Scrubbing Bubbles

BY JACK BRYANT

David Trainer and company sift through "propaganda" and "misleading accounting vernacular" to find gold for the serious investor

David Trainer is waging war on Wall Street. And as his company, Nashville-based New Constructs LLC, continues to outperform every established research firm in the industry, companies and investors alike are beginning to take notice.

A zealous man who frequently quotes Warren Buffet, Trainer began his professional career at Credit Suisse First Boston as an economic valuation strategist. He anticipated a long and successful career on Wall Street. However, disagreements with management at CSFB and Epoch Partners–a San Francisco-based investment bank–over earnings reports and cash flow statements left Trainer disillusioned. As Trainer saw it, the established investments banks and brokerage firms preferred research that falsified corporate earnings, and were sacrificing investors' returns to fill their own pockets.

After 10-years on Wall Street, he returned home to Nashville in search of the nations best computer programmers to help him create a new kind of equity research firm. Today, along with 12 employees and longtime friend Oman Sloan, Trainer offers investors a back-to-basics approach to investing and analysis that goes beyond the generally accepted accounting principles (GAAP) that govern publicly traded companies. (New Constructs has received funding from several Tennessee investors, including Solidus Co., which is majority owner of *Business Tennessee*)

According to Trainer, Wall Street firms love to sell speculative investors a false story, or, as he prefers to call it, "Wall Street propaganda." The established and "misleading accounting vernacular" of GAAP, he says, allows corporations to perpetuate this propaganda. He asserts that reported earnings are not reliable, going so far as to claim that 10Q reports are nothing more than "company commercials" for selling stock. In addition, he argues Wall Street cares more about making money for itself than investors. This assertion is founded on the gargantuan profits harvested by many Wall Street firms like Goldman Sachs, which made $1 billion in profit last year (equaling $524,000 per employee, including administrative staff).

But Trainer has a solution.

New Constructs uses an extensive 'scrubbing process' that scrutinizes the financial statement footnotes from SEC filings to find distortions in GAAP. At least 12 adjustments, like putting off-balance-sheet financing of operating leases back onto the balance sheet or deducting employee stock options from earnings statements, are made to calculate a company's economic earnings. Trainer and crew believe economic earnings are almost always meaningfully different from GAAP earnings, because they indicate a truer measure of profitability and shareholder value.

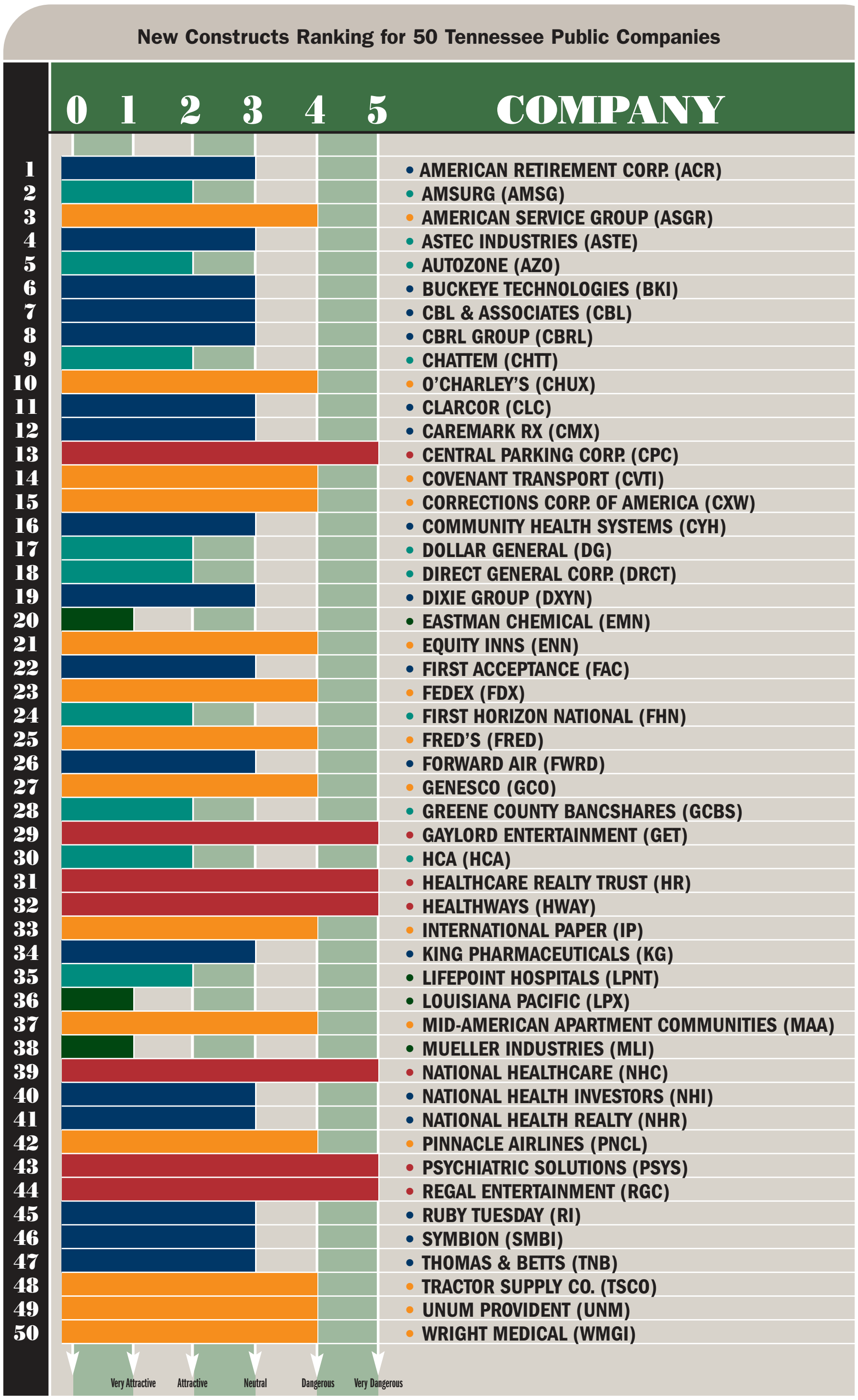
How does GAAP distort a company's earnings? For instance, off-balance-sheet financing keeps large capital expenditures off a company's balance sheet. The omission of these expenditures can falsely lower a company's debt/equity ratio and meaningfully raise their reported cash flow. Companies prefer a low debt/equity ratio because a higher ratio can result in volatile earnings reports. Also, employee stock options are an alternate form of compensation not reflected in a company's income statement. By deducting the cost of employee stock options, seemingly healthy financial earnings may become economic loses.

So far Trainer's method, inspired by John Bur Williams' *The Theory of Investment Value* (1938), has been very successful, and has garnered both him and his firm a considerable amount of recent recognition and reverence from top national business periodicals such as *Forbes* and *BusinessWeek*. In October of 2005, *Institutional Investor* magazine recognized New Constructs as the industry's best stock picker with 16.62% annualized gain, beating out such traditional stock picking stalwarts as UBS and Goldman Sachs.

Business Tennessee asked Trainer to evaluate Tennessee's 50 largest companies applying New Constructs' formula. New Construct's individual company reports or snapshots combine five equally weighted criteria: economic versus reported earnings per share (EPS), return on invested capital ranked by quintile, two-year average free cash flow yield, price-to-economic book value ratio, and the market-

Under Construction

50 top Tennessee companies, ranked on a scale of "**very attractive**" (**1**) to "**very dangerous**" (**5**) according to methodology employed by New Constructs LLC.



implied growth appreciation period (GAP). The results are used to construct a risk/reward investment rating for each company.

The economic versus reported earnings per share (EPS) criterion reflects New Constructs' 12 adjustments to GAAP. For instance, their economic EPS figures adjust for reported net assets, and economic earnings figures include over 12 adjustments like unrecorded goodwill and excess cash.

In this system, companies are ranked "1" through "5" as either "very attractive" (1), "attractive," (2) "neutral," (3) "dangerous," (4) or "very dangerous" (5). Each individual criterion is ranked 1 through 5 against the performance of over 3,000 companies.

These rankings identify disconnects between the market's expectations for future cash flows and current cash flows. A very dangerous company, then, has poor economic profits versus misleading accounting profits that exaggerate earnings. This has the potential to artificially increase stock valuation. A very attractive company on the other hand has a cheap valuation with strong economic profits, suggestive of a hidden value the market did not recognize.

The accompanying chart depicts New Constructs' findings for 50 publicly traded Tennessee companies. Eastman Chemical (EMN), Mueller Industries (MLI), and Louisiana Pacific (LPX) show the highest reward with the lowest risk, and consequently receive the very best ranking. These companies display rising economic profits and low stock valuations, and meet or outperform the S&P 500 and Russell 1000 in every factor contributing to their ranking. For example, the S&P 500 index return on invested capital is 13%, but LPX earns a 20% return.

Companies listed as attractive tend to show positive economic profits (meaning the company's return on invested capital is greater than the weighted average cost of capital) but suffer from a low ranking in one of the other criterion. Eight Tennessee companies received attractive rankings. Among them is Dollar General (DG), who despite healthy returns on invested capital and above average economic profits, is hobbled by a slightly below average free cash flow.

Nearly another third of Tennessee's companies fall into the neutral category. Neutral companies tend to be companies with rich valuations that also report healthy economic earnings.

One-third of Tennessee companies are ranked dangerous or very dangerous. (Trainer says Tennessee's stocks are valued in line with all U.S. stocks overall.) He attributes the high volume of dangerous picks to a relatively sustained bull market that has driven many stock prices high, and conditioned investors to be lazy with research and careless regarding risk. Stocks with the dangerous warning generally have high valuations and poor performance in three or more of the criterion.

More often than not, New Constructs' picks differ from Wall Streets' picks. Memphis-based FedEx (FDX) is one example. GAAP reporting commends FedEx's $29.4 billion in revenue with $4.72 earnings per share in 2005. Brokers like Legg Mason and Merrill Lynch rate FDX as a buy. Yet, New Constructs digs deeper and warns about FedEx, citing that at such a high stock price, (it's 52-week range ending June 4, 2006, was $ 76.81-$120.01) and low return on invested capital of 6%, FedEx has a dangerous risk/reward ratio.

Trainer admits the New Constructs system can sometimes be deceptive. For example, negative free cash flow might indicate that a company has more investment opportunities than it can fund with cash from operations, rather than poor business health. It can also be complicated. The investing business is very competitive and therefore challenging. Consistently making good investment decisions is a tall challenge for even the smartest investors. Trainer says as appealing as it may be, the idea that anyone can make money in the market is terribly misleading and untrue. In fact, the large majority of professional money managers underperform passively directed index funds.

A final warning is in order. New Constructs' stock picks are intended for investors, not speculators–people who sell or buy stock depending on the short-term price prediction. Those looking for the rocket ship stock that will make them rich quick need not bother with New Constructs' system. The firm's stock picks offer the greatest gain with the least risk over a long period of time. Individual investors must at all times be aware of all the risks associated with the stock market, making sure to consider not just risk/reward but also competition, strategy, etc.

Trainer, whose first book titled *Decoding Wall Street Propaganda* is due out in 2007, calls his work "a truth serum for the market." When Trainer applied his serum to Tennessee, he found three of the 20 best stock picks nationally in LPX, MLI and EMN. Given New Constructs' proven success in the wake of distressing corporate scandals, Wall Street is beginning to heed Trainer's war cry. Maybe Tennessee investors would be smart to listen too. **tn**

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