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

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

Recap from October's Picks

Our Exec Comp Aligned With ROIC Model Portfolio (+4.0%) outperformed the S&P 500 (+1.5%) last month. The best performing stock in the portfolio was Harley-Davidson (HOG), which was up 19%. Overall, 10 out of the 15 Exec Comp Aligned With ROIC Stocks outperformed the S&P in October.

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.

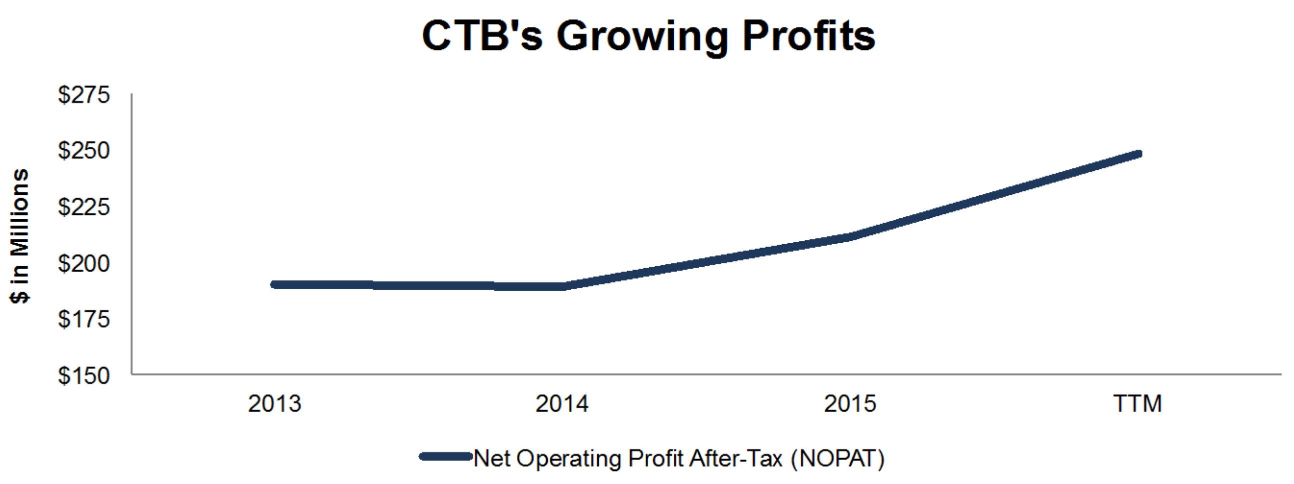
This Model Portfolio only includes stocks that earn an Attractive or Very Attractive rating and align executive compensation with improving ROIC. We think this combination provides a uniquely well-screened list of long ideas.

New Stock Feature for November Cooper Tire & Rubber Company (CTB: $37/share)

Cooper Tire & Rubber Company (CTB), automobile tire manufacturer, is one of the additions to our Exec Comp Aligned With ROIC Model Portfolio in November.

Since 2013, Cooper Tire has grown after-tax profit (NOPAT) by 5% compounded annually to $211 million in 2015 and $248 million over the last twelve months (TTM), per Figure 1. Over the long-term, CTB has grown NOPAT by 13% compounded annually over the past decade. Additionally, CTB has improved its NOPAT margin from 5.5% in 2013 to 8.5% TTM and generated a cumulative $1.1 billion in free cash flow over the past five years.

Figure 1: NOPAT Growth Since 2013

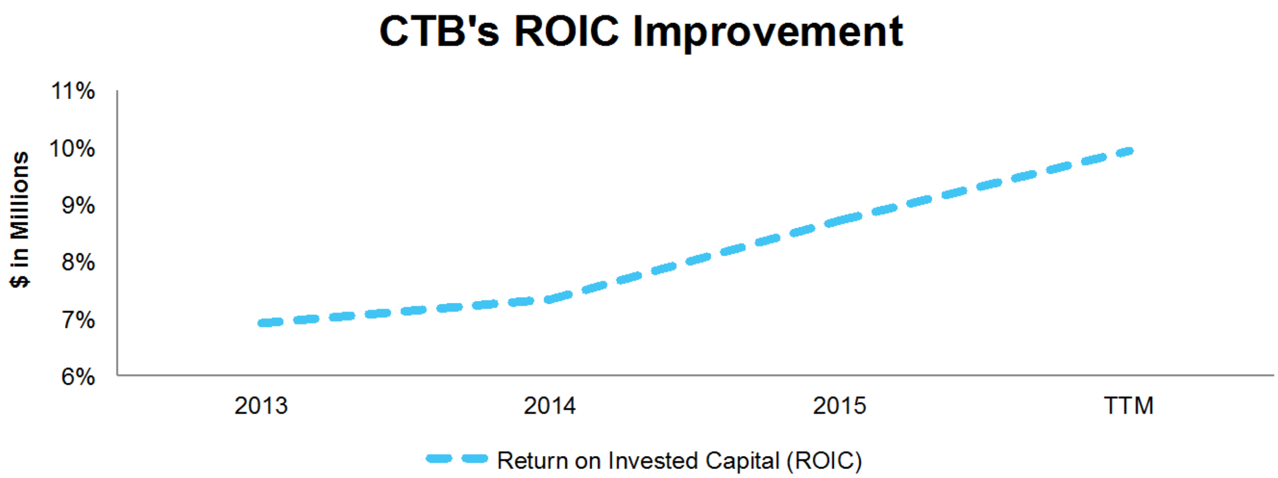


Sources: New Constructs, LLC and company filings

Executive Compensation Aligned With ROIC Creates Shareholder Value

Cooper Tire added ROIC to its executive compensation plan in 2000 and the compensation committee determined the company's ROIC correlates to changes in shareholder value, a finding we've discussed in detail here. Since 2013, CTB's ROIC has improved form 7% to 10% TTM, per Figure 2. Long-term, Cooper Tire's ROIC has improved from 3% in 2005 to 10% TTM.

Figure 2: ROIC Improvement Tied To Shareholder Value Creation



Sources: New Constructs, LLC and company filings

In 2015, ROIC was weighted at 20% of long-term incentive compensation, which includes restricted stock units, performance based stock units, and performance based cash. Net income is the other metric used to determine long-term incentive awards. Investors should see less risk and more upside in stocks where management incentivizes focus on ROIC and avoids questionable non-GAAP metrics.

Despite Price Increase, CTB Remains Undervalued

Despite Cooper Tire's share price increasing 21% over the past six months, shares remain significantly undervalued. At its current price of $37/share, CTB has a price-to-economic book value (PEBV) ratio of 0.7. This ratio means the market expects CTB's NOPAT to permanently decline by 30%. Such low expectations seem pessimistic given CTB's ability to grow NOPAT over the past decade.

If Cooper Tire can achieve 6% NOPAT margins (5 year average, but below 9% TTM) and grow NOPAT by just 3% compounded annually for the next decade, the stock is worth $46/share today – a 24% upside. This scenario assumes Cooper Tire's spending on working capital and fixed assets will be 2% of revenue, which is the average change in invested capital as a percent of revenue over the past decade. Coupled with CTB's 1% dividend yield, this stock provides a great low risk/ high reward opportunity.

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 Cooper Tire's 2015 10-K:

Income Statement: we made $290 million of adjustments with a net effect of removing $2 million in non-operating income (<1% of revenue). We removed $144 million related to non-operating expenses and $146 million related to non-operating income. See all adjustments made to CTB's income statement here.

Balance Sheet: we made $1.4 billion of adjustments to calculate invested capital with a net increase of $419 million. The most notable adjustment was $517 million (26% of reported net assets) related to other comprehensive income. See all adjustments to CTB's balance sheet here.

Valuation: we made $1.3 billion of adjustments with a net effect of decreasing shareholder value by $693 million. The most notable adjustment to shareholder value was the removal of $571 million due to pension-funded status. This adjustment represents 29% of Cooper Tire's market value. Despite the net decrease in shareholder value, CTB 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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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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