Adviser Soapbox

Stocks In The Danger Zone

David Trainer, New Constructs 08.23.07, 2:20 PM ET

August has had many investors sweating from more than just the heat. The stock market has reacquainted many investors with the concept of risk, and while many stocks have lost some of their bull-market steam, our most dangerous stocks for August are the ones that will give investors a bad case of the summertime blues.

Our monthly report, available at www.newconstructs.com, includes 40 stocks: 20 large-caps and 20 small-caps.

Before getting into the specifics of the current crop of most dangerous stocks, here is a look at the dogs we included on our list of most dangerous stocks last month. Twenty-seven of the stocks included on July's list underperformed the S&P 500, which fell 4.8% since we published our report. Additionally, 35, or 87.5%, of the stocks on our list had negative returns.

In Pictures: Most Dangerous Small-Caps

The large-cap decliners were led by Istar Finl, which fell by 23.2%, and the small-cap decliners were led by Bon-Ton Stores, which declined by 38.4%. Our decline performance analysis excludes transaction costs, dividends and rebates.

All of the stocks we designate as "most dangerous" have misleading earnings paired with exorbitant valuations. These misleading earnings mean that despite what is reported in the headlines or the earnings report, earnings quality is very low. The valuations for these stocks are precariously high, in our opinion, as they predict major profit growth against a backdrop of declining cash flow.

In most instances, these stocks are overvalued because investors are not aware of hidden financial details buried deep in the notes to the financial statements. In fact, all companies on the most dangerous stocks list reported positive and rising earnings while their actual cash flows were negative and declining. Sooner or later, in our opinion, investors will recognize the disconnect between cash flows and market valuation, and the stock price of the companies will decline.

We focus intently on understanding the true earnings of companies and scrutinize income statements, balance sheets, cash flow statements and, most important, the notes to the financial statements. Disregarding Wall Street research and company press releases, New Constructs looks at the official filings the companies submit to the Securities and Exchange Commission and scrutinize income statements, balance sheets, cash-flow statements and the notes to the financial statements.

All of these data help to ensure that we have gathered all the financial facts needed to understand corporate profitability and make a determination of a stock's desirability or danger.

Most Dangerous Large-Caps

BlackRockremains on our list this month. Despite the recent implosion that many stocks have experienced, BlackRock has maintained its lofty price level and valuation, although it has come down from where it traded in mid-July.

Our discounted cash-flow analysis shows that BlackRock must improve its profits by nearly 900% just to meet the expectations implied by its current market price. Meanwhile, despite reporting that earnings rose by $89 million last year, BlackRock's true, economic earnings actually declined by $1.2 billion.

Vornado Realty Trust is a new addition to our list of most dangerous stocks this month. Certainly, the bad news that keeps coming out about real estate doesn't help VRT, but its problems go far beyond that. Despite hitting a 52-week low in August, the stock has bounded back to the levels where it traded prior to the recent market downturn. In its last fiscal year, VRT reported an increase in accounting earnings of $10 million, when we show economic earnings declined by -$137 million. In other words, for every penny the company reports as a gain in earnings, it loses nearly 14 cents of economic earnings

Fidelity National Information Services remains on our list of most dangerous stocks with a price-to-economic-book value ratio of 4.4. For its last fiscal year, the company reported that accounting earnings rose nearly $129 million, while our analysis shows economic earnings declined by -$150 million. Additionally, FIS has one of the most negative free-cash-flow yields of any stock on our most dangerous stocks list (-36%). At its current valuation, FIS would have to grow profits at its current pace for 20 years to justify its current valuation.

Click below for details on some of the most dangerous small caps.

In Pictures: Most Dangerous Small-Caps

David B. Trainer is president of New Constructs, LLC. For more details on these stocks or any of the 40 most dangerous stocks, please go to www.newconstructs.com.

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