Top Stocks & Model Portfolios From 2016

Our Long Idea reports aim to identify those firms that the market has overlooked and that when analyzed beyond standard metrics, are significantly undervalued. These hidden gems provide excellent upside potential to any portfolio, with little downside risk.

In addition to individual Long Ideas, we provide Model Portfolios that provide well-screened lists of companies based on specific criteria such as return on invested capital (ROIC) or dividend yield. In 2016, we added two new Model Portfolios, Exec Comp Aligned With ROIC and Safest Dividend Yields, to go along with our longstanding Most Attractive & Most Dangerous Stocks Model Portfolio, which has a long history of outperformance.

Below presents the Long Idea highlights of 2016 and the performance of our new Model Portfolios.

Long Idea Highlights

It pays to read our Long Idea reports. In 2016, 10 out of our 15 Long Idea stock and mutual fund picks saw positive returns and 13 stocks outperformed the market (S&P 500). All told, the Long Idea stocks averaged a 9.9% return in 2016, which was slightly more than the S&P 500's return of nearly 9.5%, thereby outperforming as a long portfolio. Some of the top picks can be seen in Figure 1 below.

Figure 1: Top Stock Picks 2016

Publish Date	Company	Ticker	Performance Since Publish	S&P Since Publish Date	Outperformance Vs. S&P
6/23/16	Thor Industries	THO	51%	6%	45%
7/21/16	Morgan Stanley	MS	46%	3%	43%
3/16/16	American Express	AXP	24%	10%	14%
7/22/16	Lear Corp	LEA	17%	3%	14%
7/14/16	Southwest Airlines	LUV	15%	3%	12%
9/7/16	Ply Gem Holdings	PGEM	14%	2%	12%
10/5/16	National Research Corp	NRCIB	7%	4%	3%
9/23/16	Amerisafe Inc.	AMSF	6%	3%	2%

Sources: New Constructs, LLC

As 2016 is now in the rear view, we'd like to highlight a few of the many examples in which our Long Idea reports could have identified winning stock picks.

1. **Thor Industries (THO) – published June 23: up 51% vs. S&P up 6%**

Unlike many firms we place in the Danger Zone, Thor has built a highly profitable business through acquisitions. Thor's NOPAT grew from $17 million in 2009 to $295 million over the last twelve months while its ROIC improved from 3% to 21% over the same time. An unfounded concern over the economy and consumer's willingness to purchase recreational vehicles had put a damper on shares, and THO was significantly undervalued.

However, it would not take long for the market to realize the improvement in the fundamentals of the business and reward THO for creating shareholder value. Just three months after our Long Idea report was published, THO was up 30%. Due to the acquisition of Jayco in July 2016, our rating on THO is suspended until we get more details on how this large acquisition affects the profitability of the firm. Ultimately, THO ended 2016 up 51% since we published our Long Idea report and was up 79% in 2016.

2. **American Express (AXP) – published March 16: Up 24% vs. S&P up 10%**

We analyzed American Express as part of a case study on ROIC and its correlation to shareholder value creation. In our report, we not only noted that AXP was already heavily undervalued, but also outlined specific actions AXP could take to boost its value by upwards of $50 billion. Some of the steps included

- Improve NOPAT margin through cost controls

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The recipient of this report is directed to read these disclosures.

- Improve its best-in-class capital turnover by focusing on collecting receivables more rapidly
- Increase revenue growth through international markets

While these actions could take multiple quarters, or even years to achieve, AXP has already shown improvement in its NOPAT margin, which has grown from 17% in 2015 to 18% TTM. At the same time, American Express had to prove to investors that losing deals with Costco and JetBlue was a minor issue, and not a signal of the brand losing its cache among consumers. Effectively quelling these fears would be key to American Express' profit potential moving forward.

As the year continued, it was clear that investors agreed that AXP was undervalued, as the stock gradually rose throughout the year, and the firm beat Q3 expectations and raised full-year guidance in October 2016. Such positive developments in profits mean American Express still earns our Very Attractive rating, and, despite the price increase, still presents an excellent risk/reward profile. All told, AXP ended 2016 up 24% since our Long Idea was published.

3. **Lear Corp (LEA) – published July 22: Up 17% vs. S&P up 3%**

Lear Corp represented a truly hidden gem in a beaten down industry. Many believed that the automobile industry had reached a top, and that automotive parts suppliers such as Lear Corp had little upside potential. Our analysis showed otherwise. Lear Corp had grown NOPAT from $622 million in 2010 to $1 billion in 2015. It's top-quintile ROIC of 16% was well above the 9% average of the 29 Auto Parts & Equipment companies under coverage, yet its valuation did not garner a premium as one would expect.

Adding to high profitability, Lear Corp's executive compensation plan recognizes the importance of ROIC, as two-thirds of long-term incentive awards are tied to achieving a target ROIC. Better yet, long-term awards make up 52% of CEO pay and 44% of other executives' pay. This compensation plan also led to Lear Corp landing on our initial Exec Comp Aligned With ROIC Model Portfolio in May.

To top off the already compelling thesis, LEA's valuation presented significant upside potential. Its valuation at the time implied that the company's NOPAT would permanently decline by 30% from current levels, and even its economic book value, or no growth value, represented 42% upside.

Investors realized LEA's potential, as the company beat 2Q and 3Q consensus expectations and the stock steadily rose. At the end of 2016, LEA was up 17% since we published our Long Idea report and is up nearly 40% from its February 2016 lows. LEA still earns our Very Attractive rating, and is on January's Most Attractive Stocks list. The combination of excellent profitability and an undervalued share price mean LEA could be a standout holding in 2017.

Model Portfolio Highlights

As noted above, we created two new Model Portfolios in 2016.

The Executive Compensation Aligned With ROIC Model Portfolio identifies undervalued stocks that align executive compensation with ROIC. Aligning executive compensation with ROIC is a clear driver of shareholder value creation. The stocks in this model portfolio are among the best at aligning executive interests with those of shareholders. Since inception, this model portfolio is up 23% while the S&P is up 9%.

The Safest Dividend Yields Model Portfolio identifies undervalued stocks that provide investors with a high quality and safe dividend yield. Not all dividends are created equal. These companies, with strong free cash flow and economic earnings, provide higher quality and safer dividend yields because we know they have the cash to support their dividend. Since inception, this model portfolio is up 8.1% while the S&P is up 5.2%.

These new Model Portfolios join our long-running Most Attractive & Most Dangerous Model Portfolios, which identify the Most Attractive and Most Dangerous stocks in the market each month. Long-term performance results for these Model Portfolios can be seen here.

This article originally published here on January 10, 2017.

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

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