New Stocks on Most Attractive/Most Dangerous: August 2016

Recap from July Picks

Our Most Attractive Stocks (+4.6) outperformed the S&P 500 (+3.5%) last month. Most Attractive Large Cap stock VMware Inc. (VMW) gained 25% and Most Attractive Small Cap stock American Axle & Manufacturing (AXL) was up 21%. Overall, 25 out of the 40 Most Attractive stocks outperformed the S&P 500 in July.

Our Most Dangerous Stocks (+6.2%) underperformed the S&P 500 (+3.5%) last month. Most Dangerous Large Cap stock Hartford Financial Services (HIG) fell by 6% and Most Dangerous Small Cap Stock Almost Family (AFAM) fell by 10%. Overall, 14 out of the 40 Most Dangerous stocks outperformed the S&P 500 in July.

The successes of the Most Attractive and Most Dangerous stocks highlight the value of our forensic accounting as featured in Barron's. 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.

13 new stocks make our Most Attractive list this month and 14 new stocks fall onto the Most Dangerous list this month. August's Most Attractive and Most Dangerous stocks were made available to members on August 3, 2016.

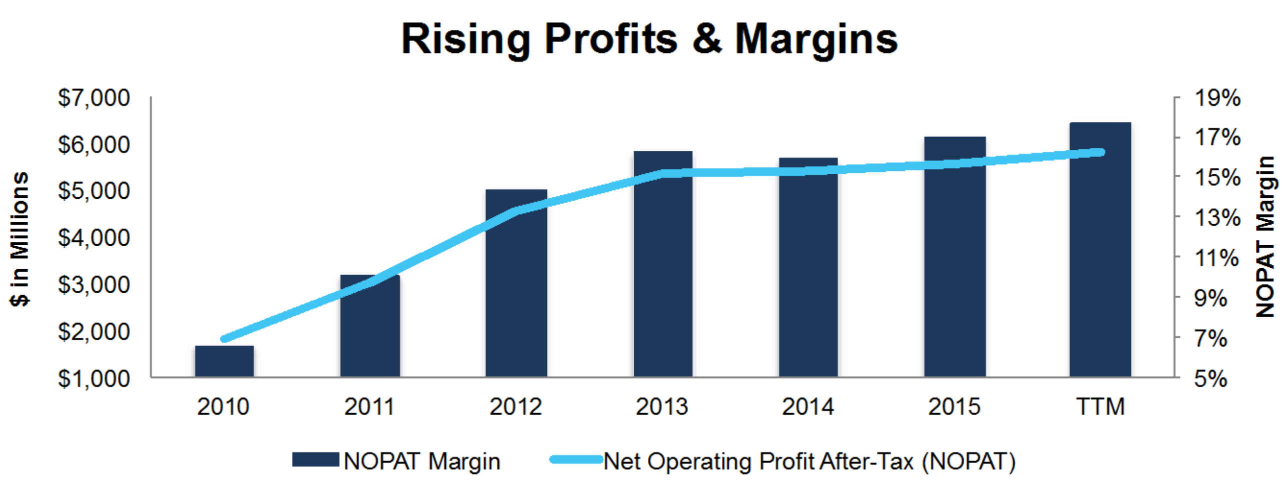
Our Most Attractive stocks have high and rising return on invested capital (ROIC) and low price to economic book value ratios. Most Dangerous stocks have misleading earnings and long growth appreciation periods implied by their market valuations.

Most Attractive Stock Feature for August: American Express (AXP: $65/share)

American Express (AXP), global credit card provider, is one of the additions to our Most Attractive stocks for August. We've previously detailed a strategy that could boost AXP's value by $50 billion.

Since 2010, American Express has grown after-tax profit (NOPAT) by 25% compounded annually to $5.5 billion in 2015. Over the past twelve months (TTM), NOPAT has grown to $5.8 billion. AXP's NOPAT margin has improved from 7% in 2010 to 18% TTM, per Figure 1.

Figure 1: American Express' Improving Margins & Profit



Sources: New Constructs, LLC and company filings

Further testament to fundamental strength of AXP's business, the company has improved its return on invested capital (ROIC) from 11% in 2005 to 14% TTM and generated cumulative $16.6 billion in free cash flow over the past five years.

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 American Express' 2015 10-K:

Income Statement: we made $733 million of adjustments, with a net effect of removing $495 million in non-operating expenses (2% of revenue). We removed $119 million in non-operating income and $614 million in non-operating expenses. You can see all the adjustments made to AXP's income statement here.

Balance Sheet: we made $7.5 billion of adjustments to calculate invested capital with a net increase of $2.5 billion. One of the largest adjustments was $2.7 billion due to other comprehensive income. This adjustment represented 7% of reported net assets. You can see all the adjustments made to AXP's balance sheet here.

Valuation: we made $2 billion of adjustments with a net effect of decreasing shareholder value by $2 billion. There were no adjustments that increased shareholder value. The largest adjustment was the removal of $1.1 billion in off-balance-sheet operating leases. This adjustment represents 2% of American Express' market cap. Despite the decrease in shareholder value, AXP remains undervalued.

Current Valuation Implies Permanent Profit Decline

AXP is down around 6% on the year and its share price is significantly undervalued. At its current price of $65/share, AXP has a price-to-economic book value (PEBV) ratio of 0.8. This ratio means the market expects AXP's NOPAT to permanently decline by 20%. This expectation seems overly pessimistic given American Express' long history of profit growth.

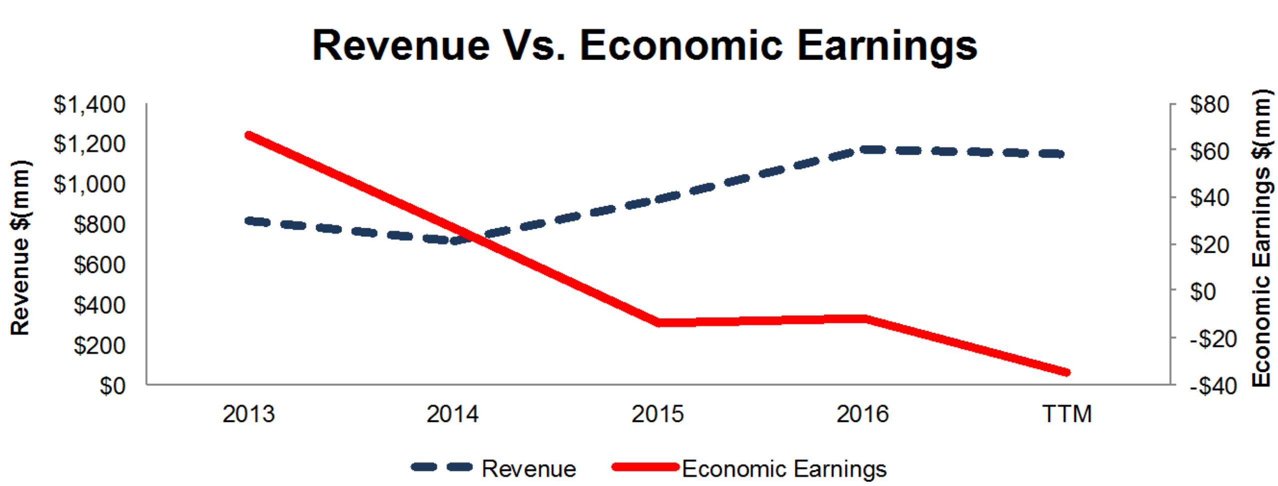
If American Express can grow NOPAT by just 3% compounded annually for the next decade, the stock is worth $94/share today – a 45% upside.

Most Dangerous Stock Feature: Cirrus Logic (CRUS: $51/share)

Cirrus Logic (CRUS), specialized semiconductor provider, is one of the additions to our Most Dangerous stocks for August.

Cirrus Logic has grown revenue by 13% compounded annually from 2013-2016. Over this same time, Cirrus Logic's economic earnings, the true cash flows of the business, have declined from $66 million to -$11 million in 2016, or -56% compounded annually. Economic earnings have fallen even further, to -$35 million, over the last twelve months, per Figure 2.

Figure 1: CRUS's Growing Losses



Sources: New Constructs, LLC and company filings

In addition to increasing losses, since 2013, Cirrus' ROIC has fallen from 20% to 8% TTM. Furthermore, Cirrus Logic has burned through cumulative $244 million in free cash flow over the past five years.

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 Cirrus Logic's 2016 10-K:

Income Statement: we made $37 million of adjustments with a net impact of removing $4 million in non-operating income (<1% of revenue). We removed $16 million in non-operating expenses and $21 million in non-operating income. You can see all the adjustments made to CRUS's income statement here.

Balance Sheet: we made $837 million of adjustments to calculate invested capital with a net increase of $213 million. The largest adjustment was $457 million related to asset write-downs. This adjustment represented 43% of reported net assets. You can see all the adjustments made to CRUS's balance sheet here.

Valuation: we made $479 million of adjustments with a net effect of decreasing shareholder value by $113 million. The largest adjustment was the removal of $72 million in outstanding employee stock options. This adjustment represents 2% of Cirrus' market cap.

High Expectations Already Baked Into Valuation

Despite the clear deterioration of CRUS' fundamentals, the stock is priced for significant profit growth long into the future. To justify its current price of $51/share, CRUS must grow NOPAT by 15% compounded annually for the next 15 years. In this scenario, Cirrus Logic would be generating nearly $10 billion in revenue 15 years from now, nearly equal to that of MasterCard's (MA) 2015 revenue and $1.5 billion greater than eBay's (EBAY) 2015 revenue.

On the other hand, even if CRUS can grow NOPAT by 10% compounded annually for the next decade, the stock is worth only $29/share today – a 43% 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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