Money & Investing

The Footnote Fanatic

Elizabeth MacDonald, 01.09.06

By obsessing over data buried in corners of corporate financial reports, onetime auditor David Trainer has come up with some surprising calls on stock buys and sells.

To David Trainer, financial statement footnotes are "the decoder key to unlocking a company's true value." But to some companies, true value is best hidden. And thus he was not very popular on bubble-era Wall Street.

When analyst Trainer pushed employer Credit Suisse First Boston to build a huge database to ferret out hidden problems in stocks, he got in big trouble. CSFB investment bankers were furious, he says, when he used the data to brand clients as sells, thus potentially undermining deals. "Information I was digging up wrecked their accounting ratios, like some phony price-to-cash-ratio [the investment bankers] made up," says Trainer, an intense fellow who vehemently jabs the air while he talks. The firm fired him in 2000.

Then Trainer hopped to San Francisco investment bank Epoch Partners, where he again made enemies, by slamming such then beloved names as Web-services outfit LoudCloud and telecom gear maker JDS Uniphase. He viewed their made-up earnings numbers, called "pro forma" profits, as funky. Management wanted him to stop talking about discounted cash flow analysis based on footnote data and focus instead on price-to-sales. What kind of accounting is that, he wanted to know, where you ignore expenses?

He clearly was not suited to sell-side financial analysis. So when Goldman Sachs bought Epoch in 2001, Trainer gladly took a severance package. He spent six months out of work, doing volunteer jobs for a Presbyterian church in New York.

"I expected to retire from Wall Street after a long and fruitful career," says Trainer, now 33. "But I came away really disappointed with what a sham it was."

Then a foul wave of corporate scandals started to build. Money managers like Stephen Waite, then with Trilogy Partners, pressed him to supply footnote-centric research. Trainer, a onetime auditor for now defunct accounting giant Arthur Andersen, had found his proper place. In July 2002 he started New Constructs out of his New York City apartment, and in February 2003 Trainer moved his stock research service to his home city of Nashville. He set up shop in an old tobacco-drying barn in the rolling hills outside town, near a Civil War battlefield. His high school buddy and fellow accounting geek Oman Sloan joined him, and they now paw through data from 3,500 public companies. Today Trainer oversees a squad of 12 footnote excavators, who compile research he sells to 40 Wall Street investment houses, mutual funds and hedge funds, including Janus Capital and Fidelity Investments.

Post-Enron, it's boom time for analysts who can poke through financial statements looking for holes. Alert for Wall Street's blind spots are such operators as Howard Schilit at the Center for Financial Research & Analysis, Donn Vickrey at Gradient Analytics and Jack T. Ciesielski at the Analyst's Accounting Observer newsletter.

New Constructs warns its clients away from companies that have a history of heavy use of stock options (which used to be omitted from employee compensation expense), serial charge-offs, off-balance-sheet financing or badly funded pension plans. "Before people break the rules, they bend the rules," says Trainer. In other words, you should stay away from companies that strain to boost earnings, even if all their gimmicks are legal.

Making a living as a pure short-seller is hard, so Trainer's firm also looks for stocks to recommend. These are typically firms with a bad earnings report or two that nonetheless exhibit such markers of underlying strength as sustained cash from operations, a healthy balance sheet and (during good quarters) a high return on invested capital. The last compares profit before interest expense with the sum of debt and equity capital.

Trainer likes aerospace manufacturer Precision Castparts despite its $1.7 million loss in the March 2005 fiscal year. His reasoning: The baby boom of commercial aircraft that entered the world fleet between 1998 and 2001 is just entering its first round of replacements and fixes. Meanwhile, the company is unloading less profitable business lines, like pumps and valves. Despite the loss, Precision showed a fiscal 2005 free cash flow (cash from operations minus capital expenditures) of $301 million, nearly triple its fiscal 2004 result.

What bad stuff has Trainer's footnote decoder ring discovered? That Flextronics International, the Singapore maker of Microsoft's Xbox hardware and Sony-Ericsson's cell phones, has fallen deep into a stock option hole. Aftertax stock option costs equal 16% of its $340 million in fiscal 2005 net income. And Flextronics can't get a grip on its six-year restructuring plan, blaming "a global economic downturn." Further, Trainer says the company has been a serial charger, with $686 million in aftertax writeoffs since 1999, 9.6% of net assets. It also overpaid for five acquisitions, issuing $6.1 billion above book value in shares to do these deals. While Flextronics insists its acquisitions were "tremendously strategic," it doesn't break out the revenue streams from these deals.

Trainer is also dismayed at the unsporting way Flextronics is preparing for new accounting rules taking effect Jan. 1 that force companies to expense stock options against profits. In early 2005 Flextronics accelerated the vesting of a big chunk of options, avoiding a painful future smack to earnings of $121 million.

That's not all: Flextronics lent $9.5 million to several executives. (They still owed $1.8 million as of March 2005.)

For Trainer another miscreant is weapons-and-ammo maker Alliant Techsystems, which is saddled with $595 million in unfunded employee retirement obligations (two-thirds of it in unfunded pensions), equal to 20% of its $3 billion in reported net assets. For its part, Alliant says it has been trying for the last two fiscal years to close its unfunded pension gap, chucking a total $147 million in cash into its pension plan.

Great, says Trainer, but this has depleted Alliant's cash stash. The footnotes tell him to sell.

New Constructs' Picks and Pans

Delving into companies' documents reveals all kinds of underlying weaknesses and strengths.

Company/Industry	Recent Price	P/E	52-week high	Rationale
BUYS Accounting geek David Trainer recommends these three stocks.				
Medtronic/medical equipment	$56.76	37	$57.95	solid return on capital, strong free cash
Precision Castparts/aerospace & defense	50.56	23	53.91	smart moves boost return on invested capital
Seagate Technology/computer storage devices	19.33	10	21.50	improving return on invested capital, profits
SELLS Trainer says unload these stocks.				
Alliant Techsystems/aerospace & defense	75.70	16	78.29	unwieldy retiree costs
Flextronics International/semiconductors	10.69	26	14.79	stock option addict, serial charger
Xilinx/semiconductors	27.54	33	32.30	free cash dropped,

serial charger

Prices as of Dec 14. Sources: New Constructs; FT Interactive Data & Reuters via FactSet Research Systems.