New Stocks Make Most Attractive/Dangerous Lists For April

Click here to subscribe.

Our Most Attractive and Most Dangerous stocks for April were made available to the public at midnight on Wednesday. March saw some strong performances from our picks. Our Most Attractive Stocks portfolio rose by 2.3%, outperforming the S&P 500 (-0.1%). Small Cap Minerals Technologies (MTX) led the way with an 18% gain, followed by Large/Mid Cap Pilgrim's Pride Corp (PPC) with a 15% gain.

Our Most Dangerous stocks also outperformed as a short portfolio last month as they fell by 1%. Small Cap Kelly Services (KELYA) fell by 7% while Large/Mid Cap Realty Income Corp (O) fell by 6%.

This success underscores the benefit of sticking to our value-investing strategy. Being a true value investor is an increasingly difficult, if not impossible, task (see "Secrets to Annual Reports"). By scrupulously analyzing every word in annual reports, our research protects investors' portfolios and allows our clients to execute value investing with more confidence and integrity.

27 new stocks make our Most Attractive list and 28 new stocks fall onto the Most Dangerous list this month.

Our Most Attractive stocks have high and rising return on invested capital (ROIC) and low price to economic book value ratios. Most Dangerous stocks have misleading earnings and long growth appreciation periods implied in their market valuations.

Most Attractive Stock Feature For April: The Chubb Corporation (CB)

The Chubb Corporation (CB) is one of the new additions to the Most Attractive list this month. CB makes the list due to the decrease in rank of some of the stocks ahead of it.

We are bullish on the insurance sector right now. PowerShares KBW Property & Casualty Insurance Portfolio (KBWP) is the only ETF or mutual fund to earn our Very Attractive rating and a full 10 out of the 40 stocks on our Most Attractive list for April are insurance companies. While popular sectors like social media and cloud stocks have no profits and sky-high valuations, we see these insurance stocks as having solid profitability to go along with cheap valuations.

CB might just be the very best stock in this attractive sector. CB grew after-tax profit (NOPAT) by over 57% in 2013 and increased its ROIC from 11% to 16%. This 16% is higher than the industry average of 11% and higher than all but five of the 50 property and casualty insurance companies we cover.

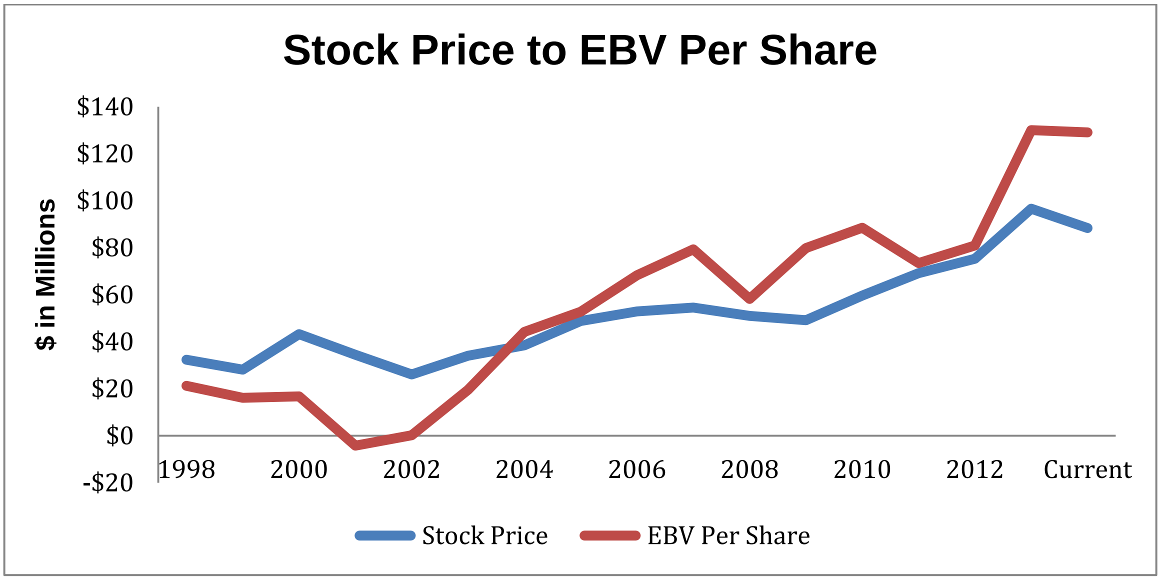
Even though CB's profits took a bit of a hit during the financial crisis, it has still grown NOPAT by 13% compounded annually over the past decade. Not many companies can match that track record of long-term growth.

If we dig deeper into CB's numbers, we see strength in every element of its business. In 2013, net premiums increased in each of CB's three segments, Personal Insurance, Commercial Insurance, and Specialty Insurance. The biggest impact on NOPAT came from the 13% decline in losses and loss expenses, from $7.5 billion to $6.5 billion. Superstorm Sandy was primarily responsible for the high level of losses in 2012, and the $6.5 billion in 2013 is closer to CB's long-term average.

Even if costs start to come back up to counteract CB's growth in revenues, this stock still has significant upside. At its current valuation of ~$88/share, CB has a price to economic book value ratio of just 0.7, which implies that NOPAT will permanently decline by 30%. Given CB's strong long-term prospects it deserves a much higher valuation.

Figure 1 shows just how rare it is to get this good company at such a cheap price. The gap between the stock price and economic book value is the largest it's been since the market bottomed in 2009.

Figure 1: Trading at a Discount to Economic Book Value



Sources: New Constructs, LLC and company filings

If we assume CB is capable of just 2% NOPAT growth compounded annually for 15 years, a fairly low bar given its historical profit growth, the stock has a fair value of ~$135/share. That's a 50% premium to the current stock price if the company can just grow profits in the low single digits. If it can surpass those low expectations the upside is even greater. I like that risk/reward profile for CB.

Most Dangerous Stock Feature For April: Inland Real Estate (IRC: $10.50/share)

Inland Real Estate (IRC) is one of the new additions to the Most Dangerous list this month.

On the opposite end of the spectrum from insurance stocks, REITs are one of my least favorite sectors. 11 out of our 40 Most Dangerous Stocks this month are REITs, and we put REITs in the Danger Zone last year.

IRC is one of the worst stocks in this dangerous sector. In the ten years that our model covers, IRC has never earned positive economic earnings. It currently earns a bottom-quintile ROIC of just 3%. Since the financial crisis, IRC has only managed to grow NOPAT by 5% compounded annually.

What's worse, IRC is burning through cash. In three of the past four years IRC has earned a negative free cash flow, including 2013, where it burned through $240 million (23% of market cap). This negative cash flow has left IRC with an unhealthy balance sheet, as it has nearly $900 million in adjusted total debt with almost no excess cash.

Someone who just looked at IRC's P/E of 10 might be tempted to think this was a cheap stock, but they would be sorely mistaken. IRC recorded a $95 million unusual gain due to the change in control of investment properties that massively distorted earnings. IRC's true NOPAT was just $43 million, not the $103 million in GAAP net income IRC reported.

Plus, IRC is dangerously expensive. In order to justify its current valuation of ~$10.50/share, the company would need to grow NOPAT by 10% compounded annually for 28 years. For a company with low returns on capital and meager profit growth in recent years, such a high expectation is unwarranted. We've seen what happens to stocks with high valuations and low profitability in recent weeks (see "Hope you didn't own these 5 'most dangerous' stocks"). Look for IRC to follow suit.

The Most Dangerous Stocks report for April can be purchased here, while the Most Attractive Stocks can be purchased here. To gain access to these reports one week earlier each month, click here to view our subscription options.

Sam McBride contributed to this report.
Disclosure: David Trainer owns CB. David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, or theme.

New Constructs® – Profile

How New Constructs Creates Value for Clients

1. **Superior Recommendations** – Our stock picks consistently outperform. See our track record in our stock-picking accolades and Proof Is In Performance reports.
2. **More Accurate Research** – Our patented Research Platform for reversing accounting distortions and discounted cash flow analysis leverages better data to deliver smarter research.
3. **Time Savings** – We check the fine print in thousands of corporate filings so you don't have to. As reported by Barron's, our expertise in analyzing SEC filings delivers Hidden Gems and Red Flags that drive long-term stock-picking success.
4. **Transparency** – We are proud to share the results of our analysis of over 50,000 10Ks. See the Corporate Disclosure Transgressions report we provided the SEC. Our reports detail all data and assumptions. Company Models enable users to change them.
5. **Objectivity** – New Constructs is an independent research firm, not tied to Wall Street or investment banking services. Our models are driven by comprehensive high-quality data not stories. See our presentation to the Senate Banking Committee, the SEC and many others in DC.

Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

Additional Information

Incorporated in July 2002, New Constructs is an independent publisher of investment research that provides clients with consulting, advisory and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. NOPAT, Invested Capital, and WACC, to create economic earnings models, which are necessary to understand the true profitability and valuation of companies. Visit the Free Archive to download samples of our research. New Constructs is a BBB accredited business and a member of the Investorside Research Association.

DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

New Constructs is affiliated with Novo Capital Management, LLC, the general partner of a hedge fund. At any particular time, New Constructs' research recommendations may not coincide with the hedge fund's holdings. However, in no event will the hedge fund receive any research information or recommendations in advance of the information that New Constructs provides to its other clients.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.