Industrial's margins and improve overall operations, which has taken on a bigger role in the firm's decision making in recent years. The goal is to transition (and this has been taking place over the past several years) MSC Industrial from a spot-buy only supplier of various industrial products "to a mission critical partner on the plant floors of North American manufacturing and industry" and one that works more closely with its many clients. MSC Industrial saw that its legacy business model would come under pressure over time, as it has, from greater pricing transparency on the transactional side of the business.

To offset this and most importantly, pivot to a more value-added role in North America's manufacturing sector, MSC Industrial changed its sales tactics and started implementing "robust cost savings documentation" to build a better relationship with its clients. **MSC Industrial started focusing more so on products and services that were highly technical in nature and less commoditized, where profitability levels can often be dearer.**

Adding value-added services to the mix was crucial to this transition, which is partially why MSC Industrial acquired Barnes Group back in calendar year 2013 for ~$550 million. Barnes Group provided "fasteners and other high margin consumable products and services (often referred to as Class C items) with an industry-leading field sales force and vendor managed inventory ('VMI') solution" and the VMI initiatives are what enabled MSC Industrial to "[expand] our supply chain onto our customers plant floors through inventory management solutions and primarily vending and VMI."

Here's what MSC Industrial's management team had to say about this strategy during the firm's first quarter of fiscal 2020 conference call (emphasis added);

> *"Since the start of our fiscal 2013, revenues to customers with those solutions are up 1,800 basis points and approaching half of total Company sales, driven by the growth of MSC's vending and VMI initiatives along with the benefit of the Barnes & AIS acquisition. Two-thirds of that list though, was organic. And looking forward, we expect continued growth in solutions.*
>
> *A noteworthy characteristic of our new strategy is that it yields revenue stream correlated with higher retention rates and that increases customer lifetime value.* ***This becomes meaningful as we model our growth over time, less customer churn and higher retention produce some more effective growth model and higher ROIC by better leveraging our fixed costs.*** *During last quarter's call, I outlined* ***three initiatives that have our near-term attention in order to restore operating margin stability and ultimately expansion****. And they are first, refining the sales effect of this plan, second, improving the profitability of our supplier programs and third, improving productivity by reducing operating expenses. We will remain focused on these three through the course of our fiscal 2020."*

At the end of MSC Industrial's first quarter for fiscal 2020 (period ended November 30, 2019), the firm was sitting on $28 million in cash and cash equivalents versus $139 million in 'current portion of long-term debt including obligations under finance leases' and $268 million in 'long-term debt including obligations under finance leases'. That net debt load is concerning but manageable given the strength of MSC Industrial's free cash flow profile and when considering its nice current ratio.

Please note MSC Industrial exited November 2019 with $1.2 billion in current assets versus $0.4 billion in current liabilities, as its inventory and accounts receivable balance each stood at over $0.5 billion at the end of this period. Near-term liquidity needs can be meet with its $0.6 billion committed revolving credit line that matures April 2022, and at the end of November 2019, this revolving credit line was undrawn. MSC Industrial has another revolving credit line as well with ~$0.4 billion in total borrowing capacity, which was ~$0.1 billion drawn at the end of November 2019 (this is an uncommitted revolving credit line for short-term lending needs, while the committed revolving credit line is for longer term lending needs).

That being said, its net debt load does weigh negatively on its dividend coverage on a forward-looking basis. We give MSC Industrial a Dividend Cushion ratio of 1.6x, which provides for a GOOD Dividend Safety rating and an EXCELLENT Dividend Growth rating (keep in mind our Dividend Cushion ratio models nice mid-to-high single-digit per share dividend growth over the coming years). Our Dividend Cushion ratio is based on the expected free cash flows MSC Industrial will generate over the next five full fiscal years, less net debt considerations (in this case), with that figure then divided by its expected dividend obligations during this period.

The upcoming graphic below, from our two-page Dividend Report, provides a visual representation of our Dividend Cushion ratio for MSC Industrial.

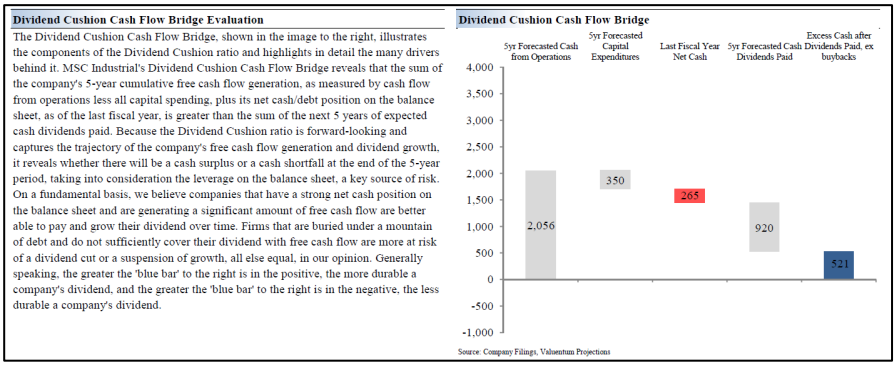


***Image Shown**: A look at MSC Industrial's Dividend Cushion ratio. We view its dividend coverage on a forward-looking basis as quite good given the strength of its free cash flow profile.* ***Image Source:** Valuentum*

Our fair value estimate for MSM stands at $90 per share, with the low end of our fair value range estimate sitting at $72 per share. As of this writing, MSM is trading in the high $60s, indicating that beyond its nice yield and payout growth trajectory, there could be room for capital appreciation upside as well. Historically, MSC Industrial has earned a return on invested capital excluding goodwill ('ROIC') that has exceeded its estimated weighted-average cost of capital ('WACC'). Going forward, we expect that to continue being the case and furthermore, that the magnitude of that spread will be quite large. This earns MSC Industrial an EXCELLENT ValueCreation rating and an ATTRACTIVE Economic Castle rating. The graphic below, from our 16-page Stock Report covering MSC Industrial, provides a nice visual overview of what that looks like. Management's new strategic focus, which has been playing out over the past several years and has really started to pick up pace within the past quarter or two, is key to generating this upside.

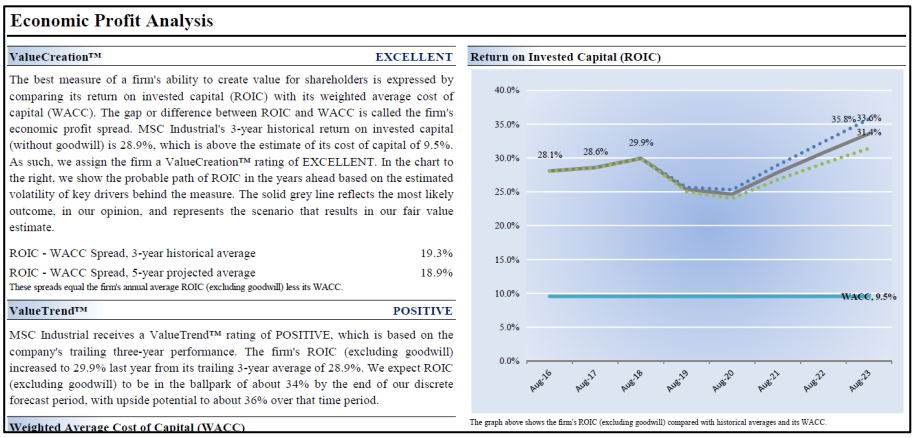


***Image Shown:** MSC Industrial has historically done a good job of generating shareholder value and we expect that to continue going forward, a trajectory assisted by management's new strategic focus for the firm.* ***Image Source:** Valuentum*

We like MSC Industrial's free cash flow profile which allows for the firm to carry both good dividend coverage and a nice yield to boot (a product of the firm directing a large chunk of that free cash flow towards dividend payments). Now that the US-China Phase One trade accord has been signed, that should relieve some of the stress facing MSC Industrial's clients which in turn could support its near- and medium-term outlook. **We like the firm's ability to generate shareholder value and expect its strategic pivot will further improve MSC Industrial's outlook.** Please note that the firm has paid out special dividends in the past, offering another avenue for income generation upside.

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

Bank Earnings Roundup

Morgan Stanley Expecting Substantial Improvement

By Matthew Warren

Morgan Stanley is guiding return on tangible equity to go from 12.9% this year to 13-15% in two years and to 15-17% in the longer term. Management was quite clear that they are using the assumption that the economy and markets move ahead at normal levels, meaning no severe recessions or booms. That said, if the company hits these goals, it will drive fundamentals ahead at a steady clip, requiring a reset higher in its valuation.

Morgan Stanley (MS) --- **2.7% yield** --- put up solid fourth-quarter results, released January 16, beating the consensus of analyst earnings-per-share forecasts by a decent margin. Net revenues advanced 8% and net income applicable to Morgan Stanley common shareholders was up a modest 1%. Adjusted return on average tangible common equity was 12% in the quarter and 12.9% for the year, as you can see in the below graphic.

Morgan Stanley

Consolidated Financial Metrics, Ratios and Statistical Data
(unaudited)

	Quarter Ended			Percentage Change From:		Twelve Months Ended		Percentage
	Dec 31, 2019	Sep 30, 2019	Dec 31, 2018	Sep 30, 2019	Dec 31, 2018	Dec 31, 2019	Dec 31, 2018	Change
Financial Metrics:								
Earnings per basic share	$ 1.33	$ 1.28	$ 0.81	4%	64%	$ 5.26	$ 4.81	9%
Earnings per diluted share	$ 1.30	$ 1.27	$ 0.80	2%	63%	$ 5.19	$ 4.73	10%
Return on average common equity	11.3%	11.2%	7.7%			11.7%	11.8%	
Return on average tangible common equity	13.0%	12.9%	8.8%			13.4%	13.5%	
Book value per common share	$ 45.82	$ 45.49	$ 42.20			$ 45.82	$ 42.20	
Tangible book value per common share	$ 40.01	$ 39.73	$ 36.99			$ 40.01	$ 36.99	
Excluding intermittent net discrete tax provision / benefit [1][2]								
Adjusted earnings per diluted share	$ 1.20	$ 1.21	$ 0.73	(1%)	64%	$ 4.98	$ 4.61	8%
Adjusted return on average common equity	10.5%	10.7%	7.1%			11.2%	11.5%	
Adjusted return on average tangible common equity	12.0%	12.3%	8.1%			12.9%	13.2%	
Financial Ratios:								
Pre-tax profit margin	25%	27%	22%			27%	28%	
Compensation and benefits as a % of net revenues	48%	44%	44%			45%	44%	
Non-compensation expenses as a % of net revenues	27%	29%	34%			27%	28%	
Firm expense efficiency ratio	75%	73%	78%			73%	72%	
Effective tax rate from continuing operations [1][2]	15.7%	18.2%	16.2%			18.3%	20.9%	
Statistical Data:								
Period end common shares outstanding (millions)	1,594	1,624	1,700	(2%)	(6%)			
Average common shares outstanding (millions)								
Basic	1,573	1,604	1,674	(2%)	(6%)	1,617	1,708	(5%)
Diluted	1,602	1,627	1,705	(2%)	(6%)	1,640	1,738	(6%)
Worldwide employees	60,431	60,532	60,348	--	--			

The End Notes are an integral part of this presentation. See pages 12 - 17 for Definition of U.S. GAAP to Non-GAAP Measures, Definition of Performance Metrics and Terms, Supplemental Quantitative Details and Calculations, and Legal Notice.

Image Source: *Morgan Stanley Earnings Presentation*

Now this is where things get interesting. Management gave a strategic update on the call, laying out expectations for two-year objectives and longer-term aspirations for Wealth Management pre-tax margin, firmwide efficiency ratio and return on tangible common equity. When comparing the graphic on the previous page (Page 18) to the upcoming graphic, you can see the substantial improvement that management is now calling for.

Morgan Stanley

Executing on the Next Phase of Shareholder Value

	2-Year Objectives	Longer-Term Aspirations
WM Pre-Tax Margin [1]	28 – 30%	30%+
Firm Efficiency Ratio [2]	70 – 72%	<70%
ROTCE [3]	13 – 15%	15 – 17%

The End Notes are an integral part of this Presentation. See slides 14 - 17 at the back of this presentation for information related to the financial metrics and defined terms in this presentation

13

Image Source: *Morgan Stanley Strategic Update (alongside quarterly earnings)*

The bottom line is that management is guiding return on tangible equity to go from 12.9% this year to 13-15% in two years and to 15-17% in the longer term. Management was quite clear that they are using the assumption that the economy and markets move ahead at normal levels, meaning no severe recessions or booms. That said, if the company hits these goals, it will drive fundamentals ahead at a steady clip, requiring a reset higher in its valuation.

Given that we are 11 years into an economic and bull market upcycle, we think these targets need to be looked at with a fair degree of skepticism. That said, we do give the firm credit for improving its financial metrics over the past few years, and most importantly return on capital steadily from low levels. If the market cooperates, Morgan Stanley is certainly levered to improving financial conditions along with self-improvement efforts to boot.

In giving partial credit for these expectations, we raised our fair value estimate to $55 per share, pending more evidence of success regarding self-improvement efforts.

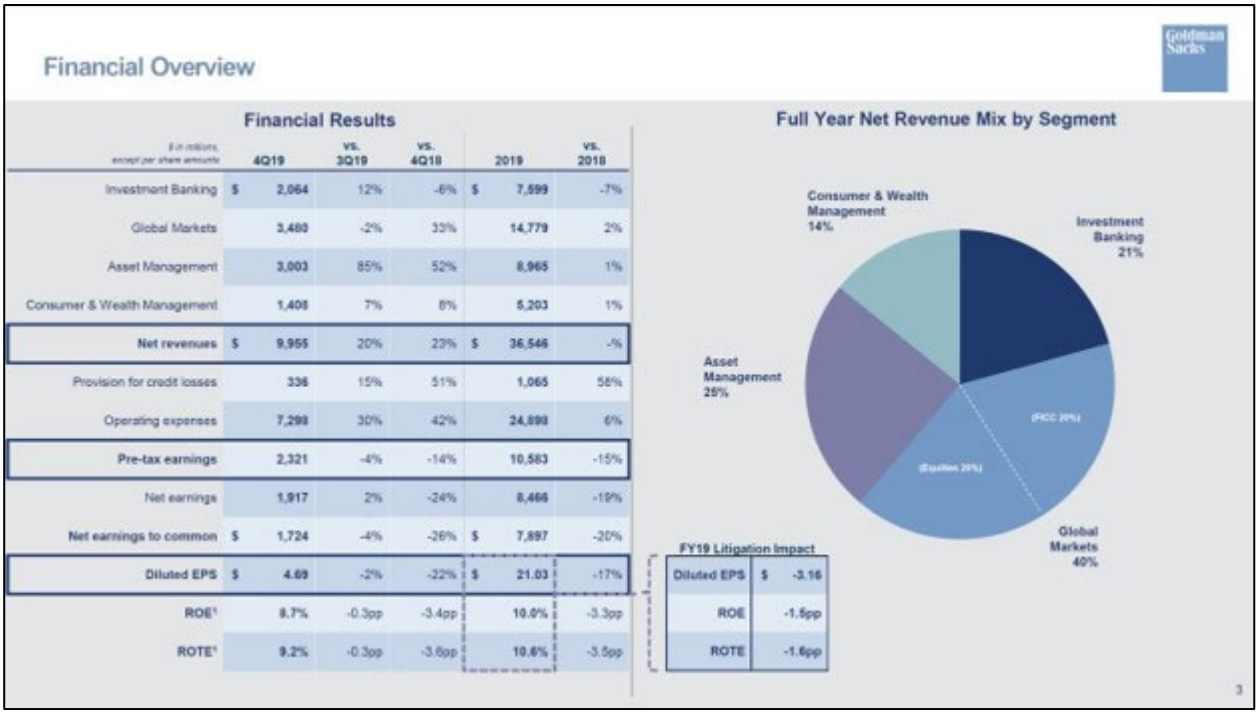
Goldman Hit By Charge Related to 1MDB

Aside from dominating the global revenue pools for investment banking and trading, Goldman is doing other things right. The firm has rapidly gathered deposits in the US and UK over the past year, bringing in a lower cost of funds to help facilitate its balance sheet. Goldman has also built up Marcus, Apple Card, and the bank is in the process of growing its asset management business to better serve institutional clients.

Goldman Sachs (GS) --- **2.1% yield** --- posted mixed fourth-quarter results, released January 15, beating consensus revenues but missing on the bottom line by a substantial amount as a result of a $1.24 billion charge related to the ongoing 1MDB (1Malaysia Development Berhad) scandal potential upcoming resolution. 1MDB is the name of a state investment fund in Malaysia where billions of dollars were stolen in one of the biggest frauds in recent times.

For the year, Goldman's revenues were flat and diluted earnings per share were down 17%. The 1MDB litigation-impact hit annual EPS by $3.16 and return on tangible equity by 1.6 percentage points, resulting in a 10.6% ROTE for 2019. **Simply put, we are not impressed by this figure.** Goldman claims number-one position in many investment banking and trading categories, but it clearly struggles to convert that into returns on capital above the cost of capital, which is pretty damning 11 years into a bull market cycle.

Below are the new segment breakdowns in the graphic (Investment Banking, Global Markets, Asset Management, Consumer & Wealth Management). During Goldman Sachs' first ever investor day presentation that was conducted in January 2020, management shed more light on their strategies with the firm's newer businesses like Marcus, as well as providing in-depth commentary on its various banking businesses. This will make them more accountable to improving these key metrics, and we fully expect the Street to hold them to their new targets.



$ in millions, except per share amounts	4Q19	vs. 3Q19	vs. 4Q18	2019	vs. 2018
Investment Banking	$ 2,064	12%	-6%	$ 7,599	-7%
Global Markets	3,480	-2%	33%	14,779	2%
Asset Management	3,003	85%	52%	8,965	1%
Consumer & Wealth Management	1,408	7%	8%	5,203	1%
Net revenues	$ 9,955	20%	23%	$ 36,546	-%
Provision for credit losses	336	15%	51%	1,065	58%
Operating expenses	7,298	30%	42%	24,898	6%
Pre-tax earnings	2,321	-4%	-14%	10,583	-15%
Net earnings	1,917	2%	-24%	8,466	-19%
Net earnings to common	$ 1,724	-4%	-26%	$ 7,897	-20%
Diluted EPS	$ 4.69	-2%	-22%	$ 21.03	-17%
ROE[1]	8.7%	-0.3pp	-3.4pp	10.0%	-3.3pp
ROTE[1]	9.2%	-0.3pp	-3.6pp	10.6%	-3.5pp

FY19 Litigation Impact	
Diluted EPS	$ -3.16
ROE	-1.5pp
ROTE	-1.6pp

Image Source: *Goldman Sachs Earnings Presentation*

Aside from dominating the global revenue pools for investment banking and trading, Goldman is doing other things right. **The firm has rapidly gathered deposits in the US and UK over the past year, bringing in a lower cost of funds to help facilitate its balance sheet.** Goldman has also built up Marcus, Apple Card, and the bank is in the process of growing its asset management business to better serve institutional clients. As these businesses have been in heavy investment mode and should theoretically be scalable, we think Goldman has room to improve its return on capital in coming years, if the economy and markets cooperate.

All things considered, while we are still disappointed in Goldman's economic returns, we raised our fair value estimate to $225 to reflect the potential for current returns to roughly equal mid-cycle returns in coming years.

Bank of America Gaining Share

We increased our fair value estimate of Bank of America to $40 per share, as we view the market share gains at the bank and steady loan and deposit growth to be more sustainable than we had previously envisioned. We like the bank's solid franchise, the management team, and we like the shares here as it tries to catch up with larger peer JPMorgan.

While Bank of America (BAC) --- **2.2% yield** --- put up middling results for the fourth-quarter, report released January 14, **they did come in better than analyst expectations on the top- and bottom-lines**. Total net revenue was down 1% in the quarter and net income was down 4%, but large share buybacks meant that diluted earnings per share was actually up 6% in the quarter--not terrible considering the downturn in rates in the second half of last year, which pressured net interest margins. As you can see in the below graphic, return on tangible equity was an impressive 15.4% in the quarter, albeit down from last year's levels.

4Q19 Financial Results

Summary Income Statement ($B, except per share data)	4Q19	4Q18	% Inc / (Dec)
Total revenue, net of interest expense	**$22.3**	$22.7	(1) %
Noninterest expense	**13.2**	13.1	1
Provision for credit losses	**0.9**	0.9	4
Pretax income	**8.2**	8.7	(6)
Income tax expense	**1.2**	1.4	(17)
Net income	**$7.0**	$7.3	(4)
Diluted earnings per share	**$0.74**	$0.70	6
Average diluted common shares (in millions)	**9,079**	9,996	(9)

Return Metrics and Efficiency Ratio		
Return on average assets	**1.13 %**	1.24 %
Return on average common shareholders' equity	**11.0**	11.6
Return on average tangible common shareholders' equity[1]	**15.4**	16.3
Efficiency ratio	**59**	58

Note: Amounts may not total due to rounding.
[1] Represents a non-GAAP financial measure. For important presentation information, see slide 30.

Image Source: *Bank of America Earnings Presentation*

Bank of America's efficiency ratio was slightly worse than last year at 59% as investments in physical plant, technology, and people outpaced efficiency savings generated by previous investments.

Looking forward, management was clear that the net-interest-margin pressure should ease up in the second half of 2020 as the firm laps lower interest rates (assuming rates do not take another leg lower.) This should allow for continued revenue growth ahead of flat expenses, allowing for operating leverage and better efficiency ratios yet again.

Underlying franchise growth was solid in the quarter as total deposits grew 5%, and loans and leases in business segments grew 6% as compared to last year. These are impressive levels for such a large bank and imply ongoing market share gains from the likes of Wells Fargo (WFC) and the long tail of small, underperforming banks in this country.

Regarding valuation, we increased our fair value estimate to $40 per share, as we view the market share gains at Bank of America and steady loan and deposit growth to be more sustainable than we had previously envisioned. We like the bank's solid franchise, the management team, and we like the shares here as it tries to catch up with larger peer JPMorgan (JPM). **Bank of America was recently added to the Dividend Growth Newsletter portfolio.**

Citigroup Succeeding at Cross-Selling

Citigroup is finally out-earning our estimate of its cost of capital with a return on tangible common equity ('ROTCE') of 12.4% in the quarter, and the shares have rallied substantially more recently as a result. Management lowered expectations for the degree of return on tangible equity improvement going into 2020, but continued improvements would be welcome, nonetheless.

Citigroup (C) --- **2.7% yield** --- posted impressive fourth-quarter results January 14 with revenue up 7% and earnings per share up a whopping 34% given significant share buybacks, beating analyst consensus estimates on both the top and the bottom lines. **Fixed income trading grew substantially against a weak quarter last year.** As you can see in the below graphic, Citi's revenue growth accelerated in the quarter, and a lower tax rate and lower share count really boosted per-share results.

Citigroup – Summary Financial Results(1)

($MM, except EPS)

	4Q'19	3Q'19	%Δ	4Q'18	%Δ	2019	%Δ
Revenues	$18,378	$18,574	(1)%	$17,124	7%	$74,286	2%
Operating Expenses	10,454	10,464	(0)%	9,893	6%	42,002	0%
Efficiency Ratio	*56.9%*	*56.3%*		*57.8%*		*56.5%*	
Operating Margin	*7,924*	*8,110*	*(2)%*	*7,231*	*10%*	*32,284*	*4%*
Net Credit Losses	1,944	1,913	2%	1,786	9%	7,768	9%
Net LLR Build / (Release)(2)	253	158	60%	111	NM	542	53%
PB&C	25	17	47%	28	(11)%	73	(28)%
Credit Costs	2,222	2,088	6%	1,925	15%	8,383	11%
EBT	5,702	6,022	(5)%	5,306	7%	23,901	2%
Income Taxes	703	1,079	(35)%	1,095	(36)%	4,430	(19)%
Effective Tax Rate	*12%*	*18%*		*21%*		*19%*	
Net Income	$4,979	$4,913	1%	$4,219	18%	$19,401	8%
Return on Assets	*0.99%*	*0.97%*		*0.86%*		*0.98%*	
Return on Tangible Common Equity(3)	*12.4%*	*12.2%*		*10.3%*		*12.1%*	
EPS	$2.15	$2.07	4%	$1.61	34%	$8.04	21%
Average Diluted Shares	*2,167*	*2,237*	*(3)%*	*2,403*	*(10)%*	*2,265*	*(9)%*
Average Assets ($B)	$1,997	$2,000	(0)%	$1,937	3%	$1,979	3%
EOP Assets (Constant $B)	1,951	2,037	(4)%	1,919	2%	1,951	2%
EOP Loans (Constant $B)	699	698	0%	685	2%	699	2%
EOP Deposits (Constant $B)	1,071	1,098	(2)%	1,015	6%	1,071	6%

4Q'19 results include a benefit of ~$0.25 per share from discrete tax items(4)

Note: Totals may not sum due to rounding. NM: Not meaningful. Constant dollar excludes the impact of foreign exchange translation into U.S. dollars for reporting purposes and, as used throughout this presentation, is a non-GAAP financial measure. For a reconciliation of constant dollars to reported results, please refer to Slide 31.

(1) Adjusted results exclude the one-time impact of Tax Reform in 4Q'18, and as used throughout this presentation, are non-GAAP financial measures. For a reconciliation to reported results, please see Slide 30.

(2) Includes provision for unfunded lending commitments.

(3) For additional information on this measure, please refer to Slides 29 and 30.

(4) In 4Q'19, the discrete tax items of roughly $540 million included an approximately $430 million benefit of a reduction in Citi's valuation allowance related to its Deferred Tax Assets (DTAs). In 3Q'19, the discrete tax items of roughly $230 million included an approximately $180 million benefit of a reduction in Citi's valuation allowance related to its DTAs.

citi

Image Source: *Citigroup Earnings Presentation*

Citigroup is finally out-earning our estimate of its cost of capital with a return on tangible common equity ('ROTCE') of 12.4% in the quarter, and the shares have rallied substantially more recently as a result. Management lowered expectations for the degree of return on tangible equity improvement going into 2020, but continued improvements would be welcome, nonetheless.

Citigroup is doing several things right. The bank is controlling expense growth to stay below the pace of revenue expansion, which it has succeeded at doing for the past few years. **It has also been very successful at cross-selling to its very large US credit card customer base.** In fact, it gathered $6 billion of deposits, proving that scaling business in credit cards can help scale up retail banking across the country, too, even though its footprint doesn't cover the nation. **This has been extremely hard to do for Internet-only banks, proving that a solid existing product relationship is a key wedge to growing the broader holistic relationship.**

We raised our fair value estimate to $90 per share to reflect the fundamental improvement at Citigroup and higher expectations for through-the-cycle return on tangible equity.

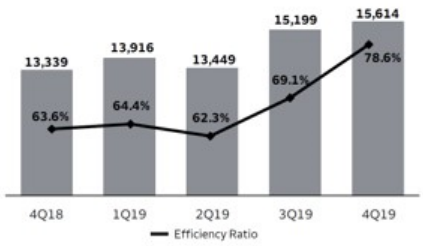
Wells Fargo Remains an Inefficient Bank Despite Regulatory Overhang

Wells has been forced to do a lot of hiring related to remediating its problems with regulators, but the problem is simply larger than that. This is an inefficient bank, which is very odd considering the massive scale that it benefits from.

Well Fargo (WFC) --- **4.3% yield** --- **reported terrible fourth-quarter results** January 14. The company earned 60 cents per share, down from $1.21 in the same quarter last year, missing analyst consensus estimates for both the top and bottom line. While it is a messy quarter with a large litigation write down related to previous scandals and other "one time" items, **the main theme is that expenses are simply too high and going in the wrong direction** at Wells Fargo. As you can see below, the bank is worst-in-class amongst its money center peers regarding its efficiency ratio, which was an enormous 78.6% in the quarter. This is more than 20 percentage points worse than JPMorgan (JPM).

Noninterest expense and efficiency ratio [1]

($ in millions)		4Q19	vs 3Q19		vs 4Q18
Noninterest expense					
Salaries	$	4,721	1	%	4
Commission and incentive compensation		2,651	(3)		9
Employee benefits		1,436	23		n.m.
Equipment		802	16		25
Net occupancy		749	(1)		2
Core deposit and other intangibles		26	(4)		(90)
FDIC and other deposit assessments		130	40		(15)
Outside professional services [2]		876	6		4
Operating losses [2]		1,916	-		n.m.
Other [2]		2,307	1		(11)
Total noninterest expense	**$**	**15,614**	**3**	**%**	**17**



- Noninterest expense up $415 million LQ
  - Personnel expense up $214 million
    - Salaries up $26 million
    - Commission and incentive compensation down $84 million and included lower revenue-related incentive compensation
    - Employee benefits expense up $272 million and included $258 million higher deferred compensation expense (P&L neutral) *(Please see page 32 for additional information)*
  - Equipment expense up $109 million on higher capitalized software impairment expense, and computer software licensing and maintenance costs reflecting the strategic reassessment of technology projects in WIM
  - FDIC and other deposit assessments up $37 million
  - Outside professional services expense [2] up $53 million driven by higher legal expense and higher project spend in technology
  - Operating losses [2] flat and included $1.5 billion of litigation accruals for a variety of matters, including previously disclosed retail sales practices matters, as well as higher customer remediation expense

(1) Efficiency ratio defined as noninterest expense divided by total revenue (net interest income and noninterest income).
(2) The sum of Outside professional services expense, Operating losses and Other expense equals Other noninterest expense in the Consolidated Statement of Income, pages 19 and 20 of the press release.

Wells Fargo 4Q19 Supplement 15

Image Source: *Wells Fargo Earnings Supplement*

Wells has been forced to do a lot of hiring related to remediating its problems with regulators, but the problem is simply larger than that. **This is an inefficient bank**, which is very odd considering the massive scale that it benefits from. Speaking of regulatory issues, this is what new CEO Charlie Scharf had to say regarding regulatory problems on the earnings call: *"I will say this several times, but you should know there's still much work to do. Many have focused on the Fed consent order but remember we have 12 public enforcement actions that require significant resource commitment. While I certainly wish more of this work was behind us, what's required of us is clear and we will get it done. It's work that other banks have done already, so there's a clear roadmap for what we need to achieve."* **The new CEO was asked several times on the call to put some kind of timeline on resolving the regulatory issues, but he flat-out refused.** He wouldn't even bite when asked whether it was a year or two or three to five years out.

In our mind, there are two ways to think about Wells Fargo. One is that it is inefficient, and management is on their back foot and simply missing out on capitalizing on the 11th year of this economic recovery. **The bank is losing market share to money center peers and the end is not currently in sight.** The other way to look at the situation is that you get paid a ~4.3% dividend yield (assuming it doesn't get cut, which appears a good assumption at this juncture) plus share buybacks to wait for new CEO Charlie Scharf to right this ship. If he executes to plan, the regulatory issues will eventually be put in the rear-view mirror, and the company will have a chance to go on a massive efficiency drive that could be a multi-year or even decade-long improving-returns story.

While this is a very messy story and involves no small amount of risk, we are inclined to believe the latter description of an (eventual) improving returns story. The core franchise has been damaged but not destroyed. Once the regulatory problems clear, watch for Wells Fargo to focus on retaining and re-growing market share while improving its fundamentals. For the risk averse, watch for many bumps on the road from here to there. We are maintaining our $52 fair value estimate.

JPMorgan's Quarter Shows Higher Sustainable Growth Potential

"We raised our fair value estimate of JPMorgan to $160 per share to reflect higher sustainable growth than we'd previously been expecting." -- Matt Warren

JPMorgan Chase & Co (JPM) --- **2.7% yield** --- reported an impressive set of results, and in fact, a record fourth quarter, with managed net revenue up 9% and net income up 21%, beating on both the top and bottom lines versus analyst consensus estimates. **The bank continues to churn out best-in-class return on tangible capital for the money center banks at 17% in the quarter.** JPMorgan's efficiency ratio came in at an impressive 56%, or 55% on an adjusted basis. For a bank with such a sizable investment-bank and capital markets business (where efficiency ratios are naturally higher), this figure is stellar. As you can see in the below graphic, the Commercial and Consumer Bank and the Asset and Wealth Management businesses stand out when it comes to return on capital.

4Q19 Financial results[1]

$B, except per share data

	4Q19	$ Q/(U) 3Q19	$ Q/(U) 4Q18
Net interest income	$14.3	($0.1)	($0.2)
Noninterest revenue	14.9	(0.8)	2.6
Managed revenue[1]	29.2	(0.9)	2.4
Expense	16.3	(0.1)	0.6
Credit costs	1.4	(0.1)	(0.1)
Reported net income	$8.5	($0.6)	$1.5
Net income applicable to common stockholders	$8.1	($0.5)	$1.4
Reported EPS	$2.57	($0.11)	$0.59
ROE[2]	14%	15%	12%
ROTCE[2,3]	17	18	14
Overhead ratio – managed[1,2]	56	55	59
Memo: Adjusted expense[4]	*$16.1*	*($0.3)*	*$0.4*
Memo: Adjusted overhead ratio[1,2,4]	*55%*	*55%*	*59%*

$B	4Q19	3Q19	4Q18
Net charge-offs	$1.5	$1.4	$1.2
Reserve build/(release)	(0.1)	0.1	0.3
Credit costs	$1.4	$1.5	$1.5

4Q19 Tax rate
Effective rate: 19.4%
Managed rate: 25.6%[1]

4Q19	ROE	O/H ratio
CCB	31%	52%
CIB	14%	55%
CB	16%	40%
AWM	29%	72%

- Firmwide total credit reserves of $14.3B
  - Consumer reserves of $8.9B – net release of $148mm
  - Wholesale reserves of $5.4B – net build of $81mm

Note: Totals may not sum due to rounding
[1] See note 1 on slide 12
[2] Actual numbers for all periods, not over/(under)
[3] See note 2 on slide 12
[4] See note 3 on slide 12
[5] Reflects fully taxable-equivalent ("FTE") adjustments of $880mm in 4Q19

2

JPMorgan Chase & Co.

Image Source: *JPMorgan Earnings Presentation*

Regarding segments, the Consumer & Community Banking segment grew revenue by 3% and net income by 5%, as 5% deposit growth helped offset net interest margin ('NIM') pressure from lower interest rates. Credit card sales were up 10% and merchant processing volume was up 7%, reflecting the strong consumer and probable (ongoing) share gains.

The Corporate & Investment Bank put up the largest growth, due to the fact that it was lapping a very weak quarter as compared to the market selloff in 4Q 2019. Revenue was up 31% and net income was up a whopping 48%, highlighting the volatility of this business segment. This is also a lower return on capital segment, so volatile and lower quality earnings than at the rest of the bank. It certainly boosted results this quarter, though! Fixed income Markets was the standout with 86% revenue growth as compared to last year's weak quarter.

Commercial Banking put up 3% revenue growth and 9% net income growth, and an ROE of 16%. **The efficiency ratio in this segment of 40% shows just how efficient a money center bank can be with sizable commercial account.** Much better than other segments and as compared to smaller regional banking peers. The Asset & Wealth Management Segment proved its operating leverage and ties to ever higher asset prices with 8% revenue growth and 30% net income growth. Return on equity was an outstanding 29% in the quarter in this segment. This is simply a great business and one that benefits from cross sell, so a real testament to the universal banking model.

Despite paying out 98% of earnings over the last 12 months, JPMorgan retains a "fortress balance sheet," with a 12.4% common equity Tier 1 ratio. While loans were down 1% year over year thanks to sales of mortgages, 7% overall deposit growth shows that the bank is deepening its relationships organically, a sign of rude health for the business. We raised our fair value estimate of JPMorgan to $160 per share to reflect higher sustainable growth than we'd previously been expecting.

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

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Disclosure: *Brian Nelson, Callum Turcan, and Matthew Warren do not own any shares of any securities mentioned in their authored articles. Please contact info@valuentum.com for more information regarding Valuentum's editorial policies.*

THE SIMULATED HIGH YIELD DIVIDEND NEWSLETTER PORTFOLIO

We can't begin to tell you how excited we continue to be about the high yield space. We think we did pretty good the past few years given the uncertainty regarding Fed policy, and 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%	8.72%
Global X SuperIncome Preferred ETF	SPFF	10.0%	5.96%
iShares International Select Dividend ETF	IDV	5.0%	5.16%
iShares MSCI Australia ETF	EWA	5.0%	3.97%
iShares U.S. Preferred Stock ETF	PFF	5.0%	5.32%
PowerShares Senior Loan Portfolio	BKLN	5.0%	4.50%
ProShares High Yield—Interest Rate Hedged	HYHG	5.0%	6.08%
Utilities Select Sector SPDR	XLU	5.0%	2.95%
Vanguard Real Estate ETF	VNQ	10.0%	3.39%
EQUITY			
AT&T	T	7.5%	5.56%
BP PLC	BP	5.0%	6.64%
CubeSmart	CUBE	5.0%	4.15%
Digital Realty Trust	DLR	5.0%	3.44%
Enterprise Products Partners	EPD	5.0%	6.71%
Magellan Midstream Partners	MMP	5.0%	6.64%
Philip Morris	PM	7.5%	5.55%
Public Storage	PSA	5.0%	3.57%
Cash*	-	0.0%	1.75%
		100.0%	**5.16%**

This is not a real money portfolio. Inception 1/1/2018. Data as of 2/1/2020. 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	Dividend Yield	Economic Castle	Multiplier
General Motors	GM	Consumer Discretionary	4.4%	Attractive	13.96
Honda	HMC	Consumer Discretionary	3.9%	Neutral	13.94
Gilead Sciences	GILD	Health Care	3.9%	Very Attractive	12.98
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
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
Automatic Data Processing	ADP	Information Technology	2.8%	Very Attractive	9.70
Total	TOT	Energy	5.6%	Neutral	9.10
Cisco	CSCO	Information Technology	3.2%	Very Attractive	8.58
Cheesecake Factory	CAKE	Consumer Discretionary	3.7%	Attractive	8.52
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
AVX Corp	AVX	Information Technology	2.5%	Attractive	7.50
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
McKesson	MCK	Health Care	1.2%	Very Attractive	6.99
Harley-Davidson	HOG	Consumer Discretionary	4.2%	Attractive	6.97
Cardinal Health	CAH	Health Care	4.2%	Attractive	6.95
Manpower	MAN	Information Technology	2.3%	Attractive	6.92
AmerisourceBergen	ABC	Health Care	2.0%	Very Attractive	6.92
Walgreens Boots Alliance	WBA	Consumer Staples	3.1%	Attractive	6.81
Altria Group	MO	Consumer Staples	6.7%	Very Attractive	6.78
Caterpillar	CAT	Industrials	2.8%	Very Attractive	6.77
Robert Half	RHI	Information Technology	2.0%	Very Attractive	6.77
British American	BTI	Consumer Staples	6.9%	Unattractive	6.74
Amgen	AMGN	Health Care	2.6%	Very Attractive	6.74
Pfizer	PFE	Health Care	3.9%	Attractive	6.71
Xerox	XRX	Industrials	3.2%	Attractive	6.69
Expeditors Intl	EXPD	Industrials	1.4%	Very Attractive	6.63
Cedar Fair	FUN	Consumer Discretionary	6.7%	Attractive	6.62
Garmin	GRMN	Industrials	2.9%	Attractive	6.59
MKS Instruments	MKSI	Information Technology	0.7%	Attractive	6.56
Johnson & Johnson	JNJ	Consumer Staples	2.8%	Attractive	6.54
Hillenbrand	HI	Consumer Discretionary	2.5%	Attractive	6.52
Paychex	PAYX	Information Technology	2.9%	Very Attractive	6.49
AstraZeneca	AZN	Health Care	3.0%	Attractive	6.42
MSC Industrial	MSM	Industrials	4.0%	Attractive	6.26
IBM	IBM	Information Technology	4.8%	Attractive	6.21
Rio Tinto	RIO	Materials	5.0%	Neutral	6.10
AbbVie	ABBV	Health Care	5.4%	Very Attractive	6.04
Merck	MRK	Health Care	2.6%	Very Attractive	6.01

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 – BROADCOM INC (AVGO)

Broadcom AVGO FAIRLY VALUED

Buying Index™ 4 **Value Rating**

Economic Castle	Stock Fair Value Range	Dividend Track Record	Dividend Safety / Cushion™	Div Growth Potential	Dividend Yield
Very Attractive	$215.00 - $323.00	HEALTHY	GOOD / 1	GOOD	3.95%

Assessment of Company Dividend Strategy

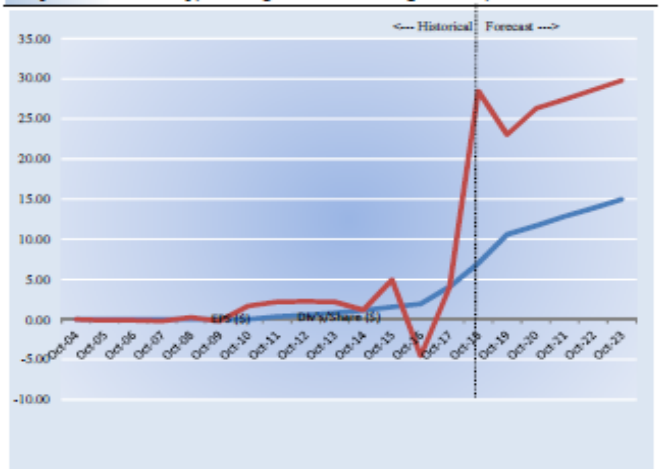
Key Strengths

The new Broadcom is levered to growth trends in the areas of LTE transition, datacenter spending, IP traffic, and the Internet of Things, all of which are expected to grow at strong double-digit CAGRs over the next 3-4 years. We're expecting robust free cash flow generation from the newly combined company, but notable execution and integration risk remains. In addition to its larger purchase of CA Tech, the company is working to integrate Brocade but has abandoned its unsolicited takeover attempt for Qualcomm, which may have been a blessing in disguise, especially for its balance sheet. Management plans to pay out 50% of prior fiscal year's free cash flow as dividends in any given year.

Potential Weaknesses

Broadcom's Dividend Cushion ratio has suffered as a result of it adding a substantial amount of debt to fund recent acquisitions. Our current estimation of its financial leverage is based on guidance that came prior to the CA Tech deal closing. While we think the firm is well-positioned to take advantage of a number of secular growth trends, we must highlight the integration risk associated with any merger of this size; synergy targets are not guaranteed. At the moment, we have confidence that management will be able to deliver on its expectations, but we think it may want to consider prioritizing deleveraging in the near term. Management expects to use the balance of free cash flow after dividends for share repurchases or M&A.

Graphical Relationship, Earnings and Dividends (per share)

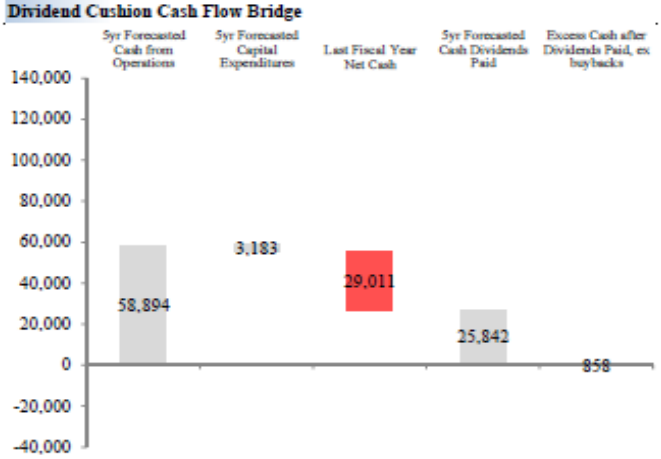


The graph above shows the relationship between a firm's earnings per share and its dividends per share.

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. Broadcom'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

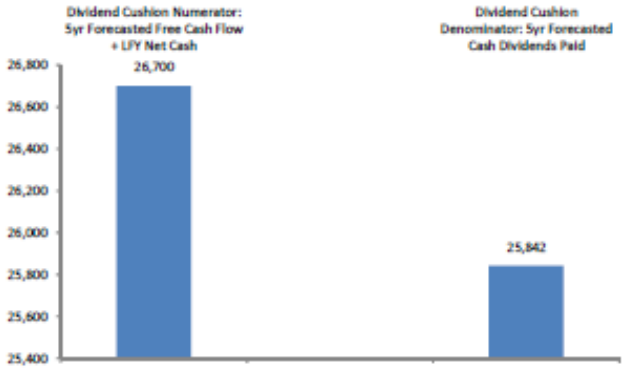


Source: Company Filings, Valuentum Projections

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, Broadcom'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



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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