1 Of These 3 Stocks Is My Next Retirement Portfolio Buy

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by: Dividend Sensei

Summary

- There are no guarantees on Wall Street. Probable events might not happen and "impossible" ones occur with alarming regularity. All investing is probabilistic and good risk management is essential.

- The goal of my retirement portfolio is to achieve sufficient safe income to be able to retire one day (live entirely off 50% of my post tax dividend income).

- To achieve that goal, I steadily buy quality stocks at attractive prices unless the risk of recession (and thus a bear market) is over 50%.

- With 12-month recession risk at about 35%, I'm investing $1,000 per week into one undervalued blue chip. This week's buy candidates are: BTI, MPC and CAT.

- This article explains the pros and cons of each company, including their current valuations and realistic 5-Year annual total return potentials as calculated by F.A.S.T Graphs.

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"THERE ARE NO GUARANTEES ON WALL STREET. PROBABLE EVENTS MIGHT NOT HAPPEN AND "IMPOSSIBLE" ONES OCCUR WITH ALARMING REGULARITY."

-DIVIDEND SENSEI

(Source: imgflip)

In the first article of this new "What I'm Buying Next" series, I explained why, despite the highest recession risk in 10 years, I'm still steadily buying stocks each week. My weekly investments are based on two main factors.

First, at the end of each month, I conservatively estimate my long-term recurring income from 35 different sources (including my portfolio). I then divide this by four to get a "standardized weekly buy" amount. Whenever 12-month recession risk (currently about 35%) is low, I buy the standard amount based on the current candidate companies.

When recession risk becomes elevated, I use the 10y-3m yield curve, the best recession forecasting tool ever discovered, to adjust my weekly buy amounts.
My 5 Yield Curve Confirmation Signals

- 10 consecutive days of inversion (Bianco Research model) - currently triggered
- 1 consecutive month of inversion (David Rice, aka Economic PI, who runs the BaR economic grid) - currently triggered
- 10 straight weeks of curve inverted at least 15 basis points (Blackstone model)
- 1 consecutive quarter of inversion (according to Campbell Harvey, a professor of finance at Duke University)
- 6 months of consecutive inversion (Morgan Stanley model)

I do this by dividing my weekly standard buy amount by five and then subtracting that amount for each confirmation signal that's triggered.

![Graph](https://seekingalpha.com/article/4275158-1-3-stocks-next-retirement-portfolio-buy)

With the curve now at -2 basis points, the Blackstone confirmation clock has reset and the curve has been inverted 49 consecutive days as of July 12th. That means two confirmations are active, and my weekly buy is reduced by 40% to $1,000 per week.

By no means do I mean to imply that this approach is one that everyone should follow. It works well for my particular needs and my goal of making "consistently not stupid" weekly decisions with my discretionary savings (money I won't need for at least 5+ years).
It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent.” - Charlie Munger, legendary value investor and Buffett's right hand at Berkshire (BRK.B) for decades

Morgan Housel recently agreed with this sentiment saying during a Morningstar's "The Long View" podcast interview that good investing isn't about being smart but acting correctly over the long term.

I'm not a market timer, looking to sell all my stocks (my personal asset allocation is 100% equities) at a market top and then buy back in at the bottom.

After all, the late John Bogle, founder of Vanguard makes clear that market timing is all but impossible:

Sure, it'd be great to get out of stocks at the high and jump back in at the low, but in 55 years in the business, I not only have never met anybody who knew how to do it, I've never met anybody who had met anybody who knew how to do it.” - Jack Bogle

This is why my version of capital allocation merely applies to new money, not the $290,000 I've already invested in my portfolio (my entire net worth). I'm confident that the 29 companies I own (which are paying me $15,357 annually in dividends that have grown organically at 10.5% CAGR over the past decade) will continue paying safe and rising dividends even during a recession.

- weighted portfolio beta: 0.87 (13% less volatile than S&P 500 over time)
- weighted forward PE: 13.0 (vs. 17.1 S&P 500, 13.7 Dec 24th low, and 10.3 March 9th, 2009 low)
- weighted price to cash flow: 8.1 (vs. 15.0 Chuck Carnevale fair value rule of thumb)

The weighted average forward PE on my 29 companies over the past five years was 25.5, which means that at least using that single historical metric, my portfolio is potentially about 49% undervalued. And my cash flow yield of 12.4% (vs. 10-year yield of 2.0%) means my cash flow risk premium is 10.4%.

In other words, my life savings is safely ensconced in a collection of quality companies with very high margins of safety. Most likely I'd suffer far smaller losses than the broader market. But having lived through three separate 50+% market/sector crashes over my 24-
year investing career, I'm not concerned about volatility (the best friend of patient investors with dry powder to put to work).

But where am I putting my hard-earned money to work next? This week I considered three potential blue chips, each that serves a different purpose.

Max Safe Yield Option (That Fits My Risk Management Rules):
British American Tobacco (BTI): 7.3% yield

- **Pros**: Deeply undervalued, maximum safe yield (likely to nearly match future market returns on dividends alone), strong collection of popular global brands diversified geographic regulatory risk, solid long-term plan for reduced-risk products

- **Cons**: 3.6% of invested capital (tobacco is 4.8%). I'm limiting tobacco to 10% of invested capital or less and need to keep room for Altria (MO) and Philip Morris International (NYSE:PM), so basically potential future opportunity cost

Fastest Dividend Growth Option: Marathon Petroleum (MPC):
Double-Digit Payout Growth

- **Pros**: Deeply undervalued, management guiding for 10+% long-term dividend growth, plan in place to cover that with cash flow growth (50% FCF payout ratio policy), 50% of cash flow from midstream (most stable cash flow of any refiner).

- **Cons**: Energy stock (at 21% my biggest sector, need to keep at 25% or less). Again, there's opportunity cost to consider because during a recession when all energy stocks will be trading at insanely great valuations.

New Company Option: Caterpillar (CAT) - Goal Is To Add At Least One New Company Per Month Until I Hit My Goal Of 60 Stock Holdings

- **Pros**: Modestly undervalued, would diversify me by sector and holdings (30th company), dividend aristocrat, level 10/11 quality SWAN stock, management plans to double high-margin, recurring aftermarket revenue by 2026 ($6 to $12 billion in FCF from that business alone).

- **Cons**: Opportunity cost, trade, and economically sensitive cyclical industry, so might fall off a cliff during a recession.

So here are the candidates, each one a worthy place for my money. So let's take a look at the valuations and return potentials of each to see whether that clarifies things a bit.
Valuations And Total Return Potentials: The Ultimate Bottom Line For My Deep Value Blue Chip Retirement Portfolio

My fellow dividend king Chuck Carnevale believes that the best valuation method is to compare several key metrics to their historical norms. While this isn't a perfect method (there is no such thing) it's highly objective and most likely to give you a realistic idea of a company's intrinsic value.

While stocks can trade at crazy prices in the short term, over the long term, valuations are mean-reverting as long as the business model hasn't deteriorated.

<table>
<thead>
<tr>
<th>Company</th>
<th>Current Price</th>
<th>Dividend Yield</th>
<th>DY 5YR FV</th>
<th>DY 13 YR FV</th>
<th>DY 25 (or Since IPO) FV</th>
<th>Historical PE FV</th>
<th>Historical P/Cash flow FV</th>
<th>Historical P/EBITDA FV</th>
<th>Historical EV/EBITDA FV</th>
<th>Average Fair Value</th>
<th>Discount To Fair Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>British American Tobacco</td>
<td>$36.29</td>
<td>7.3%</td>
<td>$65</td>
<td>$68</td>
<td>$62</td>
<td>$60</td>
<td>$41</td>
<td>$44</td>
<td>$44</td>
<td>$48</td>
<td>24%</td>
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<td>Marathon Petroleum</td>
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<td>3.8%</td>
<td>$78</td>
<td>$100</td>
<td>$83</td>
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<td>$93</td>
<td>$96</td>
<td>$96</td>
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<td>26%</td>
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<tr>
<td>Caterpillar</td>
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<td>3.0%</td>
<td>$135</td>
<td>$170</td>
<td>$162</td>
<td>$215</td>
<td>$127</td>
<td>$146</td>
<td>$146</td>
<td>$157</td>
<td>12%</td>
</tr>
</tbody>
</table>

(Source: F.A.S.T Graphs) - data as of July 12th

I'm a big fan of dividend yield theory (beating the market since 1966), and per Chuck's latest recommendation, have switched to a three time period analysis. I look at yield vs. 5-year average yield, 13-year median yield and 25-year average yield (or since IPO or spinoff).

I also look at PE, P/operating cash flow, P/EBITDA and EV/EBITDA vs. 10-year averages (the low-interest-rate environment that's likely to continue for the foreseeable future). An average of all four to seven valuation estimates (some aren't available/appropriate depending on sector/industry) provides a conservative estimate of what a company is likely worth today.

Caterpillar is the highest quality company (level 10 vs. 8s for BTI and MPC), and an aristocrat that's expected to grow rapidly due to management's smart investment into high-margin recurring aftermarket parts and services. It's about 12% undervalued. While
that's not a screaming bargain, for a level 10 quality SWAN stock it's a very attractive entry point under the Buffett rule of "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

BTI and MPC are about equally undervalued per my new multiple metric valuation model, with BTI offering by far the best yield and MPC offering a great combination of high-yield and fast dividend growth.

What about total return potential?

For most companies, I use the PE ratio reverting back to its historical norm, or Chuck Carnevale's rule of thumb of 15.0, whichever is lower. For some companies, (pass-throughs and energy mostly) other metrics are more appropriate (like P/cash flow or EV/EBITDA).

I then look at the analyst consensus growth expectations (checking for reasonableness against rolling historical growth rates) or use management guidance. F.A.S.T Graphs is then able to provide a reasonable 5-year CAGR total return potential that is normally accurate to within 20% (due to uncertainty surrounding when sectors go in and out of favor).

(Source: F.A.S.T Graphs)

Like most stocks, BTI tracks its adjusted earnings over time, though sometimes it becomes highly overvalued and today is highly undervalued.
Management is guiding for 7% to 9% long-term growth which seems reasonable given the company's rolling historical adjusted EPS growth rates. The dividend policy is 65% of adjusted EPS, so the long-term dividend growth will likely match that of earnings and cash flow (the case with most dividend stocks).

(Source: F.A.S.T Graphs)
Using Chuck's 15.0 rule of thumb PE (slightly below the historical PE) and analyst's 7.5% expected EPS (in line with management guidance and historical growth rates), you can see that BTI offers exceptional total return potential. That's not a guarantee of course, but this high-yield recession-resistant blue chip is definitely capable of outsized returns. Which is why it's one of the Dividend Kings' Top Weekly buys and part of our Deep Value Portfolio (which has a 15% to 25% long-term total return target).

In the debt-heavy, capital-intensive, and cyclical energy sector, EV/EBITDA is one of the most accurate valuation metrics you can use. Enterprise value is market cap + net debt and is also called the acquirer's multiple (used by private equity firms when valuing companies).

(Source: F.A.S.T Graphs)

Since its 2011 spinoff from Marathon Oil (MRO), MPC's EV/EBITDA has averaged 4.8, and the price cycles around this historical level which is why it's one of the best proxies for fair value.
Management is guiding for 10+% long-term cash flow and dividend growth, has a plan in place to achieve it (currently ahead of schedule), and double-digit growth seems attainable when we look at the historical rolling EBITDA growth rates.

(Source: F.A.S.T Graphs)
If management achieves its double-digit growth target, and the stock reverts back to its normal (and low) 4.8 EV/EBITDA, then five-year total return potential is 18.4% CAGR. Given that 50% of EBITDA is from the midstream MLPs it owns (MPLX) and this steady cash flow will become a much larger part of its future business, I consider a 4.8 long-term EV/EBITDA valuation highly probable.

While lower than BTI's 22% return potential, Marathon is a great way to profit from the US energy boom, and potentially earn private equity, venture capital style returns from a low-risk and perfectly liquid blue-chip. This is why it's also one of the Dividend Kings' Top Weekly Buys and in our Deep Value Portfolio.

Caterpillar is a cyclical and economically sensitive company so it's useful to look at a 20-year chart that includes two recessions and three industry downturns. 11.2% growth over the past two decades and 25 consecutive years of payout hikes has earned this level 10 SWAN aristocrat an average adjusted PE of 17.1. In our low rate environment (with one industrial recession but no economic contraction) the average PE has been 17.6.

(Source: F.A.S.T Graphs)
Caterpillar's rolling historical growth rates can be volatile due to the cyclical nature of the industry. But in most periods, it's been able to achieve low to mid-double-digits earnings growth.

(Source: F.A.S.T Graphs)
Analysts currently expect 14.1% CAGR EPS growth from Caterpillar over the next five years, which seems reasonable given its historical growth rates and management's aggressive push into more higher-margin recurring aftermarket/service revenue. That might indeed justify the PE returning to its 20-year average of 17.1. In this realistic best-case scenario, Caterpillar has the potential to deliver up to 24.2% CAGR total returns.

However, we can't forget that if we have a recession by 2024, then Caterpillar's growth will likely miss that ambitious analyst consensus. Similarly, the PE ratio may merely revert back to Mr. Carnevale's 15.0 rule of thumb PE ratio.

(Source: F.A.S.T Graphs)

Using the company's 11.2% 20-year average growth rate and a modest PE of 15.0 as our 2024 end valuation, that creates a more conservative long-term return potential of 18.2%. But 18% to 24% realistic return potential from such a high-quality wide-moat dividend growth legend certainly makes Caterpillar one of the best aristocrats you can buy today.

**Bottom Line: BTI, MPC, And CAT Are All Great Undervalued Blue Chips Worth Buying Today**

Let me reiterate that I'm a deep value blue-chip dividend growth investor. This approach works for my personal needs/time horizon/temperament and goals. I don't mean to imply that these are the only three stocks worth buying this week, just three great low-risk options for anyone who shares my personal investing philosophy.
Next week during my tri-weekly retirement portfolio update, I'll disclose which of these companies won the competition, as well as the other trades I've made over the past three weeks.

You can't go wrong with any of these three companies, as long as you remember that long-term investing success begins first with proper asset allocation, proceeds to determining the right risk management rules for you, and only then moves onto company selection, and buying at fair value or better.

**Dividend Sensei Risk Management Rules Of Thumb**

- ALWAYS maintain proper asset allocation (with periodic rebalancing) meaning owning enough cash/bonds to avoid having to sell stocks during inevitable market downturns
- Own a diversified stock portfolio (ETFs or 20 to 60 companies in most sectors)
- Limit individual holding to 5% to 10% of invested capital (my long-term goal is 5%)
- Limit sector weightings to 15% to 25% of invested capital (my personal limit is 25%)

These are my personal risk management guidelines which will work for most people. The idea is that following the above rules will minimize the risks of losing sleep at night in case something goes wrong (one of your companies' thesis breaks) and is meant to avoid future corrections/bear markets turning you into a forced seller of quality companies trading at rock bottom valuations.

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**Disclosure:** I am/we are long BTI, MO, MPLX. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.
Comments (102)

The Bucket Shop
I would be cautious about buying CAT now. The worst time to buy a stock like CAT is near the end of a bull market. I remember in 2008 and 2015, this stock got crushed. Customers can move very quickly and orders can dry up quickly. The estimates can be thrown out the window on a dime.

CAT is a great company and is worth owning. Just don't buy it now.

16 Jul 2019, 08:37 AM

Dividend Sensei, Contributor

Author’s reply » Bucket Shop, I'm buying $1000 blocks of stock.

If I buy a new stock, such as CAT or MPC (don't own that either yet), I'm not trying to time the bottom.

I just want to buy a quality company at a good to great price. If that price gets better then I'll buy more later.

I've bought plenty of economically sensitive companies. But what if the great recession scare of 2019 turns out like 2016 and we avoid a downturn?

That remains the highest probability outcome today, and if we get a trade deal the probability goes up even more.

Investing is all about probabilities and risk management. For my personal needs I'm happy with what I own.

I don't fear volatility but embrace it, since I'm in the accumulation phase of my investing career. I'll be in that phase for decades so can patiently wait out any crashes.

16 Jul 2019, 04:29 PM

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