New Constructs Rates Top Hedge Fund Holdings

Each quarter, the SEC requires institutional investment managers to disclose their holdings through a Form 13-F. These forms reveal exactly what many of the largest hedge funds and institutions have purchased or sold over the past three months.

We've taken the 10 companies most widely held by investment managers as of 12/31/14 and analyzed their 10-Ks with our proprietary technology and models. This analysis allows us to get a clear picture of each company using all of the information from their 10-Ks — even things found only in the MD&A and footnotes sections. This is something no other company does.

Surprisingly, some of the top holdings are highly overvalued companies that have made the news recently. Don't get caught following money managers who buy bad stocks.

However, there are a few gems in here that certainly warrant their large hedge fund stakes.

Note: This list excludes American Airlines (AAL), which is not under our coverage at this time.

#1: A Money Machine? — Apple (AAPL)

Number one on our list is no surprise — the largest and one of the most profitable companies on the planet, Apple. It has been said that Apple's stock is the key reason that hedge fund returns are still in positive territory, and the stock finds its way into 82 of the top 10 holdings of the largest hedge funds with an average holding weight of 8%. But does that mean that you should own AAPL?

Since Apple released its iPhone in 2007, the company's profits have been on a tear. Apple's after-tax operating profit (NOPAT) has increased by a remarkable 43% compounded annually. And while the company's return on invested capital (ROIC) topped out at 338% in 2011, it has declined to a still-impressive 177% today, Revenue has increased every year since 2002, topping out at 66% growth in 2011 but slowing to just 7% in 2014. Accordingly, most of Apple's decline in NOPAT is a result of its declining margins due to competition from companies like Samsung and Microsoft (MSFT).

Apple has more than enough excess cash ($152 billion) to cover its total debt ($39 billion) and reinvest in its business. Best of all is the fact that the company has grown into its once-lofty valuation — at its current price of $131/share, AAPL has a price to economic book value (PEBV) ratio of just under 1.2. This means that the market expects Apple to grow NOPAT by no more than 20% over the rest of the company's lifetime. This seems pessimistic for a company with the brand, resources, and momentum of Apple. If Apple's after-tax margins fall to 15% and if it can grow profits by just 7% compounded annually for the next 12 years, the company is worth $182/share — a 39% upside. As a result of this upside, Apple earns our Attractive rating.

#2: Paying for Growth — Actavis Plc (ACT)

Actavis is the most popular of the many Health Care stocks on this list, and finds itself in the top 10 holdings of 59 of the largest hedge funds with an average weight of 6%. This company has been in the news lately as it is set to acquire Allergan (AGN) the maker of Botox which happens to be next on this list. Hedge funds like acquisition heavy industries as they can lead to short-term stock price increases.

Accordingly, ACT seems to have found its way into hedge fund holdings as a result of this news, not the company's fundamentals. Actavis' NOPAT has grown by just 4% compounded annually since 2009, and NOPAT actually declined by 30% in 2014 due to dramatic increases in expenses. This is reflected in the company's lower after-tax margins of 3%, down from over 6% in 2013. That being said, revenue growth at Actavis remains strong due to the company's acquisition spree. Revenue was up 51% in 2014 and has grown year over year continually since 1998.

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The recipient of this report is directed to read these disclosures.

Cash flow is another story though. As a result of its acquisitions, the company had free cash flow of -$29 billion in 2014, and has had cumulative free cash flow of -$44 billion since 2009. Acquisitions may generate increased operating profits and revenue, but when this is all said and done, what cash is left for the shareholders? We prefer organic growth, and while Actavis increased its research and development spending by 76% in 2014, it is a gamble whether or not these efforts will pay off in the form of a new blockbuster drug. Add the company's $16 billion in total debt and $2.5 billion in deferred taxes to the mix, and it's hard to see when shareholders will be receiving their piece of the pie.

For a multi-billion dollar company that is bleeding cash, Actavis sure is expensive. To justify its current price of $293/share, Actavis must raise its margins to over 7% and grow NOPAT by 43% compounded annually for the next 12 years. At that level, Actavis would be pulling in $490 billion in sales, more than Walmart (WMT) currently earns. This stock is just not worth an investment from a cash flow or valuation perspective, and earns our Dangerous rating. Don't be fooled by management's rhetoric of "growth pharma."

#3: Another Company Gets Acquired — Allergan (AGN)

Allergan is soon to be acquired by Actavis, which would explain why it is number three on this list. Allergan, the maker of the increasingly popular Botox, is in the top 10 holdings of 56 of the top hedge funds with an average portfolio weight of 7%.

Allergan has an impressive history of profitability thanks to the increasing number of applications for Botox since 2000. The company also has an impressive portfolio of cosmetic pharmaceutical products that have propelled the company's NOPAT growth at a rate of 19% compounded annually since 2001. Allergan's after-tax margins have been on the upswing as well, rising from 10% to 25% since 2001. Although the company had a few expensive acquisitions in 2006 and 2007, its cumulative free cash slow stands at $3.5 billion since 2002. Its free cash flow of $1.4 billion in 2014 would have helped it pay off its $2.4 billion in debt in the coming years.

Unfortunately this great company will be off the table in the coming months as Actavis finalizes its acquisition. Despite the great fundamentals the company was not necessarily a great stock. As the acquisition bidding war with Valeant last summer drove up the company's price to $233/share, the company's price to economic book value ratio reached 3.0, a number that normally would imply that the market expected Allergan to triple its profits into the future.

At a cheaper price, this company would have made a good addition to any investor's portfolio, but the same lesson applies to Actavis, which appears to be paying too much for Allergan. At a purchase price of $66 billion, the ROIC from this acquisition, based on Allergan's 2014 NOPAT, is under 3%. While this is above Actavis' 2014 ROIC of 1%, it is below the company's five-year weighted average ROIC of 3% and hardly a good ROIC in its own right. Good companies can be bad stocks and when Allergan became so overvalued, it quickly became a bad stock to own. Actavis ultimately paid the price for this bidding war-fueled valuation.

#4: What Will They Do Next? — Facebook (FB)

As a relatively new company to the stock market, it is somewhat of a surprise to see Facebook as high as number 4 on this list. Nevertheless, Facebook is found in the top 10 holdings of 41 hedge funds with an average portfolio weight of 7%. Since going public in 2012, Facebook stock has delivered an impressive return of 108%. But what kind of investment is FB going forward?

Facebook has done an excellent job monetizing its user base, and the company's NOPAT has grown from $1.1 billion in 2012 to over $3 billion in 2014 while its after-tax margins have risen to 24% from under 22% in 2012. Facebook had just over 1 billion monthly active users in 2012, a number that increased to 1.4 billion in 2014. Not only is Facebook increasing in popularity, but it is also becoming a better-run business.

That last point may be true as Facebook currently boasts a 24% ROIC — but some recent business decisions have left many investors scratching their heads despite Facebook's $11 billion in excess cash and low debt. A big question pertains to the $19 billion deal for messaging app WhatsApp and the $2 billion deal for Oculus VR, a virtual reality gaming company. WhatsApp, which reportedly hit 700 million users earlier this year, lost around $233 million for Facebook in the first half of 2014. While there are certainly opportunities for growth and

diversification in both of these companies, one must wonder if over $21 billion was the right price. As a result of these purchases, Facebook's cumulative free cash flow since 2012 is -$19 billion.

Investors are certainly paying a premium for all of this growth and risk. At its current price of $78/share, FB has a PEBV ratio of over 4.8. To justify its current price, Facebook must grow NOPAT by 14% compounded annually for the next 19 years. These are lofty expectations for a company in an industry prone to sudden shifts and only two years of profitability. Facebook's expensive valuation relative to its risk earns it our Dangerous rating.

#5: A Well Run Pharmaceutical Company — Medtronic (MDT)

Medtronic, a healthcare solutions company specializing in cardiac, vascular, restorative, and diabetes products is a bit different from other large medical companies. Over the past few years, Medtronic has transitioned into a steady but slow growth company that incrementally improves its operations to increase profits. It's likely that Medtronic found its way onto this list as a result of its recent $43 billion acquisition of medical device maker Covidien (COV). Medtronic is found in the top 10 holdings of 39 hedge funds with an average weight of 7%.

Over the past five years, Medtronic has grown revenues and NOPAT by 3% compounded annually. The company's ROIC sits at 14% and has been stable since 2005. Medtronic has delivered positive economic earnings every year since 2003, and over the past few years has been growing its free cash flow, which was $5 billion in 2014.

This steady growth in NOPAT coupled with a strong ROIC position Medtronic well going forward. In an industry that is constantly seeing acquisitions, the company's strong free cash flow is also a plus. Unlike Valeant, Medtronic has made strategic acquisitions that create long-term value, and with the purchase of Covidien in January, we believe Medtronic can turn this deal into another successful acquisition that will add value to its current product base. Another positive is the potential tax advantage of the deal that Medtronic could take advantage of by moving its headquarters to Ireland.

Medtronic is not likely going to blow investors away with growth numbers and some could argue it is fairly valued in at current prices. At its current price of ~$79/share, Medtronic has a PEBV ratio of 1.3, which implies that the market expects Medtronic to grow profits by 30% going forward., That being said, Medtronic has proven its ability to grow NOPAT over the long term and it is certainly possible that Medtronic will exceed this expectation, especially given the widespread M&A activity in the sector. MDT isn't cheap, but it isn't especially expensive either.

If we give Medtronic credit for 3% compounded annual NOPAT growth for the next decade, the stock is fairly priced today. Any increased growth due to the Covidien acquisition or greater cost controls, however, could provide further upside to this stock. With little downside risk, strong fundamentals, and a fair valuation, Medtronic earns our Attractive rating.

#6: Value Destruction Continues — Valeant Pharmaceuticals (VRX)

Valeant Pharmaceuticals (VRX) has been in the news quite a bit over the past few years, mainly due to its failed attempt at acquiring Allergan but also because of its 22 acquisitions over the past three years. VRX is in the top 10 holdings of 38 hedge funds with an average weight of 8%, matched only by AAPL in this respect.

Valeant was not deterred by the Allergan setback though, and the acquisition spree has continued into 2015 with the recent announcement that Valeant will acquire Salix Pharmaceuticals for $14.5 billion. We've noted before how Valeant's touted acquisition strategy is flawed and if history repeats itself, the acquisition of Salix will provide short-term gain at the expense of long-term value creation.

Since 2009, Valeant has increased its invested capital from $2 billion to nearly $27 billion. NOPAT, however, has not grown at nearly the same pace — just 3% compounded annually. As a result, Valeant's ROIC has fallen from 15% in 2009, to just 4% today. The acquisition-only business model Valeant claims is creating value has actually been doing the exact opposite for five years. As more money is invested into Valeant's business, it creates incrementally less profit each time.

Even more worrisome is how Valeant is funding this value destruction. With its most recent acquisition, the company is funding the purchase through bonds and credit, bringing its long-term debt to $30 billion, right around

half of its market cap. Valeant has also had negative free cash flow since 2009, further hampering any growth or efforts to pay down debt.

Despite poor capital allocation and value-destroying actions, Valeant's showy strategy has continued to prop up its stock price. To justify its current price of $202/share, Valeant must grow NOPAT by 31% compounded annually for the next 10 years.. Hedge fund owners may hold Valeant for its headline-friendly growth strategy, but for investors that can't afford to get burned Valeant's track record of value destruction and numerous red flags earn it our Dangerous rating.

#7: Trust in Buffet? Not So Fast — Liberty Global (LBTYA)

Liberty Global, provider of video, broadband internet, and mobile services across Europe, Chile, and Puerto Rico recently made headlines when it was disclosed that Warren Buffett's Berkshire Hathaway had taken a stake in the company. LBTYA jumped in popularity, and how finds itself in the top 10 holdings of 34 hedge funds with an average weight of 7%.

Many think this may be a case of Mr. Buffett finding yet another undervalued company, especially after poor 4Q14 results caused the stock to take a hit, but a closer look raises some concerns. While the company has been growing NOPAT at an impressive pace over the last few years, there are cracks beneath the surface.

In 2014, Liberty Global earned an ROIC of only 5%, below its weighted average cost of capital (WACC) of 7%. Such a low ROIC is nothing new for Liberty Global, and the company has generated negative economic earnings every year since 2005. Liberty Global has also had negative free cash flow every year since 2005 and currently holds $48 billion in total debt, which represents 100% of its market cap.

While Warren Buffett is widely considered one of the greatest investors in history, and we often times agree with his investment decisions, we aren't sure what he sees in Liberty Global. Including the fundamental issues above, the company is vastly overvalued. To justify its current price of ~54/share, Liberty Global would have to grow NOPAT by 13% compounded annually for the next 10 years while maintaining its current 15% pre-tax margins. These margins are already down from the 20% achieved in 2012, and the telecom industry is known to be facing margin pressures. Liberty Global is one top holding that you should avoid, and the stock earns our Dangerous rating.

#8: Has the Turnaround Run its Course? — American International Group (AIG)

American International Group (AIG) may be better known for its downfall in during 2008 than anything that has occurred after that point. 2014 was a mixed bag for the company, and despite being one of the top holdings of hedge fund managers; there is no clear path to future growth for this company. AIG is in the top 10 holdings of 32 hedge funds with an average weight of 7%.

Prior to 2014, AIG had returned to profitability levels last seen in 2007. The company's NOPAT had grown from a loss of -$81 billion in 2008, to a profit of $8 billion in 2013. Similarly, AIG had increased its ROIC to 6% last year, up from -56% in 2008. Along with this turnaround of massive proportions, the stock price is up over 500% from the lows of 2009. 2014, however, did not continue this excellent turnaround, and now may be a good time to review your position.

In 2014, NOPAT declined 22% year over year, ROIC fell to 4%, and revenue declined 6%. Free cash flow remained negative along with economic earnings. As such, AIG currently earns our Neutral rating. The company obviously still believes it can continue growing and executing on the excellent turnaround from the 2008 doldrums, but we feel that AIG may have run its course for now. At its current price of ~$55/share, the company is neither over or undervalued. As such, there is not much upside in the stock price.

American International Group currently has a PEBV ratio of 1.3. This ratio implies the market expects AIG to grow NOPAT by 30% over the life of the business. This growth won't happen overnight, but barring a drastic setback such as 2008, this seems achievable over many years of consistent NOPAT growth. If AIG can grow NOPAT by 6% compounded annually for the next 10 years, the stock is worth $61/share today — an 11% upside. With little upside to be had, and a shaky 2014 in the books, now may be the time to take profits in AIG.

#9: An American Icon Awakens — General Motors (GM)

It was a rough year for General Motors after numerous recalls hit the company, but it weathered the storm better than most expected and delivered a solid 2014. However, the stock price did not agree, as it tumbled a total of 15% last year. With 31 hedge funds putting GM in their top 10 at an average weight of 7%, many hedge fund managers think now may be the time to own GM — and we agree. GM earns our Attractive rating.

General Motors' GAAP net income for 2014 doesn't tell the full story. Non-recurring items lowered net income and masked the true cash flows of the business. In 2014, General Motors recorded over $7 billion non-operating expenses and bundled these into operating expenses. These included charges due to the recalls, as well as a $400 million expense due to Venezuelan currency devaluation. Removing these items and calculating General Motors' NOPAT reveals General Motors' true, recurring cash flows and provides investors with a better picture of the economics of the company.

General Motors has grown NOPAT by 40% compounded annually since 2012. The company currently has a 12% ROIC, which is up from 6% in 2012. General Motors is proving its ability to reinvigorate its business and provide products that consumers want to drive, with Consumer Reports' top picks for best large car and sports sedans in 2015. General Motors ended 2014 with over $2.2 billion in free cash flow and positive economic earnings.

In 2014, General Motors issued recalls which totaled $2.9 billion in costs, which was one of the main reasons for the stock price decline throughout 2014. If the recall issues are in the past, and General Motors focuses on becoming proactive not reactive, 2015 could be a much different story. With new models of the Chevrolet Silverado and Chevrolet Colorado (the Motor Trend truck of the year) being released, General Motors is poised for a great 2015

At its current price of ~$38/share, General Motors has a PEBV ratio of 0.9, which implies that the market expects the company's NOPAT to permanently decline by 10%. If General Motors can grow NOPAT by just 6% compounded annually for the next seven years, the stock is worth $53/share — a 39% upside. If GM can grow NOPAT by even more, the stock price has even greater upside.

#10: From Rebel to Mature Cash Machine — Microsoft (MSFT)

Microsoft has maintained its a long history of growing profits, even if they're not growing at the breakneck pace they once were. The new Microsoft that has consistently grown at a steady pace could provide great upside, which is why we're not surprised to see it on this list. MSFT is in the top 10 holdings of 31 hedge funds with an average weight of 6%.

Microsoft has grown NOPAT by 8% compounded annually over the last five years. The company currently has a 55% ROIC which is beyond impressive for a company that is entering its fifth decade. As we mentioned above, Microsoft is no longer the high-growth stock it once was, but is now a company that consistently produces profits while incrementally improving its business operations. In 2014, Microsoft grew revenues by 12% over 2013 and generated $14 billion in free cash flow. While allowing for more free software, services, and monetization of add-ons will be difficult, CEO Satya Nadella is off to a great start in his turnaround efforts, and the future looks bright at Microsoft.

At the moment the market is undervaluing MSFT, and the stock earns our Very Attractive rating. Microsoft has long been shifting to become a more stable company, and as this shift continues, investors should give MSFT a serious look. At its current price of ~$44/share, Microsoft has a PEBV ratio of 1.0, which implies that the market expects Microsoft's NOPAT to never grow again.

If Microsoft can grow NOPAT by just 7% compounded annually for the next eight years, the stock is worth $68/share — a 54% upside. Coupled that potential upside with the near 3% dividend yield and its clear why Microsoft is a great addition to anyone's portfolio and earns our Attractive rating.

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2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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