New Stocks on Exec Comp Aligned With ROIC Model Portfolio: September 2016

Two new stocks make our Exec Comp Aligned With ROIC Model Portfolio this month. September's Exec Comp Aligned With ROIC Model Portfolio was made available to members on September 15, 2016.

Recap from August Picks

Our Exec Comp Aligned With ROIC Model Portfolio (+0.7%) outperformed the S&P 500 (-2.3%) last month. The best performing stock in the portfolio was Francesca's Holdings (FRAN), which was up 8%. Overall, 10 out of the 15 Exec Comp Aligned With ROIC Stocks outperformed the S&P in August.

The success of the Exec Comp Aligned With ROIC Model Portfolio highlights the value of our forensic accounting (featured in Barron's). Return on invested capital (ROIC) is the primary driver of shareholder value creation. By analyzing key details in SEC filings, we are able to calculate an accurate and comparable ROIC for 3000+ companies under coverage.

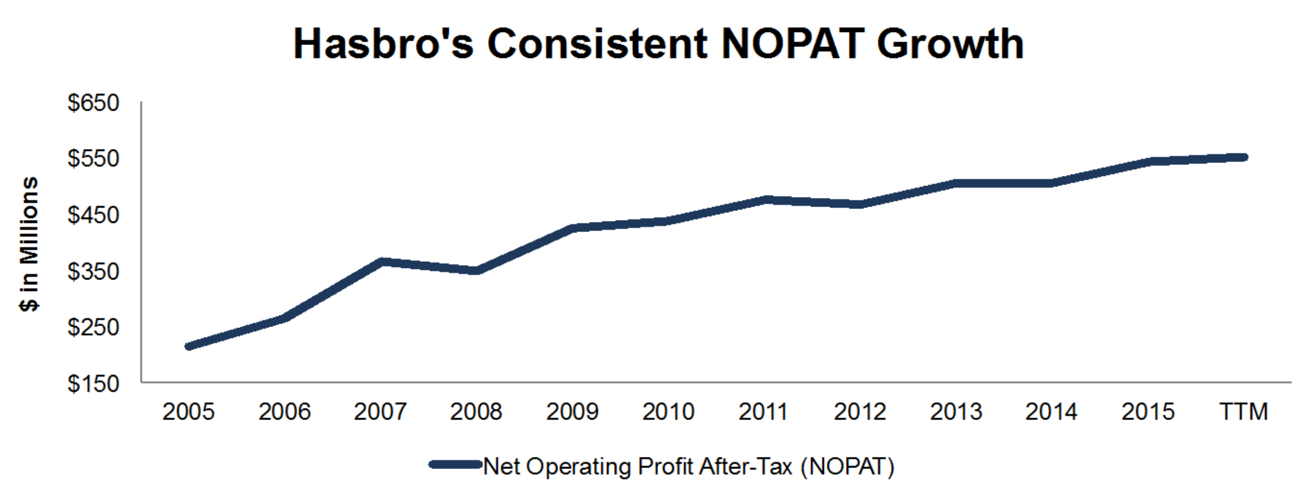
This Model Portfolio only includes stocks that earn an Attractive or Very Attractive rating and align executive compensation with improving ROIC. We think this combination provides a uniquely well-screened list of long ideas.

New Stock Feature for September: Hasbro Inc. (HAS: $77/share)

Hasbro Inc. (HAS), global toy and game manufacturer, is one of the additions to our Exec Comp Aligned With ROIC Model Portfolio in September.

Over the past decade, Hasbro has grown after-tax profit (NOPAT) by 10% compounded annually to $542 million in 2015 and $552 million over the last twelve months (TTM), per Figure 1. At the same time, Hasbro has improved its NOPAT margin from 7% in 2005 to 12% TTM and generated a cumulative $2.1 billion in free cash flow (FCF) over the past five years.

Figure 1: NOPAT Growth Over Past Decade

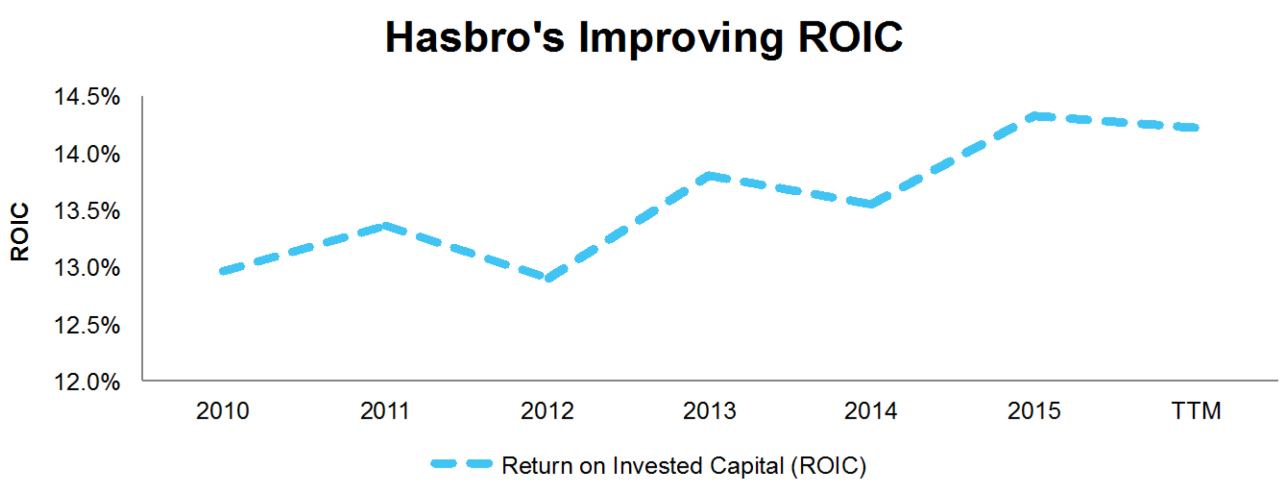


Sources: New Constructs, LLC and company filings

Executive Compensation Aligned with ROIC Creates Shareholder Value

Improving ROIC is directly correlated with creating shareholder value and Hasbro added ROIC to its executive compensation plan in 2015. Despite the focus on ROIC being new, Hasbro's ROIC has improved from 13% in 2010 to 14% TTM, per Figure 1. Long-term, Hasbro's ROIC has improved from 7% in 1999 to 14% TTM.

Figure 2: Executive Compensation Aligned with ROIC



Sources: New Constructs, LLC and company filings

Beginning in 2015, ROIC was added as a metric that determined Hasbro executive's long-term performance share awards, which make up 50% of long-term incentive compensation. ROIC is weighted at 33% of performance metrics and was initially added based on feedback received from Hasbro shareholders. The other metrics upon which performance share awards are based are EPS and revenue. Investors should see less risk and more upside in stocks where management incentives focus on ROIC and avoid questionable non-GAAP metrics.

Despite Price Increase, Shares Remain Undervalued

Despite Hasbro's share price increasing 17% year-to-date, its shares remain undervalued. At its current price of $77/share, HAS has a price-to-economic book value (PEBV) ratio of 1.3. This ratio means the market expects Hasbro's NOPAT to grow by only 30% over the remainder of its corporate life. This expectation seems pessimistic for a company that has grown profits by 10% compounded annually over the past decade.

If Hasbro can maintain 2015 NOPAT margins (12%) and grow NOPAT by just 6% compounded annually for the next decade, the stock is worth $90/share today – a 17% upside. Coupled with Hasbro's nearly 3% dividend yield, this stock provides a great low risk/high reward opportunity. This scenario also assumes Hasbro's spending on working capital and fixed assets will be 3% of revenue, which is the average change in invested capital as a percent of revenue over the past decade.

Impacts of Footnotes Adjustments and Forensic Accounting

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

Income Statement: we made $204 million of adjustments with a net effect of removing $91 million in non-operating expenses (2% of revenue). We removed $147 million related to non-operating expenses and $57 million related to non-operating income. See all adjustments made to HAS's income statement here.

Balance Sheet: we made $2.3 billion of adjustments to calculate invested capital with a net increase of $131 million. The most notable adjustment was $432 million (12% of net assets) related to asset write-downs. See all adjustments to HAS's balance sheet here.

Valuation: we made $2.6 billion of adjustments with a net effect of decreasing shareholder value by $1.2 billion. The largest adjustment to shareholder value was the removal of $1.7 billion in total debt, which includes $115 million in off balance sheet operating leases. This lease adjustment represents 1% of Hasbro's market value. Despite the net decrease in shareholder value, HAS remains undervalued.

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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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