Filing Season Finds: Week of February 19-24

Our latest featured stock is a credit card company that is improving its profitability even as reported earnings decline.

We pulled this highlight from last week's research of 403 10-K filings, from which our Robo-Analyst technology collected 65,183 data points. Our analyst team used this data to make 10,444 forensic accounting adjustments with a dollar value of $6.9 trillion. The adjustments were applied as follows:

- 4,591 income statement adjustments with a total value of $519 billion
- 4,143 balance sheet adjustments with a total value of $3.4 trillion
- 1,710 valuation adjustments with a total value of $3 trillion

Figure 1: Filing Season Diligence for Week of February 19-24

	Filings Parsed	Data Points Collected	# of Adjustments	Total Value of Adjustments ($Billions)
Filing Season Week 1	403	65,183	10,444	$6,924

Sources: New Constructs, LLC and company filings.

Every year in this six-week stretch from mid-February through the end of March, we parse and analyze roughly 2,000 10-Ks to update our models for companies with a 12/31 fiscal year end. This effort is made possible by the combination of expertly trained human analysts with what we call the "Robo-Analyst." The Robo-Analyst uses machine learning and natural language processing to automate much of the parsing process.

A Fiduciary Level of Diligence

Our technology enables us to deliver fundamental diligence at a previously impossible scale. We believe this research is necessary to fulfill the Fiduciary Duty of Care. Ernst & Young's recent white paper, "Getting ROIC Right", demonstrates how these adjustments contribute to materially superior models and metrics.

Only by reading through the footnotes and making adjustments to reverse accounting distortions can advisors go beyond the suitability standard and provide a fiduciary level of service to their clients.

One Company to Watch in 2018

We featured Discover Financial Services (DFS) as one of five undervalued stocks with high ROICs last summer. The stock is up 32% since that article, but DFS is still undervalued. The company's 10-K, filed at the end of last week and parsed by analyst Lindsay Bohannon, shows that the company is significantly more profitable than its reported income suggests. Based on our findings, we have upgraded DFS from Attractive to Very Attractive.

Discover's GAAP net income declined by 13% in 2017, from $2.34 billion to $2.03 billion. However, its after-tax operating profit (NOPAT) actually increased by 3%, from $2.66 billion to $2.74 billion. Two major items in the footnotes drive this discrepancy.

On page 62, DFS disclosed that it increased its allowance for loan losses by $454 million in 2017. This change in reserves decreases reported income even though it doesn't impact the actual cash flows of the company.

On page 127, DFS disclosed a 5.1% increase to its effective income tax rate due to the revaluation of its deferred tax assets as a result of tax reform. This 5.1% increase comes out to an additional $177 million in non-operating taxes. We made an adjustment for this unusual event to keep DFS's cash tax rate at ~35%, in line with its historical average.

In total, we made the following adjustments to Discover Financial Services' 2017 10-K:

Income Statement: we made $711 million of adjustments, with a net effect of removing $711 million in non-operating expense (6% of revenue). You can see all the adjustments made to DFS's income statement here.

Balance Sheet: we made $3.6 billion of adjustments to calculate invested capital with a net increase of $3.1 billion. In addition to excluding the change in reserves from NOPAT, we also added back the entirety of DFS's $2.6 billion (24% of reported net assets) in loan loss allowances to invested capital. You can see all the adjustments made to DFS's balance sheet here.

Valuation: we made $815 million of adjustments with a net effect of decreasing shareholder value by $815 million. The largest adjustment to shareholder value was $563 million in preferred capital. This adjustment represents 2% DFS's market cap.

After making all these adjustments, we found that Discover's return on invested capital (ROIC) increased from 19.4% to 19.9% in 2017. Even after the big increase in its stock price, DFS still has a price to economic book value (PEBV) of just 0.8, which means the market expects NOPAT to permanently decline by 20%.

An increasing stock price and decreasing GAAP net income sounds like a bad combination, but our research shows that DFS is still increasing its profitability and remains undervalued.

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Disclosure: David Trainer, Lindsay Bohannon, and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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To fulfill the Duty of Care, research should be:

1. **Comprehensive** - All relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including footnotes and the management discussion & analysis (MD&A).
2. **Un-conflicted** - Clients deserve unbiased research.
3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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