Featured Stocks in July's Most Attractive/Most Dangerous Model Portfolios

Recap from June's Picks

Our Most Attractive Stocks (-2.9%) underperformed the S&P 500 (-1.9%) last month. Most Attractive Large Cap stock Kellogg Company (K) gained 11%. Most Attractive Small Cap stock Value Line (VALU) was up 18%. Overall, 19 out of the 40 Most Attractive stocks outperformed the S&P 500 in June.

Our Most Dangerous Stocks (-1.1%) underperformed the S&P 500 (-1.9%) as a short portfolio last month. Most Dangerous Large Cap stock Blackberry, Ltd (BB) fell by 23% and Most Dangerous Small Cap Stock Monotype Imaging Holdings (TYPE) fell by 10%. Overall, 19 out of the 40 Most Dangerous stocks outperformed the S&P 500 as shorts in June.

The successes of these model portfolios highlight the value of our machine learning and AI Robo-Analyst technology[1], which helps clients fulfill the fiduciary duty of care and make smarter investments[2].

12 new stocks make our Most Attractive list this month and five new stocks fall onto the Most Dangerous list this month. July's Most Attractive and Most Dangerous stocks were made available to members on July 3, 2018.

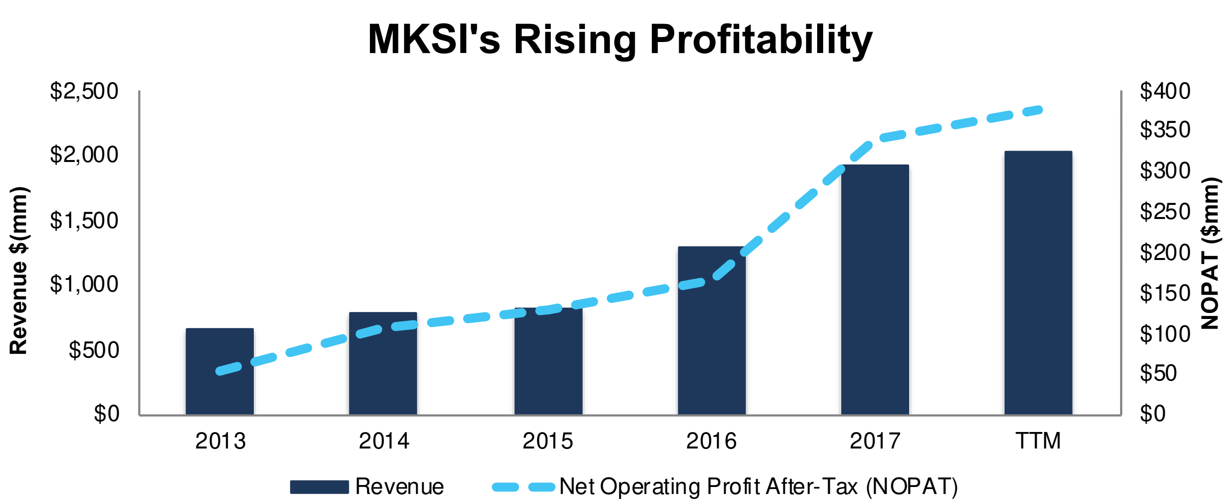
Our Most Attractive stocks have high and rising returns on invested capital (ROIC) and low price to economic book value ratios. Most Dangerous stocks have misleading earnings and long growth appreciation periods implied by their market valuations.

Most Attractive Stocks Feature for July: MKS Instruments (MKSI: $97/share)

MKS Instruments (MKSI), a provider of technical instruments that measure, control, power, deliver, monitor, and analyze manufacturing processes, is the featured stock from July's Most Attractive Stocks Model Portfolio.

Since 2013, MKSI has grown after-tax profit (NOPAT) by 59% compounded annually, from $53 million in 2013 to $340 million in 2017. MKSI has continued to grow profits in 2018, and it's NOPAT is $377 million over the trailing twelve months (TTM). The company's NOPAT margin has risen from 8% in 2013 to 19% TTM while its return on invested capital (ROIC) has improved from 6% to 16%.

Figure 1: MKSI's Revenue & NOPAT Since 2013



Sources: New Constructs, LLC and company filings

[1] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.
[2] Ernst & Young's recent white paper "Getting ROIC Right" proves the superiority of our holdings research and analytics.

MKSI Valuation Provides Upside

MKSI has significantly outperformed the S&P 500 over the past five years (+250% vs. +66%), but the stock remains undervalued. At its current price of $97/share, MKSI has a price-to-economic book value (PEBV) ratio of 1.1. This ratio implies that the market expects MKSI's NOPAT to grow by no more than 10% over the remaining life of the corporation. This expectation seems rather pessimistic for a company that has grown NOPAT by 18% compounded annually since 1999.

If MKSI can maintain current margins (19%) and grow NOPAT by just 7% compounded annually for the next decade, the stock is worth $116/share today – a 20% upside. See the math behind this dynamic DCF scenario.

Critical Details Found in Financial Filings By Our Robo-Analyst Technology

As investors focus more on fundamental research, research automation technology is needed to analyze all the critical financial details in financial filings. Below are specifics on the adjustments we make based on Robo-Analyst findings in MKS Instruments' 2017 10-K:

Income Statement: we made $157 million of adjustments, with a net effect of removing $1 million in non-operating expense (<1% of revenue). We removed $78 million in non-operating income and $79 million in non-operating expenses. You can see all the adjustments made to MKSI's income statement here.

Balance Sheet: we made $1.2 billion of adjustments to calculate invested capital with a net increase of $111 million. One of the largest adjustments was $299 million due to asset write-downs. This adjustment represented 14% of reported net assets. You can see all the adjustments made to MKSI's balance sheet here.

Valuation: we made $961 million of adjustments with a net effect of decreasing shareholder value by $60 million. The largest adjustment to shareholder value was $451 million in excess cash. This adjustment represents 8% of MKSI's market cap.

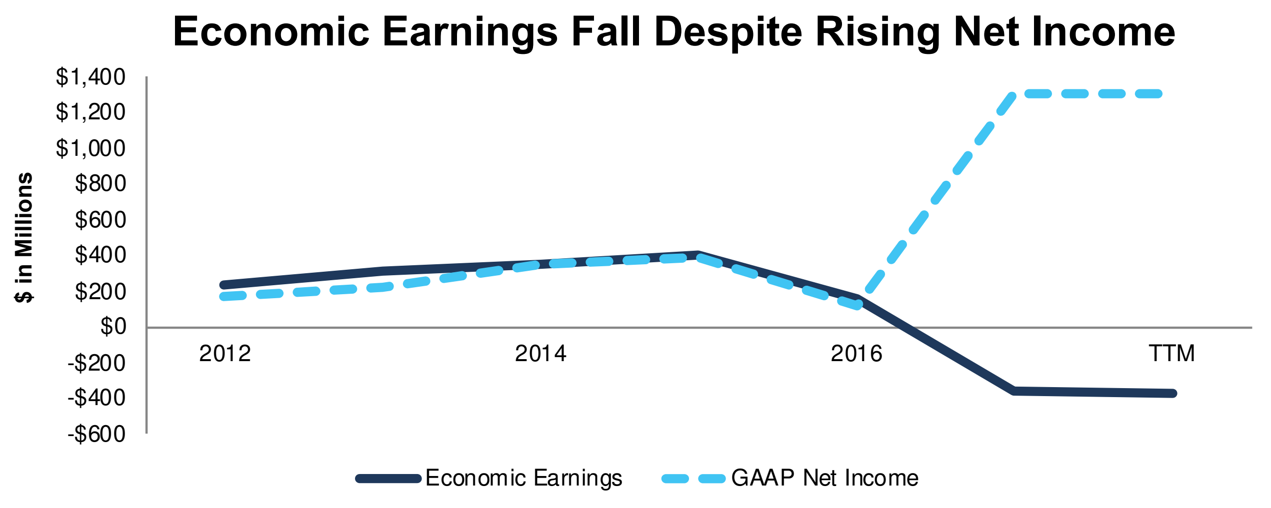
Most Dangerous Stocks Feature: IQVIA Holdings Inc. (IQV: $102/share)

IQVIA Holdings (IQV), a healthcare data analysis and clinical trial research provider, is the featured stock from July's Most Dangerous Stocks Model Portfolio. IQV was also a featured Danger Zone pick in May 2018.

In 2016, IQV acquired IMS Health, which provides data and technology to the healthcare industry, and changed its name to IQVIA. The company, which had just $1.9 billion in invested capital prior to the acquisition, paid over $17.5 billion when factoring in the debt it took on as part of the deal.

The acquisition led to a nearly 1000% increase in invested capital. Put simply, IQVIA paid $17.5 billion for $192 million in annual NOPAT, an ROIC of just 1%. Per Figure 2, IQVIA's economic earnings – the real cash flows of the business, which account for the cost of capital – have been negative since the acquisition.

Figure 2: IQVIA's Misleading Earnings



Sources: New Constructs, LLC and company filings

IQV Provides Poor Risk/Reward

At IQV's current price of $102/share, the market's expectations for profit growth look overly optimistic. To justify its current price, IQV must immediately raise its NOPAT margin to 11% (compared to 7% TTM) and grow NOPAT by 14% compounded annually for the next seven years. See the math behind this dynamic DCF scenario.

Even if company can achieve a 9% NOPAT margin (regaining the pre-tax margins of 12% it earned in 2015-2016 and benefiting from a reduction of its tax rate to 24%) and grow NOPAT by 8% compounded annually over the next decade, the stock is worth $62/share today – a 39% downside. See the math behind this dynamic DCF scenario here.

Critical Details Found in Financial Filings By Our Robo-Analyst Technology

As investors focus more on fundamental research, research automation technology is needed to analyze all the critical financial details in financial filings. Below are specifics on the adjustments we make based on Robo-Analyst findings in IQVIA Holdings' 2017 10-K:

Income Statement: we made $2 billion of adjustments, with a net effect of removing $655 million in non-operating income (7% of revenue). We removed $1.3 billion in non-operating income and $657 million in non-operating expenses. You can see all the adjustments made to IQV's income statement here.

Balance Sheet: we made $2.5 billion of adjustments to calculate invested capital with a net increase of $514 million. One of the largest adjustments was $629 million due to operating leases. This adjustment represented 3% of reported net assets. You can see all the adjustments made to IQV's balance sheet here.

Valuation: we made $13 billion of adjustments with a net effect of decreasing shareholder value by $12 billion. Apart from $11 billion in total debt, which includes the $629 million in operating leases noted above, the largest adjustment to shareholder value was $715 million in deferred tax liabilities. This adjustment represents 3% of IQV's market cap.

This article originally published on July 10, 2018.

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

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

New Constructs® - Research to Fulfill the Fiduciary Duty of Care

Ratings & screeners on 3000 stocks, 450 ETFs and 7000 mutual funds help you make prudent investment decisions.

New Constructs leverages the latest in machine learning to analyze structured and unstructured financial data with unrivaled speed and accuracy. The firm's forensic accounting experts work alongside engineers to develop proprietary NLP libraries and financial models. Our investment ratings are based on the best fundamental data in the business for stocks, ETFs and mutual funds. Clients include many of the top hedge funds, mutual funds and wealth management firms. David Trainer, the firm's CEO, is regularly featured in the media as a thought leader on the fiduciary duty of care, earnings quality, valuation and investment strategy.

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.

DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.