Introduction

When investing in common stocks, there is no one strategy that fits all investors. Some investors are focused on investing for income, some for capital appreciation and others for various combinations of both. Additionally, there is the issue of risk tolerance. Some investors are willing and capable of assuming greater risk if they believe it will lead to greater returns, while others are more risk adverse. These are just but a few of the many variations that apply to the individual investor’s own unique goals and characteristics.

Therefore, I have initiated this series of articles with the hopes of providing fairly valued stock research candidates that potentially offer something for everyone. In part 1 I introduced the series and provided a few examples of each specific equity class that I would cover in the series. In part 2 I covered high-growth stocks, which I consider the most aggressive, but perhaps potentially the most profitable equity class. In this part 3, I offer a review of what appear to be fairly valued growth and income stocks. Consequently, this category contains selections that may be appropriate for investors in the accumulation phase of building their retirement portfolios.

Similar to high-growth stocks, but ideally in a more conservative fashion, the primary focus of my growth and income selections is total return. Therefore, I offer this group of research candidates to those investors desirous of building and accumulating long-term wealth, through investing in high quality blue-chip dividend paying stocks for the purpose of generating an above-average rate of total return through the combination of capital appreciation, dividend income, and in many cases a growing dividend income stream.

Therefore, each candidate that will be found in this article will pay a dividend. However, the current yields available may not meet the needs or objectives of those retired investors currently seeking income. On the other hand, this article will be reviewing candidates that I believe provide the opportunity for generating double-digit future long-term total returns. Moreover, many of these selections are poised with the potential to deliver long-term total returns that are the equivalent, or close to it, of many of the high growth candidates covered in part 2.
Total Return: The Capital Appreciation Component + The Income Component

Very simply stated, for common stocks the total return is comprised of the two primary components of return; the capital appreciation (growth) component and the income (dividends) component. When investing in pure growth stocks (stocks that pay no dividends), total return is comprised only of capital appreciation. However, with dividend paying stocks the investor still receives the capital appreciation component but also receives additional return from the income component. These two returns together make up the total return received on a dividend paying growth stock.

Although this is a very straightforward calculation, it is not void of controversy or debate. There are those that would argue that dividend income does not provide additional return. For example, these individuals argue that since the company’s stock price is reduced on the ex-dividend date by the precise amount of the dividend, the dividend itself provides no additional return. Although this is technically correct, I would argue that it’s much ado about nothing. I am not alone on this position. In his excellent and newly released book titled Top 40 Dividend Growth Stocks For 2014, author David Van Knapp has this to say on the subject. First, on pages 23 and 24, David explains the ex-dividend date as follows:

“Ex-dividend date: “Without-dividend date.” The first day that a newly purchased share of stock comes without the right to receive the next dividend. If you purchase a stock on or after the ex-dividend date, you will not receive the next dividend. In order to be entitled to the next dividend, you must buy prior to the ex-dividend date.

From the seller’s point of view, the ex-dividend date is the first day on which you can sell the shares and nevertheless be entitled to receive the next dividend. The ex-dividend date precedes the payment date by a few days or weeks.

Before the market opens on the ex-dividend date, stock exchanges usually adjust the previous day’s closing price downward by the amount of the dividend. This price adjustment reflects the fact that the cash to pay the next dividend will not be retained by the company, as it is earmarked to pay the dividend. For most stocks, that adjustment in price soon gets lost in the noise of the next day’s trading.”

Then, later on pages 57 and 58, Dave goes on to further explain why he does not consider this temporary dividend reduction a big issue:

“10. Stock prices drop by the amount of the dividend

This is not really a disadvantage either, although some people view it as one.

Stock exchanges follow a long-standing practice. When a company declares a dividend, it sets the record date. Under exchange rules, the ex-dividend date is thereby established a few days prior to the record date. That ex-date becomes the first day on which new buyers of the stock will not receive the upcoming dividend.

Before the opening of trading on the ex-dividend date, the exchange reduces the quoted price of the
stock by the exact amount of the declared dividend.

The idea is that this money will not be received by new buyers, so they should pay that much less for the stock.

Because of this price adjustment, shareholders who owned the stock before the ex-dividend date, and who hold on straight through, see the price of their stock momentarily lowered by the amount of the dividend. In practice, as soon as trading opens on the ex-dividend date, market participants establish the actual price of the stock. The exchange’s price adjustment is usually hard to detect after an hour or two of trading. There certainly is no long-term impairment to the price of the stock.”

Moreover, I wrote extensively on the subject in a previous article found here. However, since this article is focused on total return I thought it would be useful to elaborate on how total return is comprised, calculated and produced. Since a picture is worth 1000 words, I will utilize the F.A.S.T. Graphs™ Fundamentals Analyzer Software Tool to illustrate how total return on a common stock is accomplished. I will use a few quintessential examples of companies that are included on my list of fairly valued growth and income candidates that will be produced later in the article.

**Stanley Black & Decker Inc: (SWK)**

Stanley Black & Decker, Inc. provides power and hand tools, mechanical access solutions, and electronic security and monitoring systems and products and services for various industrial applications.

The following 15 calendar year graph on Stanley Black & Decker plots its monthly closing stock price (the black line) and earnings (the orange line). Notice how the stock price tracks and closely correlates to earnings. Additionally, notice what happens when the price line disconnects from earnings and moves either above the orange line or below it. Inevitably, it moves back into alignment. This relationship of price-to-earnings is what establishes the capital appreciation component of total return.

In sophisticated terms, this represents how the market sets the company's stock price by capitalizing earnings. By capitalizing earnings, I am referring to how the market applies a P/E ratio to the company's earnings-per-share which in turn creates the stock price quote. When the market applies this capitalization of earnings rationally, long-term capital appreciation is both functionally related to and in close approximation to the company's earnings-per-share growth rate. Therefore, when fair valuation is in alignment, the capital appreciation component and the company's earnings growth rate will be equal or very similar.
Importantly, this capitalization of earnings is similarly applied based on a company’s earnings growth rate regardless of whether it pays a dividend or not (Note: the above graphic does not include dividends). However, because of the minute-to-minute fluctuations in stock price, the earnings growth rate and the capital appreciation component will be in close approximation to each other. In other words, in the long run earnings determine market price. We can clearly see this relationship when reviewing the performance results associated with the above 15 calendar year earnings and price only graph on Stanley Black & Decker that follows.

On this next graph, I add the dividend component in order to vividly illustrate the second component of
total return - dividends. F.A.S.T. Graphs™ expresses dividends in two important ways. First of all, they are expressed by the pink line on the graph. This expression shows the portion of earnings prior to being paid out as dividends, which simultaneously provide two important perspectives.

The first perspective that the viewer receives when dividends are shown in this manner (the pink line) is how consistently dividends have grown, and a visualization of the growth rate. The second perspective is the instantaneous graphical expression of the company’s payout ratio. The portion of earnings (the green shaded area) below the pink line, graphically reveal the company’s payout ratio. Therefore, without looking at the payout ratio column on the performance report, the viewer can instantaneously see that this company is paying approximately one-third of their total earnings out as dividends.

The second expression of dividends on the graph is the light blue shaded area above the orange earnings justified valuation line. When expressed this way, the viewer receives a clear perspective of how dividends represent a return in addition to the capital appreciation component. The black price line tracks earnings creating capital appreciation as previously discussed, and the dividend income is vividly revealed as the additional and second component of total return.

Here, one note of clarification is in order. If the dividend was only expressed by the light blue shaded area, the viewer might get the illusion that the dividend on Stanley Black & Decker went lower during the Great Recession. This is only an illusion because when the dividends are expressed this way, they track the earnings line. Stanley Black & Decker’s earnings did fall during calendar years 2008 and 2009, however, the company’s dividend increased each of those years as seen by reviewing the pink line and the dividend column under the graph.
This point is further validated by reviewing the performance table associated with the earnings and price correlated graph. The annualized rate of return without dividends is as previously reported 7.3%. However, add in the dividend income that shareholders received over this timeframe and we see that the annualized total return increases to 8.8%. Therefore, a quick review of the complete performance report clearly illustrates the two separate components of total return—growth and income.
The validity of dividend income as a total return component is more greatly reinforced when performance is calculated with dividends reinvested. The following performance calculation with dividends reinvested illustrates that Stanley Black & Decker’s total return exceeds double digits at 10.2% per annum. Consequently, an earnings growth rate of 8% per annum expands to a double-digit return when dividends are reinvested and included in the calculation.

<table>
<thead>
<tr>
<th>End FYr</th>
<th>Dividends per Share</th>
<th>Dividend Growth%</th>
<th>Div. Payout Ratio</th>
<th>#Shares</th>
<th>End of Period</th>
<th>Dividends Paid</th>
<th>%Yield On Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/2000</td>
<td>0.93</td>
<td>3%</td>
<td>41%</td>
<td>311.95</td>
<td>311.95</td>
<td>$299.75</td>
<td>3.0%</td>
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<td>12/2001</td>
<td>0.94</td>
<td>4%</td>
<td>40%</td>
<td>311.95</td>
<td>311.95</td>
<td>$312.04</td>
<td>3.1%</td>
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<tr>
<td>12/2002</td>
<td>0.99</td>
<td>5%</td>
<td>46%</td>
<td>311.95</td>
<td>311.95</td>
<td>$328.64</td>
<td>3.3%</td>
</tr>
<tr>
<td>12/2003</td>
<td>1.03</td>
<td>4%</td>
<td>49%</td>
<td>311.95</td>
<td>311.95</td>
<td>$341.92</td>
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</tr>
<tr>
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<td>5%</td>
<td>36%</td>
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<td>311.95</td>
<td>$358.52</td>
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<tr>
<td>12/2005</td>
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<td>6%</td>
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<td>311.95</td>
<td>$378.44</td>
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<tr>
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<td>$391.70</td>
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<td>1.22</td>
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<td>$404.95</td>
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<td>3%</td>
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<td>12/2009</td>
<td>1.30</td>
<td>3%</td>
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<td>311.95</td>
<td>$431.52</td>
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<td>12/2010</td>
<td>1.34</td>
<td>3%</td>
<td>30%</td>
<td>311.95</td>
<td>311.95</td>
<td>$444.89</td>
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<tr>
<td>12/2011</td>
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<td>22%</td>
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<td>311.95</td>
<td>$544.49</td>
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<tr>
<td>12/2012</td>
<td>1.80</td>
<td>10%</td>
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<td>$597.52</td>
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<td>1Q2013**</td>
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<td></td>
<td></td>
<td></td>
<td>311.95</td>
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<td>4Q2013**</td>
<td>0.50**</td>
<td></td>
<td></td>
<td></td>
<td>311.95</td>
<td>$105.97**</td>
<td></td>
</tr>
</tbody>
</table>

Dividend Growth Rate: (13yr Avg) 5.8% Total Dividends Paid: $5,908.72 $1,881.40
Annualized ROR (w/o Div): 7.3% S&P 500
Investment plus Appreciation (w/o Div): $26,944.38 $12,521.55
Total Investment plus Appreciation plus Dividends Paid (not reinvested): $32,853.10 $14,502.95
Total Annualized ROR plus Dividends Paid (not reinvested): 8.8% 2.7%

** NOTE: Fiscal year data is incomplete and only current dividends in our database are included in these calculations.

www.fastgraphs.com
Silgan Holdings Inc.: (SLGN)

With my second example, Silgan Holdings Inc, I show a company with a lower dividend yield but a higher earnings growth rate than we saw with Stanley Black & Decker. Once again, my first graph shows earnings and stock price only (with dividends excluded). The earnings and price relationship and correlation holds true. As we saw in the first example, stock price tracks earnings, and when it occasionally deviates away from the orange earnings justified valuation line, it soon moves back into alignment. As we saw with our first example, earnings drive stock price over the long run.
However, when dividends are added on to the graph (the pink line and the light blue shaded area) the relevant contribution of dividends to total return is once again revealed. Yet again, we see clear evidence of the principle that capital appreciation and dividend income are the two components of total return. Therefore, the principle remains intact; however, there are two important differences with this example.

The first difference is the rate of earnings growth is much faster at almost 14% per annum. The second difference is that the dividend yield is approximately half of what we saw in our first example. The importance of these differences will become clear when we review the performance report without dividends included.
When dividends are added to the equation, we get the visual perspective of the two components of total return—capital appreciation + dividend income.

The capital appreciation component of Silgan Holdings is highly correlated to the company’s faster rate of earnings growth. On the other hand, even though the dividend yield is lower than we saw with our first example, the growth rate of this company’s dividends is much higher as a result of the faster earnings growth rate. Consequently, total dividends paid are lower, yet growing faster, but the total return is much higher, again as a result of faster earnings growth. Nevertheless, the contribution from dividend income is still clearly evident.
Moreover, for those investors attempting to build future wealth as quickly as possible, but perhaps with less risk than is found in a pure growth stock, the benefit of investing in a moderately low yielding dividend growth stock cannot be denied. This is especially compelling when dividends are reinvested as seen in the following 11 calendar year performance report for Silgan Holdings.
33 Fairly Valued Dividend Growth Stocks by Sector

Over the course of conducting my research looking for fairly valued dividend growth stocks with an objective of total return, I uncovered 33 potential candidates. Since diversification within a common stock portfolio is of such great importance, I organized the candidates by sector. Consequently, the 33 candidates I felt comfortable offering as research candidates are spread out over 8 different sectors. Therefore, I believe that an investor seeking an above-average total return would be offered an adequate number of possibilities from which to construct a diversified portfolio of dividend growth stocks.

Moreover, since my objective was for total return, I have highlighted the five-year estimated annual total return column on each sector grouping for perspective. Therefore, assuming that the consensus analyst estimates are within reasonable parameters of accuracy, each of these candidates would have the potential of generating double-digit long-term rates of return. I will include one historical earnings and price correlated graphical example for each sector. My purpose in doing so is to illustrate that each of these candidates represent reasonably valued dividend growth stocks in spite of the market’s strong run up over the past several years.

Sector 10: Energy - 2
Murphy Oil Corp: (MUR)

Murphy Oil Corporation operates as an oil and gas exploration and production company worldwide. The company has retail and wholesale gasoline marketing operations in the United States, and refining and marketing operations in the United Kingdom.
Silgan Holdings Inc: (SLGN)

Silgan Holdings Inc. manufactures rigid packaging for shelf-stable food and other consumer goods products. The company operates 81 manufacturing plants in North America, Europe, Asia, and South America. (For an expanded view on this company see the provided graphics above).

Sector 20: Industrials - 5

CSX Corp: (CSX)

CSX Corporation provides rail-based transportation services, including traditional rail service and the transport of intermodal containers and trailers.
Gap Inc: (GPS)

The Gap, Inc. operates as an apparel retail company. The company offers apparel, accessories, and personal care products for men, women, children, and babies.
Wal-Mart Stores Inc: (WMT)

Wal-Mart Stores, Inc. operates retail stores in various formats worldwide. The company operates through three segments, including Wal-Mart U.S.; Wal-Mart International; and Sam’s Club.
Baxter International Inc: (BAX)

Baxter International Inc., through its subsidiaries, develops, manufactures, and markets products for people with hemophilia, immune disorders, infectious diseases, kidney disease, trauma, and other
chronic and acute medical conditions worldwide.

Aflac Inc: (AFL)

Aflac Incorporated, through its subsidiary, American Family Life Assurance Company of Columbus,
markets and administers supplemental health and life insurance. The company also offers voluntary insurance policies that provide a layer of financial protection against income and asset loss. It conducts insurance business in various 50 states, the District of Columbia, various United States (U.S.) territories, and Japan.
International Business Machines Corp (IBM)

International Business Machines Corporation, an information technology company, provides various services, software, and integrated solutions. I am going to add additional information on this example because I believe it represents a classic case of price bias. Notice that I have circled the recent price performance of IBM on the Earnings and Price Correlated Graph below. It has been my observation that when the price of a stock drops it stimulates a lot of negative sentiment about the company. However, as we can see from reviewing IBM’s earnings (the orange line on the graph below) that only stock price has fallen even though earnings continue to advance.

I have read numerous articles over the past year focusing on IBM’s negative cash flow growth. However, I believe that many investors are overstating the negativity regarding IBM’s cash flows. The following FUN Graph (Fundamental Underlying Numbers) plots IBM’s cash flow per share (cflps), free cash flow per share (fcflps), and operating cash flow per share (ocflps).

The only negative regarding IBM’s cash flows that I can see relate to free cash flow per share. However, free cash flow per share as calculated by FUN Graphs is after dividends have been paid. Therefore, although free cash flow has been flat over that last three years, the graph illustrates that IBM has ample free cash flow left over even after dividends.
When reviewing IBM’s gross profit margin (gpm) and net profit margin (npm) we discover that both have been increasing albeit only moderately. Consequently, there is little evidence that IBM’s business is deteriorating based on margins.
A final factor supporting future earnings growth is IBM’s rather substantial share buy backs over the past 9 years. What’s most important about this share buy-back initiative by IBM is that the company’s stock price has generally been fairly valued or undervalued over this timeframe. In other words, I am suggesting that IBM’s purchasing of those shares since 2006 has been an effective use of capital because their shares were attractively priced (see the Earnings and Price Correlated Graph above).
The primary focus of this article was to identify dividend paying stocks forecast to grow at above-average long-term rates in order to achieve an above-average long-term total return. Although each of these candidates pay a dividend and several have long streaks of increasing their dividend, each was selected primarily based on their forecast earnings growth rates. Simply stated, it is my contention based on years’ of experience that above-average earnings growth represents the primary source of above-average long-term total return.

Frankly, it was hard to distinguish between candidates for this article and candidates that will be presented in part 4 of this series where my focus will be more on current yield and dividend income growth. Consequently, regular readers may find attractive opportunities that meet their unique objectives among both this group and the group included in the next article. Moreover, the primary objective of this entire series is to identify attractive looking research candidates capable of providing something for everyone.

**Disclosure**: Long NSC, UNP, COH, TGT, WMT, BAX, AFL, TRV, HPQ, IBM, ORCL, QCOM at the time of writing.

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