# The Value Of Transparency: Why Methodology Matters

Disagreement makes markets. Every time you buy a stock, someone on the other side has to be selling it. You're making a bet that the stock is going to outperform in the future; the other person is betting that it will underperform.

This point seems obvious, but it's one that investors forget time and time again when they try to chase "sure things." Many ignored this fact when they fell for Bernie Madoff's Ponzi scheme. They forgot it when they chased highflying stocks like Twitter, LinkedIn, or Valeant (and many others). Any investment that seems too good to be true probably is.

Chuck Jaffe of MoneyLife and MarketWatch.com made an excellent point on this topic in his recent article, "Here's One Stock Market Tip You Really Want to Follow."

"On the MoneyLife show, money managers spend the bulk of their time discussing methodology and markets before moving to which stocks pass or fail their personal tests," Jaffe writes. "In the end, however, what most people remember is the simple buy-sell-hold recommendation."

That's a problem, Jaffe argues, because he often gets different money managers taking opposite opinions on the same stock. These are (presumably) sophisticated investors, with similar styles, who have taken a deep look at the same stocks and come to opposite conclusions. For every very smart investor that believes a security is undervalued, there's usually another smart person with their own reasons to believe that it's overvalued.

Recently we faced off against another analyst over Valeant Pharmaceuticals (VRX). The other analyst put more emphasis on the company's stated numbers, leading him to call it a good buy. We reiterated our position that VRX has questionable accounting and its business model destroys shareholder value.

Investors couldn't just look at the headline to make their decision; they had to dig into the logic and methodology of each argument to decide who they thought was right (given VRX's 50% drop this week, we think that was us).

Not only that, but on some occasions both sides could be right! A risk-averse analyst with a shorter timeframe might see significant challenges for the company in the coming years and want to sell. A more opportunistic analyst with a longer horizon could see a cheap valuation and long-term growth opportunity. Neither one is wrong, they just have different criteria.

### Take A Look Underneath The Hood

For this reason, investors always need to dig deeper than looking at a simple "buy" or "sell". Sometimes, these ratings can be driven by factors that have nothing to do with markets or fundamentals. On other occasions, the argument might sound convincing but completely crumble when you examine some of the underlying assumptions.

Even if the call looks accurate at the time, markets and the economy change constantly. For instance, let's say an analyst rates a company a buy due to the fact that he or she believes it has pricing power, so you buy the stock. Now, if the company tries to raise prices and starts losing market share, you know that the underlying thesis does not hold up and you should sell right away. This is important, because analysts generally aren't going to tell you when their calls go wrong.

In addition, almost any call will be impacted by developments in other parts of the economy. It's possible for analysts to be absolutely right on stock-specific issues but to miss on a more macro level.

We have firsthand experience in this area. In 2012, we put Goodyear Tires (GT) in the Danger Zone. Given that the company had never earned an economic profit in any year we had data for (going back to 1998), had significant pension liabilities, and little history of growth, the call seemed eminently reasonable at the time.

What we didn't predict was the complete rout in commodities that would decrease the price of rubber by almost 80%. This price decline helped boost GT's margins to record levels and gave it the cash flow it needed to make up the gap in its pension funding and justify a valuation significantly higher than we anticipated.

We wrote back then that GT needed to grow after-tax profit (NOPAT) by 4% compounded annually for 10 years in order to justify its valuation of $10.16/share, a target we didn't think was likely given that the company's NOPAT had actually declined since 1998.

Instead, the major decrease to one of its primary costs helped GT's NOPAT grow by 18% compounded annually since our article. This major profit growth has allowed it to justify a valuation of ~$33/share today.

**Transparency Makes For More Informed Investors**

Why are we writing about a sell call we made that went over 200% in the opposite direction? Because it's important for investors to remember that nobody has all the answers. We believe our methodology helps investors identify fundamentally undervalued and overvalued companies—and the data bears that out—but we still get calls wrong from time to time.

That's one of the primary reasons why we put such a big emphasis on transparency. It's why we do things like:

- Give definitions and formulas for all the metrics we use
- Explain the adjustments we make to close accounting loopholes
- Show our calculations for the different factors that comprise our stock ratings
- Include links to our DCF models in all our long and short calls

We want investors to understand our underlying methods and assumptions so they can analyze our findings, try to poke holes in our arguments, and make informed decisions about whether to follow our recommendations.

Ultimately, our commitment to transparency comes from the confidence we have in our research. Our analysts digging through thousands of filings to create models that reflect the underlying economics of the thousands of stocks we cover, and we want people to be able to see the fruits of their labor.

Compare this level of transparency with some of the other major providers of equity research out there:

- Morningstar's explanation of how they calculate the fair value of a stock just says, "It is the Morningstar analyst's estimate of what the stock is worth."
- Zacks provides a lot of material on their Education tab, but their methodology ultimately comes down to just buying stocks with rising earnings estimates, and they provide little fundamental research.
- Sell-side analyst price targets usually come from assigning a seemingly arbitrary multiple to earnings forecasts that have repeatedly been proven unreliable.

A lot of the work these analysts do can actually be valuable. Unfortunately, the lack of transparency makes it difficult for investors to analyze these research reports and form their own opinions. This leads to the situation Jaffe described where investors have learned to just pay attention to buy-sell-hold ratings rather than dig into methodology.

We don't want investors to just blindly buy our top-ranked stocks. Instead, we want to help them become more sophisticated by providing the data, tools, and frameworks they need to succeed.

*Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.*

## *New Constructs® – Profile*

### *How New Constructs Creates Value for Clients*

We find it. You benefit. Cutting-edge technology enables us to scale our forensics accounting expertise across 3000+ stocks. We shine a light in the dark corners of SEC filings so our clients can make safer, more informed decisions.
Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?
ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

The drivers of our forward-looking fund ratings are Portfolio Management (i.e. the aggregated ratings of its holdings) and Total Annual Costs. The Total Annual Costs Rating (details here) captures the all-in cost of being in a fund over a 3-year holding period, the average period for all fund investors.

### *Our Philosophy About Research*

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

### *Additional Information*

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