Long Idea Highlights & Lowlights From 2017

Our Long Idea reports aim to identify stocks that the market has overlooked and that, when analyzed with more rigor[1] than provided by tradition financial metrics, offer excellent risk/reward.

It pays to read our Long Idea reports. In 2017, 19 out of our 29 Long Idea picks saw positive returns and 13 outperformed the market (S&P 500).

However, the thesis does not always play out as we expect and, at times, some stocks only get more undervalued.

Below, we present the Long Idea highlights and lowlights.

Long Idea Highlights

1. **Highlight 1: NVR Inc. (NVR) – published April 17 – reiterated November 28: Up 63% vs. S&P up 14%**

When we first featured NVR Inc. as a Long Idea, we felt its shareholder friendly exec comp plan, history of increasing market share, and a rising housing market could propel shares over the long-term. Despite positive catalysts and a strong competitive position, the market had priced NVR for permanent profit decline at the time of writing. NVR had a price-to-economic book value (PEBV) ratio of 0.9. This ratio meant the market expected NVR's after-tax profit (NOPAT) to permanently decline by 10%.

Instead, over the past twelve months NVR has grown NOPAT 27% over the prior trailing twelve months (TTM). TTM NOPAT margin improved to 9% versus 8% in 2016, and its return on invested capital (ROIC) improved 380 basis points over the prior TTM. These impressive results led to multiple earnings beats and a 59% increase in stock price, which caused us to revisit, and reiterate, the idea in late November. At that time, we still found NVR to be undervalued by the market and maintained our Long Idea.

By the end of 2017, NVR increased 63% from the publish date while the S&P rose 14%. The stock still earns an Attractive rating and its strong fundamentals coupled with its valuation land it a spot in the Most Attractive Stocks, Exec Comp Aligned with ROIC, and Focus List – Long Model Portfolios.

2. **Highlight 2: Spirit AeroSystems (SPR) – published June 26 – reiterated September 22: Up 56% vs. S&P up 10%**

Spirit AeroSystems was an underappreciated Industrials stock with strong fundamentals that the market had failed to recognize. Since restructuring in 2013, the company's profitability was on the rise, and its competitive position within the aircraft supplier market was improving. At the time of publishing, we noted that SPR's top-quintile 16% ROIC exceeded its peer average (9%) and the company's balance sheet efficiency, as measured by average invested capital turns (1.8), were more than double its peer average (0.7).

Despite the rising strength in the business' fundamentals, the market undervalued the stock. At the time of publishing, SPR had a PEBV of 0.7. This ratio meant the market expected SPR's NOPAT to permanently decline by 30%. However, this expectation proved too pessimistic. Instead, SPR beat expectations in the past three quarterly earnings reports, and its largest customers, Boeing and Airbus, increased production throughout the year.

After the stock rose 40%, we reiterated SPR as a Long idea because it still presented an attractive risk/reward tradeoff. We found that, despite the increase in price, the stock was still undervalued relative to Industrial peers, and its profitability was still well above industry averages.

SPR ended 2017 up 56% since the publish date while the S&P was up 10%. SPR earns our Attractive rating and a spot in our Focus List – Long Model Portfolio.

[1] Ernst & Young's recent white paper "Getting ROIC Right" proves the superiority of our holdings research and analytics.

3. **Highlight 3: Ross Stores (ROST) – published September 11: Up 35% vs. S&P up 7%**

We first featured Ross Stores in July as one of our "5 Unappreciated Stocks with High ROICs." We followed with a feature as a Long Idea in September with the thesis that it could buck the "failing retail" trend. Despite large box retailers turning in years of disappointing profits, ROST has consistently grown NOPAT since 2007. Better yet, the firm's profit margins were nearly double some competitors (such as Kohl's and Macy's), and its balance sheet efficiency, as measured by invested capital turns, ranked well above industry averages.

Perhaps, most telling of Ross' sustained success was its track record of comparable store sales growth, which at the time of writing spanned 34 consecutive quarters. Since then, Ross continued this consecutive comparable store sales growth.

ROST was not given a premium valuation despite the clear outperformance in a struggling retail market, which created a buying opportunity. At the time of publishing, ROST had a PEBV ratio of 1.1, which implied just 10% NOPAT growth over the remaining life of the firm. Keep in mind ROST has grown NOPAT 16% compounded annually since 2007. This pessimistic expectation, coupled with a potential 5% shareholder yield (dividend plus repurchase yield) made Ross an excellent portfolio addition.

ROST ended the year up 35% since the publish date while the S&P was up 7%. Its continued profit growth and ability to navigate a tough retail environment help it earn a spot in our Focus List – Long Model Portfolio.

Long Idea Lowlights

Below, we highlight Long Idea picks that did not work. Even where we've been wrong, we think our reasoning for featuring these stocks was solid despite their underperformance.

1. **Lowlight 1: Hooker Furniture (HOFT) – published December 6: Down 18% vs. S&P up 2%**

Hooker Furniture exhibited many of the same characteristics of the successful picks above. It has a history of profit growth (33% compounded annually since 2010), an improving ROIC, and margins above its competitors. At the same time, the improving economy seemed to bode well for HOFT's long-term profit growth. More money in consumers' pockets should lead to increased spending on discretionary items such as those sold by HOFT.

In our pick, we noted that upcoming earnings could be a positive catalyst for the firm, but the opposite proved true. Fiscal 3Q18 revenue and earnings, despite both rising year-over-year, missed expectations and the stock fell 20% in the four days following the report. Despite the miss, signs of a strong Black Friday holiday could bode well for future earnings. We've seen before that HOFT can be volatile around earnings releases, and one positive beat could send shares back on an upward trajectory.

HOFT ended 2017 down 18% since publish while the S&P was up 2%. The stock still earns our Attractive rating and shares still look undervalued.

2. **Lowlight 2: Hasbro Inc. (HAS) – published June 5: Down 16% vs. S&P up 10%**

Hasbro started as a promising Long Idea after rising 8% in the six weeks following our Long Idea report. When analyzing the business fundamentals, stock price outperformance did not come as a surprise. The company had more than a decade of profit growth and rising margins, as well as an executive compensation plan tied to improvements in ROIC. The firm's margin and ROIC ranked near the top of its main competitors, and its licensing deal with Disney provided an attractive runway for future profit growth.

However, when HAS reported 2Q17 earnings, the stock fell 9% despite beating on both top and bottom line expectations. The selling would continue when it was reported that Hasbro was calling off merger talks with Lions Gate (LGF.A) and Toys 'R' Us (Hasbro's second largest customer) filed bankruptcy in September. The stock largely traded sideways until it was reported in November that Hasbro was interested in acquiring Mattel (MAT). The stock jumped 6% following the report, but the increase would be short lived.

When we analyzed the potential acquisition, we found that a combined Hasbro/Mattel could provide big profits for investors. The combined firm would have leverage over distributors, larger intellectual property to monetize, and significant cost synergies. With or without the acquisition, we remain confident in Hasbro's future.

All told, the stock ended 2017 down 16% since the publish date while the S&P was up 10%. However, we believe this price decline has only made shares more attractive. The stock finds itself in our Dividend Growth, Exec Comp Aligned with ROIC, and Focus List – Long Model Portfolios.

3. Lowlight 3: Spectrum Brand Holdings (SPB) – published May 15: Down 14% vs. S&P up 11%

Spectrum Brands Holdings, a conglomeration of numerous household products, represented a bet on the growing economy. The company exhibited strong profit growth over the past five years and had improved its ROIC from 6% in 2011 to 8% TTM. The company's profitability, which outranked nearly all competition, allowed the firm flexibility to maintain its share in its many markets while continually growing profits.

Best of all, the firm was expanding its higher margin segments and focusing less on its lower margin Global Batteries segment. At the time of writing, SPB had a PEBV ratio of 0.9, which seemed overly pessimistic given SPB's historical profit growth.

Unfortunately, strong fundamentals would fall short of expectations in fiscal 3Q17, when SPB missed both top and bottom line expectations. The stock fell 12% over the next month. Fiscal 4Q17 results helped, as revenue beat expectations and the stock price would jump 10% the next day. Despite the rebound, SPB still finished 2017 down 14% from publish while the S&P was up 11%.

SPB still earns an Attractive rating, and its 2017 underperformance could be a thing of the past. In January, SPB announced a deal to sell its Global Battery and Lighting business to Energizer Holdings (ENR), and SPB jumped 5% on the news. Moving focus to its fastest growing and highest margin businesses could lead to the long-term profit growth we expected when we first featured SPB in May 2017.

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

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