Top 20 Most Dangerous Stocks

Stocks with the Greatest Risk of Downside

Investment Perspective

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

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Note
This document is available to clients in the ***Research*** area of our site *www.newconstructs.com*.

- **Our Top 20 Most Dangerous Stocks represent those companies with the worst economics and most expensive valuations.**
- **These stocks are risky investments because their valuations imply future financial performance far greater than what the companies have achieved historically.**
- **Even after recent declines in most major indices, there are many dangerous stocks in the market.**
- **Despite reporting positive GAAP earnings and GAAP earnings growth, these companies have negative and declining economic earnings.**
- **The key accounting issues that cause GAAP profits to differ from a company's underlying economic earnings are listed in Figure 1.**
- **If accounting measures of profitability can be unreliable, then so can the valuation metrics that rely on them.**
- **Our economic measures overcome accounting distortions to help investors make more informed decisions.**
- **Our Top 20 Most Dangerous Stocks are listed on page 4.**
- **A detailed description of how we identify the Most Dangerous Stocks is on page 3.**

Figure 1: Accounting Issues that Distort GAAP Profit Reports

- Employee Stock Options
- Pension Over/Under Funding
- 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

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 three or less than zero, and they have *Growth Appreciation Periods* (GAP) greater than 50 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 entirely 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 great 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 cash flow that 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

[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 – Debt (incl. Operating Leases) - Value of Outstanding Stock Options – Minority Interests - /+ Under/Over-Funded Pensions.

stretch accounting rules in order to appear more profitable than they truly 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 multiplies by its Invested Capital. We believe our measures of economic performance to be 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

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 Top 20 Most Dangerous Stocks as of Market Close on 7/26/04

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

	Expensive Valuation		Poor Economics		Misleading Earnings (Lastest Fiscal Year)		
	Price-to-EBV	**GAP**	**Economic Profit Margin (5yr avg)**	**Economic Earnings Per Share (Last Fiscal Year)**	**Positive EPS**	**Positive EPS Growth**	**Negative Economic Earnings Trend ($mm)**
UVN	115.1	Greater than 100 years	-4.9%	($2.20)	$0.55	62.3%	($370)
DNA	29.8	Greater than 100 years	-9.0%	($0.59)	$0.53	774.5%	($228)
AXP	17.8	Greater than 100 years	-4.5%	($2.17)	$2.30	14.6%	($2,864)
FDX	17.8	Greater than 100 years	-2.4%	($2.33)	$2.74	16.9%	($67)
BA	15.6	Greater than 100 years	-1.4%	($4.31)	$0.89	45.8%	($2,913)
MOLX	10.6	Greater than 100 years	-5.8%	($1.01)	$0.44	12.6%	($1)
WAG	10.1	Greater than 100 years	-1.3%	($0.36)	$1.14	15.4%	($159)
CAM	9.6	Greater than 100 years	-3.7%	($1.61)	$1.29	27.7%	($10)
CECO	8.5	Greater than 100 years	-1.6%	($0.13)	$1.19	67.1%	($3)
VIAB	7.1	81 years	-7.8%	($3.57)	$0.80	96.8%	($129)
WPO	5.8	Greater than 100 years	-2.9%	($14.19)	$25.12	17.7%	($54)
PH	5.5	Greater than 100 years	-1.3%	($2.22)	$1.68	49.7%	($11)
ADS	4.5	Greater than 100 years	-4.3%	($0.68)	$0.84	145.3%	($1)
CAT	3.6	Greater than 100 years	-4.6%	($4.00)	$3.13	36.0%	($120)
NSC	3.5	Greater than 100 years	-3.5%	($1.77)	$1.36	15.7%	($131)
NMGA	3.5	Greater than 100 years	-1.8%	($1.00)	$2.29	9.9%	($5)
ORLY	3.1	Greater than 100 years	-1.1%	($0.17)	$1.84	20.2%	($11)
STN	(36.3)	67 years	-1.0%	($0.62)	$0.72	142.8%	($17)
WFMI	(44.2)	Greater than 100 years	-2.2%	($1.10)	$1.59	19.0%	($27)
YHOO	(103.9)	Greater than 100 years	-17.8%	($1.15)	$0.19	427.9%	($21)

Sources: New Constructs, LLC

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The result is a research platform that empowers better investment performance.

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