MarketWatch

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Push and a shovel

Money manager hits pay dirt by digging deep into company reports

By Chuck Jaffe, MarketWatch

BOSTON (MarketWatch) -- While not "The Da Vinci Code," the obscure footnotes of a company's financial statements hold information that David Trainer swears will tell you if a stock is worth buying or selling.

He has the record to prove it. Trainer, president of New Constructs, a Nashville-based independent research firm, uses an intensely bottom-up approach to analyze stocks. Each month, from the 3,000 stocks his staff dives into, New Constructs produces a list of the 25 most attractive and most dangerous.

If you bought the 25 most attractive each month and sold short the 25 most dangerous dating back to April 2006, your long/short strategy would be up 63%. That doesn't just beat the market, it kills it -- topping the Standard & Poor's 500-stock index's (INDEX:SPX) return over the same period by 86 percentage points.

Trainer's research process and dedication to rooting out what he calls the "truth" about a company's numbers is why he is part of a series of columns I am writing focused on interviews with outstanding money managers.

Straight and narrow

Trainer's philosophy is straightforward: "The economics of the business is what investors should care about, not the accounting," he said.

"Accounting rules were actually not designed for equity investors," Trainer added. "They were designed for debt investors, so when you trust the financial statements on their face -- if you trust the net income number or you trust the cash flow statement number -- ... you are getting a very small piece of the overall picture with respect to the financial performance of the business."

Beware managers bearing new funds

Bruce Berkowitz of the Fairholme Fund may be one of the best stock-fund managers around, but that doesn't mean investors should jump into his new bond fund, says MarketWatch Senior Columnist Chuck Jaffe.

Trainer digs to determine the economics of a business, looking for "everything that helps you understand how much cash flow the company is generating based on how much cash flow was invested in the business."

He frequently finds that good companies are bad stocks, improperly valued with what New Constructs labels "misleading earnings." That's where a company cites rising profits in its accounting, while the underlying figures Trainer's research show that economic earnings in fact are moving in the other direction.

Couple an inflated stock valuation with misleading earnings, and you have a stock that's a candidate for New Construct's "most dangerous" list. Of the stocks on that list for this month -- and you can get free downloads of lists that are three months old or older at www.newconstructs.com -- Trainer said Red Hat Inc. (NYSE:RHT) may be the epitome of the kind of trouble stocks that his research weeds out.

"That's a company whose stock price implies that their profits will be 400% greater, and we show in our model that it would take them more than 100 years of profit growth to actually realize what is embedded into the value of the stock already," Trainer said. "They show their accounting earnings rose by $2 million last year, even though we show that their economic earnings fell by $10 million."

Another dangerous stock is Sprint Nextel Corp. (NYSE:S) , which has been bouncing on and off the danger list for months, coming off whenever its price falls (so that its valuation improves). Now it's on the list.

Said Trainer about the stock: "The economics of the business have been horrendous for a long time, and the valuation is already pricing in profit growth for more than we can see -- our model says for more than 100 years, which just means forget about it, it's over the top -- and the economics of the business just don't support [uninterrupted profit growth for the next century].

Appealing prospects

On the flip side, two stocks from the most-attractive list include Dish Network Corp. (NASDAQ:DISH) and McDonald's Corp. (NYSE:MCD) .

Dish has a valuation that "implies that its profits are going to be 30% lower than they currently are ... forever, perpetually ... while we see that their profits are very strong and rising," Trainer said.

McDonald's, he noted, is a stock with very low risk of being crushed by current market conditions. "No growth expectation is baked into the stock price and we believe the competitive position and the economics are very strong," he said. "If the market catches up to where we believe the profitability actually is, it could go up quite a bit."

Trainer's research isn't foolproof. His system sometimes produces a clunker or a stock that the market can sustain or depress despite all of the obvious signs. Part of the problem, Trainer said, is that corporations can hide a lot of information in footnotes and statements.

"In the last 10 years, corporations, auditors and Wall Street in many ways conspired together to try and make the financial statement, the accounting statement, do what they need [the numbers] to do, which is to help them sell stock," Trainer said. "Just like any salesman, you're going to put your best foot forward always, you're going to focus on the positives instead of the negatives, and so the accounting statements are essentially a sales tool."

He added: "We make it our goal in life to go through and gather all of the relevant financial information in all the statements ... The income statement, the balance sheet, the cash-flow statement, even the statement of shareholder's equity, where they are burying some important details with respect to preferred stock that they don't want you to see."

The research also can reveal industries where there are opportunities. The most attractive list favors energy and oil stocks and pharmaceuticals, including Chevron Corp. (NYSE:CVX) , Diamond Offshore Drilling (NYSE:DO) , and VAALCO Energy (NYSE:EGY) on the energy side, and Bristol-Myers Squibb Co. (NYSE:BMY) , AmerisourceBergen (NYSE:ABC) , Cubist Pharmaceuticals Inc. (NASDAQ:CBST) and Questcor Pharmaceuticals Inc. (NASDAQ:QCOR) on the biotech/pharma front.

Yet neither industry is a slam dunk, Trainer said. The dangerous stocks list included Allscripts-Misys Healthcare Solutions (NASDAQ:MDRX) and Northeast Utilities (NYSE:NU) .

"So much of the propaganda machine with respect to investing is trying to get you to start with a supposition [such as energy and pharma being hot industries]," Trainer said. "It's just not that simple."