20 Most Dangerous Stocks for February

Large/Mid Cap and Small Cap Stocks

Investment Perspective

The report presents unique investment ideas produced by our integrated research database and platform.

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Note
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- **Our 20 Most Dangerous Stocks have greater downside risk than upside potential because of: Expensive Valuations, Poor Economics, and Misleading Earnings.**
- **3 new Large/Mid-Cap stocks make our Most Dangerous list for February. The top 5 are: STN, IVGN. DNA, EDMC, and UVN.**
- **3 new Small-Cap stocks make our Most Dangerous list. The top 5 are: CWTR, COKE, JLL, AMHC, and BONT.**
- **These stocks are risky investments because their valuations imply future financial performance far greater than what the companies have achieved historically.**
- **Despite reporting positive GAAP earnings and GAAP earnings growth, these companies have negative and declining economic earnings.**
- **Our economic measures overcome accounting distortions to provide investors with an unadulterated analysis of the underlying economics of businesses.**
- **Our 20 Most Dangerous Stocks list for February featuring Large and Mid-Cap Stocks is on page 4 and the list featuring Small-Cap Stocks is on page 5.**
- **A detailed description of how we identify the Most Dangerous Stocks is on pages 2 and 3.**

Figure 1: Accounting Issues that Distort GAAP Profit Reports

- Employee Stock Options
- Pension & OPEB Funded Status
- Excess Cash
- Restructuring Charges
- Pooling Goodwill
- Minority Interests
- Off-Balance-Sheet Financing
- LIFO Reserve
- Unrealized Gains/Losses
- Goodwill Amortization
- Unconsolidated Subsidiaries
- Capitalized Expenses

Sources: New Constructs, LLC

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Top 20 Most Dangerous Stocks: Methodology

We determine the Most Dangerous Stocks based on three criteria. The stocks exhibit:

1. **Expensive valuations** because their *Price-to-Economic Book Value* (EBV) ratios are greater than 2 or less than zero, and they have *Growth Appreciation Periods* (GAP) greater than 20 years.
2. **Poor economic performance** because they generated negative economic earnings in the last fiscal year, and their Economic Profit Margins have been negative on average during the past five years.
3. **Misleading accounting performance** because they reported positive GAAP Earnings and GAAP Earnings Growth while their economic profits declined in their latest fiscal year.

We do not predict the future value of stocks.

Identifying Expensive Valuations. The most dangerous stocks have valuations that imply that the company's future financial performance will meaningfully exceed anything the company has done in the past 5 years. Rather than predicting a warranted or future value for a company or stock, we measure **the market's** prediction for the financial performance of companies as reflected in stock prices. Our measures of valuation are intentionally objective. Our goal is to position investors to make informed decisions about whether or not they agree with the market's prediction for the future financial performance of companies.

Our valuation analysis focuses on assessing the feasibility of future financial performance requirements embedded in stock price.

In our opinion, a more rigorous way to assess the valuation of stocks is to look at two metrics: the ratio of *Price-to-Economic Book Value* (EBV)[1] per share and the market-implied *Growth Appreciation Period* (GAP). The ratio of Price-to-EBV highlights the degree of difference between the company's current level of cash flow and the level of future cash flow that the market expects. Economic Book Value essentially measures the perpetuity value of the company's current annual after-tax cash flow (NOPAT). The larger the Price-to-EBV ratio (whether or not it is positive or negative), the greater is the improvement in cash flow required to justify the stock price. The market-implied GAP measures the number of years the company must grow its economic profits in order to justify its stock price. The longer the GAP the longer a company must maintain a competitive advantage and earn returns above its cost of capital on new investments.

New Constructs rectifies accounting distortions in GAAP financial statements.

Identifying Poor Economic Performance. The most dangerous stocks also have reported profits that tell a different story than the economics of their businesses. As noted in Figure 1, there are many ways that GAAP profits can differ from Economic Profits. Scandals at Enron, Worldcom, Adelphia, and others provide evidence of just how far companies can stretch accounting rules in order to appear more profitable than they truly

[1] Economic Book Value (EBV) measure the no-growth value of the business based on its annual after-tax cash flow. The Formula for EBV is: (NOPAT / WACC) + Excess Cash + Non-operating assets – Debt (incl. Operating Leases) - Value of Outstanding Stock Options – Minority Interests -/+ Under/Over-Funded Pensions.

are. New Constructs rectifies accounting distortions in order to provide investors with a cleaner and truer analysis of a company's profitability. Our process involves digging vigorously into SEC filings, especially the Notes to the Financial Statements in order to gather, model, and deliver the economic results of a company's performance.

The metrics we use to measure the economic performance of companies are Economic Profit Margin and Economic Earnings. The Economic Profit Margin for a company equals its Return on Invested Capital (ROIC) minus its Weighted-Average Cost of Capital (WACC). The Economic Earnings of a company equal its Economic Profit Margin multiplied by its Invested Capital. We believe our measures of economic performance are substantially more accurate than accounting metrics because we make adjustments for all the issues listed in Figure 1.

Cash is king. When reported earnings and economic cash flow diverge, the market follows cash.

Identifying Misleading Accounting Performance. When accounting results do not jibe with economic results, the market follows economic results, which provide a much better reflection of cash flow. Dangerous stocks report positive GAAP Earnings and Earnings Growth while their economic profits are negative and declining.

Conclusion

Companies that have expensive valuations, poor economics and misleading earnings present investors more risk of downside than upside price performance. We believe these stocks present investors with stocks that offer dangerous risk/reward.

We consider companies whose Price-to-EBV ratios and market-implied GAPs exceed the thresholds stated above to have **expensive valuations**.

We consider companies with negative economic earnings and a negative economic profit margin on average over the past five years to have **poor economics**.

We consider companies whose GAAP Earnings and GAAP Earnings trends contradict their economic performance to have **misleading earnings**.

The 20 Most Dangerous Stocks for February – Large and Mid-Cap

Figure 2: Ranked by Price-to-EBV Ratio in Descending order

			Expensive Valuation		Poor Economics		Misleading Earnings			
			as of 02/03/05		Last Fiscal Year		Last Fiscal Year			
	Ticker	Company Name	Price-to-EBV	Market-Implied GAP (years)	Economic Profit Margin (5yr avg)	Economic Earnings Per Share	Positive EPS	Positive EPS Growth	Negative Economic Earnings Trend ($mm)	Market Value ($mm)
1	STN	Station Casinos Inc	383.4	60	-1.0%	($0.34)	$0.72	143%	($3)	$3,609
2	IVGN	Invitrogen	78.4	Greater than 100	-12.5%	($3.47)	$1.17	30%	($30)	$3,478
3	DNA	Genentch	33.0	Greater than 100	-7.9%	($0.48)	$0.53	775%	($192)	$48,362
4	EDMC	Education Management Corp	11.1	29	-1.2%	($0.23)	$1.03	34%	($15)	$2,406
5	UVN	Univision	8.6	21	-3.5%	($1.62)	$0.55	62%	($271)	$6,689
6	CAM	Cooper Cameron	8.4	97	-3.0%	($1.16)	$1.29	28%	($2)	$3,162
7	BA	Boeing	7.9	72	-1.9%	($3.37)	$0.89	46%	($1,482)	$41,605
8	SPLS	Staples Inc	6.3	60	-1.9%	($0.24)	$0.99	5%	($142)	$15,453
9	WPO	Washington Post	4.8	68	-1.9%	($8.11)	$25.12	18%	($36)	$8,727
10	BGP*	Borders Group	4.7	46	-2.0%	($0.79)	$1.52	11%	($4)	$2,097
11	EQR	Equity Residential	4.3	28	-0.8%	($0.64)	$1.44	32%	($150)	$8,649
12	MAR	Marriott International Inc	4.1	34	-1.3%	($0.20)	$2.05	88%	($28)	$14,910
13	ORLY	O'Reilly Auto	3.4	20	-0.6%	($0.03)	$1.84	20%	($6)	$2,501
14	AVB	AvalonBay Communities	3.1	76	-2.3%	($0.78)	$3.71	69%	($4)	$4,709
15	TEK	Tektronix	3.0	Greater than 100	-2.1%	($0.50)	$1.35	365%	($39)	$2,420
16	AXP	American Express	2.9	Greater than 100	-2.0%	($0.28)	$2.30	15%	($1,042)	$71,146
17	FBR	Friedman, Billings, Ramsey Group	2.9	Greater than 100	-8.2%	($0.57)	$1.63	49%	($89)	$2,331
18	PNR	Pentair	2.9	32	-0.1%	($0.19)	$1.42	9%	($5)	$4,002
19	NIHD*	NII Holdings	2.1	76	-13.3%	($0.14)	$2.54	3%	($255)	$3,459
20	RJF*	Raymond James Financial	2.1	Greater than 100	0.0%	($0.29)	$1.71	46%	($4)	$2,255
	SPX	S&P 500	1.8	24 yrs	5%	($0.08)	$2.15	179%	$562	

* Denotes stocks that have not appeared on the Most Dangerous list within the last 3 months.

Sources: New Constructs, LLC

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The 20 Most Dangerous Stocks for February – Small-Cap

Figure 3: Ranked by Price-to-EBV Ratio in Descending order

			Expensive Valuation		Poor Economics		Misleading Earnings (Latest Fiscal Year)			
			as of 02/03/05		Last Fiscal Year		Last Fiscal Year			
	Ticker	Company Name	Price-to-EBV	Market-Implied GAP (years)	Economic Profit Margin (5yr avg)	Economic Earnings Per Share (Last Fiscal Year)	Positive EPS	Positive EPS Growth	Negative Economic Earnings Trend ($mm)	Market Value ($mm)
1	CWTR*	Coldwater Creek	96.6	92	-1.7%	($0.21)	$0.34	32%	($3)	$1,009
2	COKE	Coca-Cola Bottling	15.0	73	-2.5%	($3.31)	$3.40	33%	($21)	$491
3	JLL	Jones Lang LaSalle	14.9	101	-5.8%	($1.07)	$1.12	32%	($39)	$1,223
4	AMHC	American Healthways	13.5	25	-2.9%	($0.01)	$0.75	34%	($2)	$1,015
5	BONT	Bon-Ton Stores	13.4	101	-3.3%	($1.21)	$1.33	113%	($6)	$263
6	ANSI	Advanced Neuromodulation Systems	12.3	55	-4.0%	($0.33)	$0.64	71%	($1)	$740
7	ARXX	Aeroflex	8.1	101	-17.6%	($0.53)	$0.17	65%	($14)	$666
8	LIN	Linens 'N Things	7.4	39	-2.1%	($1.13)	$1.67	4%	($6)	$1,230
9	TOA	Technical Olympic USA	6.6	101	-0.5%	($0.51)	$1.94	13%	($28)	$1,180
10	ACMR	AC Moore Arts & Crafts	6.2	101	-1.3%	($0.29)	$0.88	14%	($3)	$515
11	DRS	DRS Technologies	5.8	25	-0.7%	($1.24)	$1.80	14%	($19)	$1,005
12	MOBI	Mobius Management Systems	5.8	22	-26.3%	($0.11)	$0.24	7%	($3)	$111
13	FORR	Forrester Research	5.8	42	-30.3%	($0.46)	$0.10	285%	($14)	$363
14	CAI	CACI International	5.6	32	-0.2%	($0.58)	$2.13	40%	($13)	$1,529
15	SSYS*	SSYS	5.6	101	-2.1%	($0.03)	$0.64	72%	($1)	$314
16	WMAR	West Marine Products	5.3	71	-2.7%	($0.51)	$0.99	2%	($1)	$477
17	RS	Reliance Steel and Aluminum	5.3	53	-0.2%	($0.93)	$1.07	13%	($18)	$1,250
18	WDHD*	WDHD	5.1	29	-3.8%	($0.74)	$0.66	20%	($1)	$175
19	ROG	Rogers	4.9	76	-0.5%	($0.38)	$1.61	39%	($1)	$657
20	CSH	Cash America International	4.7	101	-2.5%	($0.40)	$1.13	45%	($25)	$744
	SPX	S&P 500	1.8	24 yrs	5%	($0.08)	$2.15	179%	$562	

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