AMERICAN MONEY MANAGEMENT, LLC

SEC Registered Investment Advisor

Lockheed Martin

One of the hardest things for us to do as a portfolio manager is to sell a portion of a winning position.

A position that has gained in value is a symbol of our brilliance and a testament to our skill as an investor. If the position continues to gain more than the market our performance will be even better! And our ego will continue to swell.

But what if we sell some of the position to bring it back down to its target weight and the position continues to gain? Then we’re angry with ourselves. We feel the loss of missing out. And our ego contracts back to its normal size.

What we’re not thinking about in these moments is the risk profile of your portfolio. The AMM Dividend Growth Portfolio is a concentrated portfolio already. Letting one position become too large concentrates your portfolio even further. This increases the portfolio's overall risk profile.

Higher risk can produce higher returns, but it also can lead to lower returns and drastic underperformance. If the position is too large and something bad happens then your portfolio is at risk for a permanent loss of capital. **This is the biggest risk we seek to avoid**.

We know in the heat of the moment our quick-emotional-heuristic-based thinking system will make irrational decisions. This is why we make portfolio rules and follow those rules.

Every position in the AMM Dividend Growth Strategy has a percentage range for how big it will be in the portfolio. If the position becomes too small, and we still find it attractive, then we will buy more of it. If a position becomes too large we will sell a portion of it.

As we're writing this letter we are selling some positions that have become too big. Your account may not see any trades if the positions fall within our acceptable range for size.

So far 2019 is another great year for stocks. The broad market is up 16-17% on price returns alone. The stock market may continue to rise and trimming some positions may hurt us in the short-run. **What we do know is that the stock market does not generate returns in a linear fashion**. The stock market will sell-off at some point.

If a sell-off takes our current positions to prices below our estimate of fair value then we will likely reinvest the previously raised cash. All else being equal, at these lower prices the risk/reward profile is more favorable to us as investors.

Selling a part of or all of a winning position is mentally and emotionally hard. To alleviate these problems we will continue to rely on rules to ease our investing decisions.

Dividend Stock in Focus

Lockheed Martin (LMT): $378.16

Price as of the close October 2, 2019

Lockheed Martin makes its second appearance in the AMM Dividend Growth Portfolio.

We first bought Lockheed Martin back in 2012 on the fears of a government shutdown and defense spending sequestration. The entire defense contracting sector sold off and we invested in a couple companies. Lockheed Martin was one of them.

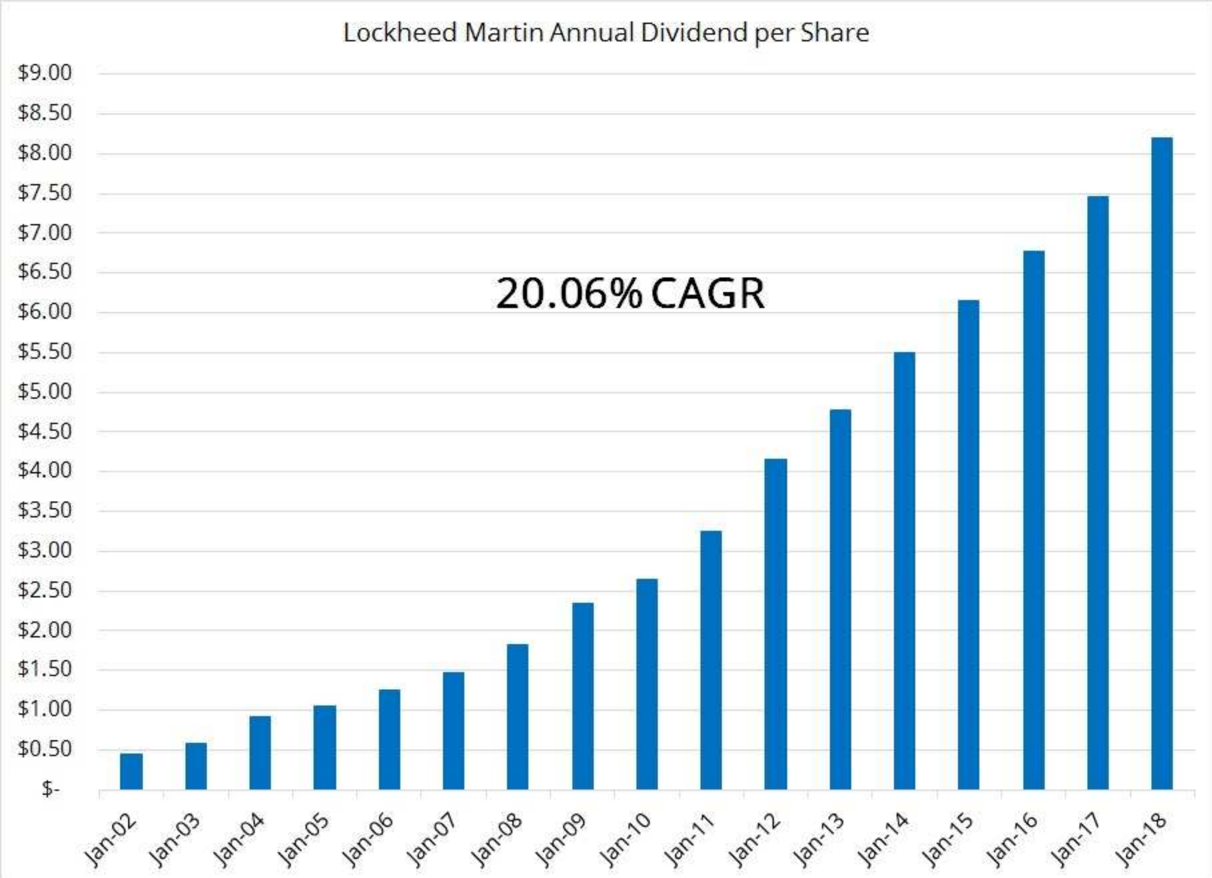
Early in the life of the AMM Dividend Growth Portfolio, we used a covered call option strategy to generate additional income. One of the challenges with a covered call strategy is that a position that has risen in price above the option's strike price can be called away, “sold”. While the additional income received from the call option may have offered additional portfolio income, too often we found that good businesses were getting "called away".

We sold covered calls against our Lockheed Martin position and Lockheed's stock price rose above our strike price. Instead of rolling the options we let our position in Lockheed Martin get called away. The caveat was we could always buy Lockheed Martin back.

It's taken a few years but we recently added Lockheed Martin to portfolios as it appears to be a compelling enough value again.

Dividend History

We classify Lockheed Martin as a Dividend Stalwart. The company has paid a dividend since 1995. Since 2002 the company grew its dividend at a **compound annual growth rate of 20.06%**. Over the last five years that growth rate has **dropped down to 8.35%**. This is the growth rate we're looking for with dividend stalwarts. High single digits with the occasional year of double-digit growth.



Dividend Safety

Dividend Payout Ratio < 60%?	42.57%	✓
Cash Dividend Payout Ratio < 60%?	67.04%	✗
FCFE Coverage Ratio > 100%?	373.14%	✓
Debt to Equity < 1.00?	5.17	✗
Interest Coverage > 2.00?	10.98	✓

Lockheed Martin has two marks against it for dividend safety. The first one is its cash dividend payout ratio is greater than 60%. These cutoffs are more guidelines than hard and fast rules. With Lockheed's Cash Dividend Payout ratio at 67%, we're still comfortable with this ratio.

The other mark against Lockheed's dividend safety is its debt to equity ratio. It is high at 5 times. Its interest payment is well covered at 11x and Lockheed's Debt to Equity ratio is on a downward trend. Lockheed purchased Sikorsky Aircraft a couple of years ago and took on debt to complete the acquisition. We expect Lockheed's debt to equity ratio to continue fall over the next few years.

Catalysts for Price Appreciation & Dividend Growth

F-35

The F-35 is the only 5th generation fighter in production. The F-22 Raptor is the only other 5th generation fighter in the U.S. arsenal but it is not in production right now. The F-22 is also built by Lockheed Martin.

Only 350 of the total 2,400 F-35s ordered in the U.S. have been delivered. The delivery, revenue, and costs of the remaining aircraft will be spread over the next 5-10 years.

Then there are the F-35 sales to Australia, Canada, Denmark, Italy, Netherlands, Norway, ~~Turkey~~, the U.K., Israel, South Korea, and Japan. Japan has the largest F-35 order with 147 planned aircraft.

Then there are potential sales to Singapore, Greece, Romania, Spain, and Poland. Poland is freeing itself from its old Soviet-era equipment and its former status as a Warsaw Pact country.

It is possible over the next decade that Lockheed Martin is operating the only production line for manned aircraft in the western world.

Lockheed Martin would not only benefit from the sale of the fighters but the long-term service costs. They'll also benefit from upgrading the plane's avionics and weaponry over time.

Loyal Wingman

The F-35 is on its way to becoming the new aerial combat platform. The Loyal Wingman, a program whereby a single F-35 is accompanied by several AI powered drones, is gaining steam. The drones which cost a lot less than the F-35 could take a hit for the F-35, jam radars, carry extra launch weapons, and scout ahead.

Kratos’ XQ-58A Valkyrie is the leading drone design for the Loyal Wingman program. An Australian company is also working on its own drone for the F-35. It might make sense for Lockheed Martin to buy the winning company and own the entire combat infrastructure for the F-35.

The F-35 as a combat platform means the F-35 will be the dominant aerial fighter for a long-time. The F-35 will be a large source of revenue and profits for Lockheed Martin over this time too.

Missile Defense

Raytheon and Lockheed Martin are the duopoly in missile defense. The current missile defense system is designed to track ICBMs. It is not suited to track the new class of hypersonic missiles that Russia and China have developed. Lockheed Martin which designed both the THAAD and Aegis systems won a contract to upgrade and modernize both systems.

Missiles and fire control account for ~17% of Lockheed Martin’s revenue and operating profit.

The critical nature of missile defense and fire control and the expertise needed creates high switching costs for Lockheed customers. Governments are highly unlikely to switch to other contractors and risk disruption in their ability to launch or counteract missiles.

The urgent need to upgrade the U.S. and its allies’ missile defense systems lends itself to larger government spending over the next few years.

Trusted Partner

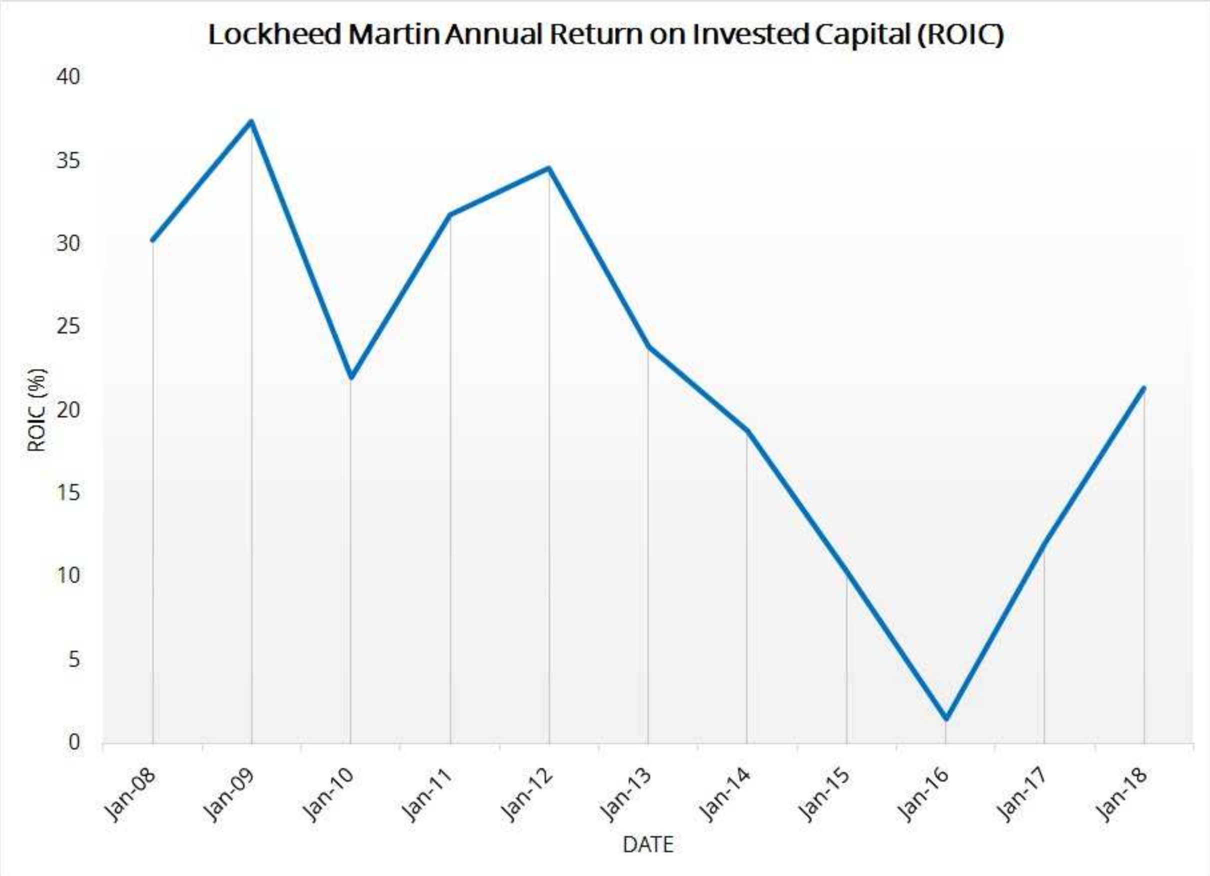
Lockheed Martin's decades of experience working within the bureaucracy of military procurement creates a hard to replace business moat. Lockheed Martin is the primary defense contractor for our military’s combat systems. And it will become the lead aerial combat platform provider. Given their lead position and expertise, the other defense contractors can't outbid Lockheed Martin in such mission-critical systems.

50% of Lockheed Martin's revenue in Space Systems comes from building satellites for the Department of Defense. These are highly classified satellites and extremely costly. The Department of Defense needs a trusted partner that can not only build these satellites but build them in secrecy. Lockheed Martin has proven its reputation to do both over the life of the company. A new company would be hard pressed to take this business away from Lockheed Martin.

ROIC Growth

Lockheed Martin's Return on Invested Capital (ROIC) dipped as it invested in the F-35 program. Then its ROIC fell further after it bought Sikorsky Helicopters.

But now that the production and sales of the F-35 are ramping up, Lockheed Martin's Return on Invested Capital should continue its recent growth. Growing ROIC combined with sales growth leads to increased shareholder value and excess capital. Capital that Lockheed Martin can use to increase its dividend.



Risks

F-35

As we mentioned above, the F-35 program is Lockheed Martin's largest driver of revenue and profits.

It is a controversial jet based on its costs and its effectiveness. We do not have the expertise to determine how good the F-35 is as a fighting vehicle but this Reddit thread will catch you up on some of the arguments.

[F-35 Reddit Thread]

And some opinions from pilots.

F-35: What the Pilots Say

The crux of the argument against the F-35 is it tries to be all things to everyone. Which is one of the problems with the current procurement process. The movie The Pentagon Wars is an entertaining look at how bad the process is.

Aeronautics is 38% of Lockheed's revenue and 30% of its operating profits. The F-35 accounts for about 70% of Aeronautics' revenue and the bulk of its future growth. If the F-35 is the new Bradley Fighting Vehicle and is ineffective in combat then it will be a financial disaster for Lockheed Martin.

The F-35 is also a manned aircraft. It will eventually get its AI drones as support craft. The question is how long before all aircraft are unmanned?

If the switch to unmanned aircraft comes sooner rather than later, then Lockheed Martin's F-35 program will also suffer.

Nuclear Arsenal

The U.S. nuclear arsenal is old. As of 2016, the coordination of the U.S. nuclear triad (missiles, bombers, and submarines) ran on 1970s computers and floppy disks.

The U.S. nuclear arsenal needs an expensive overhaul to modernize old warheads, build new warheads, modernize delivery systems, and expand its capabilities.

The program is expected to cost $1.2 trillion over the next 30 years. This includes a replacement for the Ohio class nuclear submarine, the new B-21 long-range bomber, and a replacement for the Minuteman III ICBM.

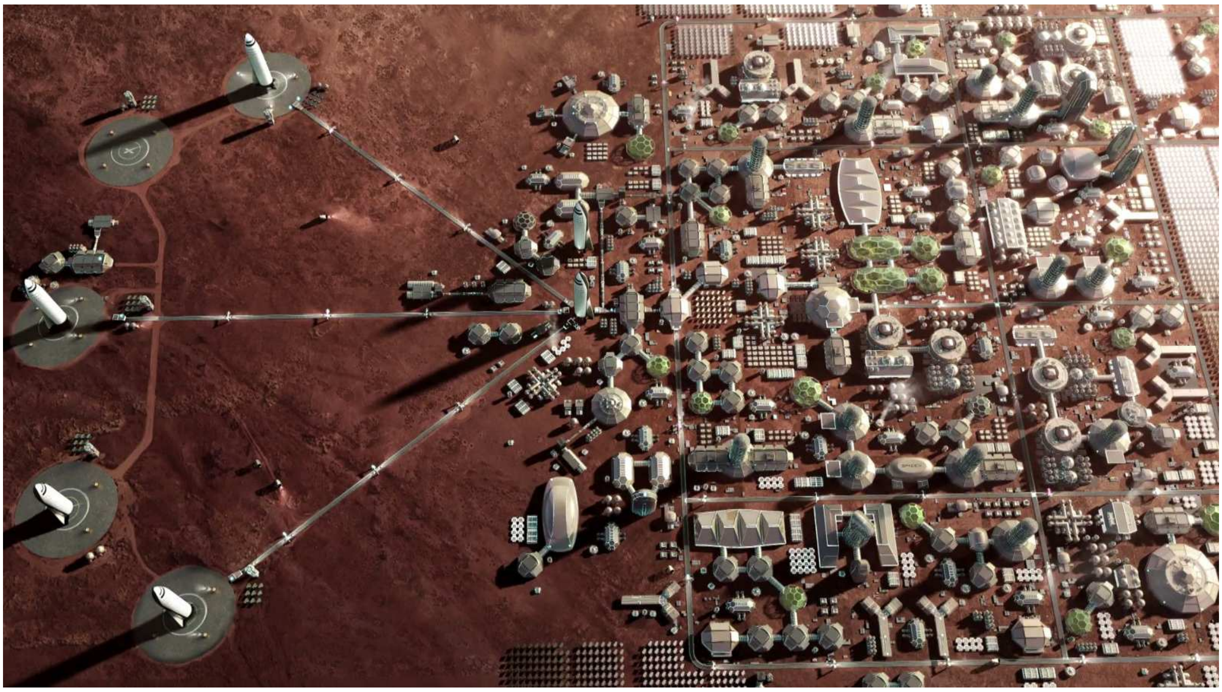
Lockheed Martin does not have a program for this major project. It will be involved with ancillary systems but it doesn't have a major project in the nuclear triad modernization. Lockheed lost its joint bid with Boeing for the B-21 project. This is a large revenue pool for Lockheed Martin to miss out on.

Moonraker

A billionaire industrialist builds spaceships to start a post-Earth colony in a bid to escape a global catastrophe.

You may think that's the plot to the James Bond movie Moonraker but you'd be wrong.

Part of SpaceX's vision is to build interplanetary spaceships to colonize Mars. With the goal to prevent humans from going extinct if the Earth is destroyed.



Space is the new playground for billionaires. Jeff Bezos has Blue Origin. Elon Musk has SpaceX. And Sir Richard Branson has the soon to be public Virgin Galactic.

Lockheed Martin in partnership with Boeing runs the United Launch Alliance. This is 15-20% of Lockheed Martin's Space Systems. SpaceX and Blue Origin want a piece of the government rocket/satellite launching business. SpaceX launch prices drastically undercut Lockheed and the United Launch Alliance. A Falcon 9 launch costs $57 million versus the estimated cost of $380 million per launch for Lockheed's Atlas rocket.

SpaceX is a private company. Despite SpaceX's claim that they are profitable, there are indications that it is pricing its services at a large loss to win business.

SpaceX and Blue Origin are pushing the reusability of their rockets. Reusable rockets means their design is standard. The U.S. government tends to need some rocket customizations to facilitate the satellites they want to launch. So we'll see how much business SpaceX or Blue Origin can win away from Lockheed Martin and United Launch.

Valuation

We utilized a discounted cash flow model to generate our estimate of fair value. Our expectations over the next few years is 5% revenue growth that fades to a long-run growth rate of

3%. Right now we are valuing Lockheed Martin at **$410 per share**. The company is trading at a slight discount to our estimate of fair value.