New Stocks on Most Attractive/Most Dangerous: June 2016

Recap from May Picks

Our Most Attractive Stocks (+0.9%) underperformed the S&P 500 (+2.2%) last month. Most Attractive Large Cap stock United Therapeutics (UTHR) gained 10% and Most Attractive Small Cap stock American Axle & Manufacturing (AXL) was up 12%. Overall, 17 out of the 40 Most Attractive stocks outperformed the S&P 500 in May and 24 had positive returns.

Our Most Dangerous Stocks (+2.4%) underperformed the S&P 500 (+2.2%) last month. Most Dangerous Large Cap stock Norwegian Cruise Line (NCLH) fell by 6% and Most Dangerous Small Cap Stock Marchex Inc. (MCHX) fell by 18%. Overall, 17 out of the 40 Most Dangerous stocks outperformed the S&P 500 in May.

The successes of the Most Attractive and Most Dangerous stocks highlight the value of our forensic accounting. Being a true value investor is an increasingly difficult, if not impossible, task considering the amount of data contained in the ever-longer annual reports. By analyzing key details in these SEC filings, our research protects investors' portfolios and allows our clients to execute value-investing strategies with more confidence and integrity.

19 new stocks make our Most Attractive list this month and 28 new stocks fall onto the Most Dangerous list this month. June's Most Attractive and Most Dangerous stocks were made available to members on June 2, 2016.

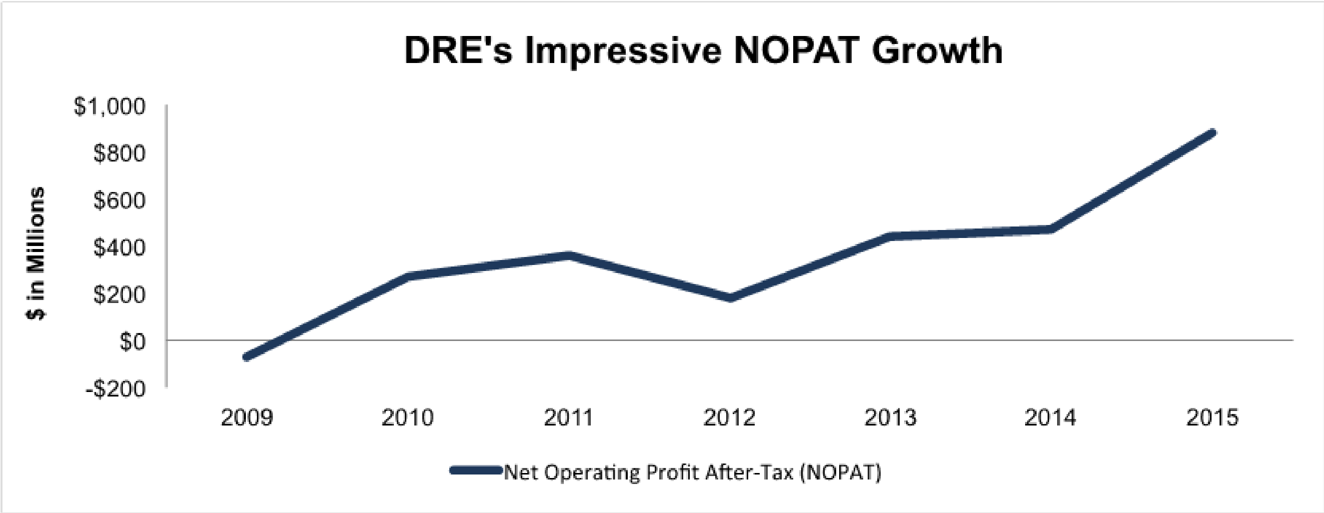
Our Most Attractive stocks have high and rising return on invested capital (ROIC) and low price to economic book value ratios. Most Dangerous stocks have misleading earnings and long growth appreciation periods implied by their market valuations.

Most Attractive Stock Feature for June: Duke Realty (DRE: $24/share)

Duke Realty (DRE), commercial real estate investor, is one of the additions to our Most Attractive stocks for June.

Duke Realty has recovered from the 2008/2009 economic crisis quite impressively. Since 2009, DRE has grown after-tax profit (NOPAT) from -$74 million to $884 million in 2015. Over the past five years, DRE has grown NOPAT by 26% compounded annually. See Figure 1.

Figure 1: DRE NOPAT Growth Since 2009



Sources: New Constructs, LLC and company filings

Duke Realty's return on invested capital (ROIC) has improved from -1% in 2009 to 12% over the last twelve months. Further highlighting the profitability of DRE's business over the long-term, 2009 was the only year in which the company earned a negative ROIC.

Impacts Of Footnotes Adjustments And Forensic Accounting

In order to derive the true recurring cash flows, an accurate invested capital, and an accurate shareholder value, we made the following adjustments to Duke Realty's 2015 10-K:

Income Statement: we made $288 million of adjustments, with a net effect of removing $272 million in non-operating expenses (29% of revenue). We removed $8 million in non-operating income and $280 million in non-operating expenses. You can see all the adjustments made to DRE's income statement here.

Balance Sheet: we made $521 million of adjustments to calculate invested capital with a net increase of $483 million. One of the largest adjustments was $110 million due to operating leases. This adjustment represented 2% of reported net assets. You can see all the adjustments made to DRE's balance sheet here.

Valuation: we made $3.5 billion of adjustments with a net effect of decreasing shareholder value by $3.5 billion. There were no adjustments that increased shareholder value. The largest adjustment was the removal of $3.5 billion in adjusted total debt, which includes $110 million in off-balance sheet debt. This adjustment represents 42% of Duke Realty's market cap. Despite the decrease in shareholder value, DRE remains undervalued.

Current Valuation Provides Upside Opportunity

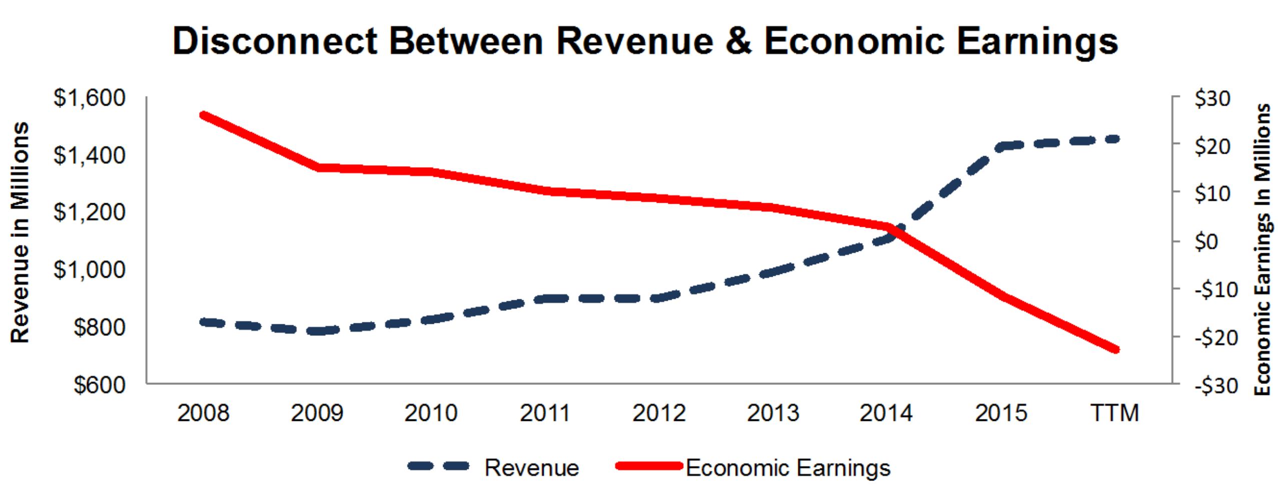
Duke Realty's share price has increased 80% over the past five years. Despite this impressive performance, opportunity for upside still exists, as shares remain undervalued. At its current price of $24/share, DRE has a price-to-economic book value (PEBV) of 0.9. This ratio means that the market expects DRE's NOPAT to permanently decline by 10%. This expectation seems low given the NOPAT growth DRE has achieved since 2009. If the company can grow NOPAT by just 2% compounded annually for the next decade, the stock is worth $31/share today – a 29% upside.

Most Dangerous Stock Feature: Matthews International (MATW: $55/share)

Matthews International (MATW), a memorialization and industrial product provider, is one of the additions to our Most Dangerous stocks for June.

Matthews International has grown revenue by 8% compounded annually from 2008-2015. Over this time, Matthews' economic earnings, the true cash flows, have fallen from $26 million to -$12 million. Over the most recent twelve months, economic earnings have fallen further to -$23 million. Figure 2 has the details.

Figure 2: Revenue Doesn't Equate To Profits



Sources: New Constructs, LLC and company filings

Apart from growing losses, Matthews' ROIC has fallen from 12% in 2008 to only 5% over the last twelve months. Additionally, over the past five years, Matthew's has burned through a cumulative -$802 million in free cash flow.

Forensic Accounting Reveals Overstated EPS

In order to derive the true recurring cash flows, an accurate invested capital, and a real shareholder value, we made the following adjustments to Matthews International's 2015 10-K:

Income Statement: we made $133 million of adjustments with a net impact of removing $46 million in non-operating expenses (3% of revenue). We removed $89 million in non-operating expenses and $44 million in non-operating income. You can see all the adjustments made to MATW's income statement here.

Balance Sheet: we made $422 million of adjustments to calculate invested capital with a net increase of $56 million. The largest adjustment was $150 million related to other comprehensive income. This adjustment represented 8% of reported net assets. You can see all the adjustments made to MATW's balance sheet here.

Valuation: we made $1.2 billion of adjustments with a net effect of decreasing shareholder value by $1.2 billion. One adjustment increased shareholder value by $13 million. All other adjustments decreased shareholder value. Apart from debt, the largest adjustment was the removal of $124 million in net deferred tax liabilities. This adjustment represents 7% of Matthews' market cap.

Valuation Implies Unrealistic Growth

Despite the issues above, the market has priced MATW for significant profit growth in the future. To justify its current price of $55/share, MATW must grow NOPAT by 11% compounded annually for the next 14 years. This expectation is nearly quadruple the NOPAT CAGR achieved by Matthews since 2008 and seems too optimistic.

Even if Matthews can grow NOPAT by just 5% compounded annually for the next decade, the stock is still worth only $25/share today – a 55% downside.

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Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, 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 forensic 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.

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