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

Three new stocks make our Exec Comp Aligned With ROIC Model Portfolio this month. October's Exec Comp Aligned With ROIC Model Portfolio was made available to members on October 14, 2016.

Recap from September's Picks

Our Exec Comp Aligned With ROIC Model Portfolio (+1.8%) outperformed the S&P 500 (-0.4%) last month. The best performing stock in the portfolio was Southwest Airlines (LUV), which was up 8%. Overall, nine out of the 15 Exec Comp Aligned With ROIC Stocks outperformed the S&P in September.

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 footnotes in SEC filings, we are able to calculate an accurate and comparable ROIC for 3000+ companies under coverage.

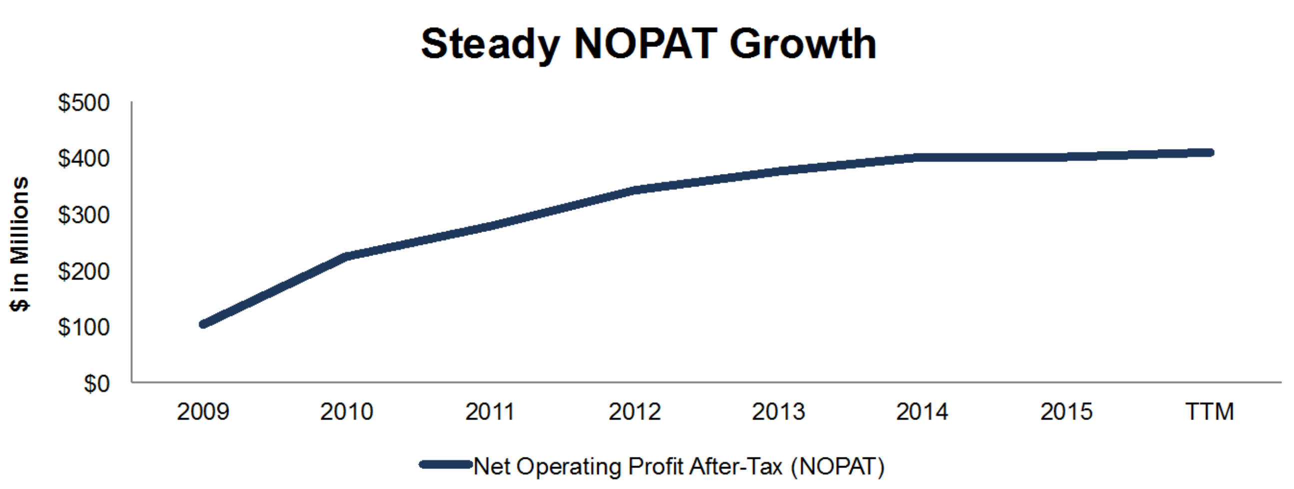
This Model Portfolio only includes stocks that earn an Attractive or Very Attractive rating and align executive compensation with improving ROIC. We think this combination provides a uniquely well-screened list of long ideas.

New Stock Feature for October: Tenneco Inc. (TEN: $55/share)

Tenneco Inc. (TEN), automotive parts manufacturer, is one of the additions to our Exec Comp Aligned With ROIC Model Portfolio in October.

Since 2009, Tenneco has grown after-tax profit (NOPAT) by 25% compounded annually to $403 million in 2015 and $411 million over the last twelve months (TTM), per Figure 1. At the same time, Tenneco has improved its NOPAT margin from 2% in 2009 to 5% TTM and generated a cumulative $888 million in free cash flow over the past five years.

Figure 1: Tenneco's NOPAT Growth Since 2009



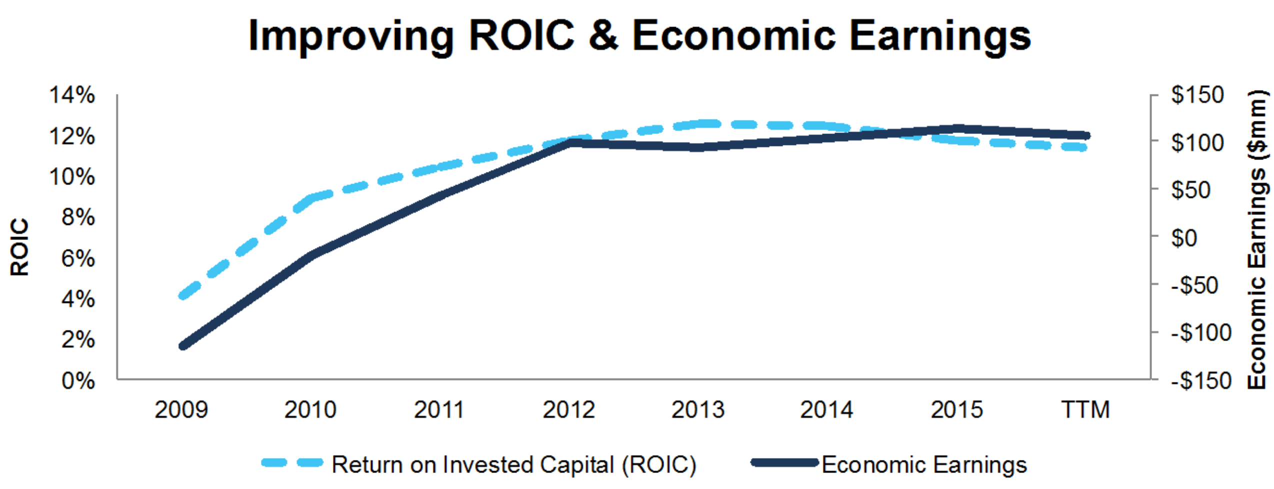
Sources: New Constructs, LLC and company filings

Executive Compensation Aligned With ROIC Creates Shareholder Value

Tenneco has aligned executive compensation with the principles of Economic Value Added (EVA), aka economic earnings, since at least 1997, which is the earliest available electronic filing. While economic earnings have held steady in recent years, Tenneco has improved economic earnings from -$115 million in 2009 to $105 million TTM. ROIC has risen from 4% in 2009 to 11% TTM over the same time.

Important Disclosure Information is contained on the last page of this report.
The recipient of this report is directed to read these disclosures.

Figure 2: Tenneco's ROIC & Economic Earnings Improvement Since 2009



Sources: New Constructs, LLC and company filings

Improving ROIC is directly correlated with creating shareholder value, and Tenneco's focus on EVA ensures that executive's interests are properly aligned with shareholders' interests. 75% of Tenneco's annual cash bonuses are tied to EVA improvement and Tenneco states it uses this approach because "EVA improvement performance is correlated with stockholder returns." Per Figure 1, we see that linking executive compensation to economic earnings has resulted in improved economic earnings. Investors should see less risk and more upside in stocks where management incentives focus on economic earnings (aka EVA), the primary driver of which is ROIC.

TEN Is Significantly Undervalued

Despite the focus on EVA, the improving business fundamentals, and the stock price rising nearly 19% year-to-date, TEN remains significantly undervalued. At its current price of $55/share TEN has a price-to-economic-book value (PEBV) ratio of 1.0. This ratio means the market expects Tenneco's NOPAT to never grow over the remainder of its corporate life. This expectation seems rather pessimistic for a firm that has grown NOPAT by 10% compounded annually since 1999.

If Tenneco can maintain TTM NOPAT margins (4.9%) and grow NOPAT by just 5% compounded annually for the next decade, the stock is worth $75/share today – a 36% upside. This scenario assumes Tenneco's spending on working capital and fixed assets will be 1% 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 Tenneco's 2015 10-K:

Income Statement: we made $348 million of adjustments with a net effect of removing $156 million in non-operating expenses (2% of revenue). We removed $252 million related to non-operating expenses and $96 million related to non-operating income. See all adjustments made to TEN's income statement here.

Balance Sheet: we made $1.8 billion of adjustments to calculate invested capital with a net increase of $1.3 billion. The most notable adjustment was $665 million (31% of net assets) related to other comprehensive income. See all adjustments to TEN's balance sheet here.

Valuation: we made $1.9 billion of adjustments with a net effect of decreasing shareholder value by $1.9 billion. A notable adjustment to shareholder value was the removal of $323 million due to pension-funded status. This lease adjustment represents 10% of Tenneco's market value. Despite the net decrease in shareholder value, TEN remains undervalued.

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Disclosure: David Trainer, Kyle Guske II, and Kyle Martone receive no compensation to write about any specific stock, style, or theme.

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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.

Additional Information

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