STOCK PICKS AND PANS

12/11/19

This New Long/Short ETF Finds Great Fundamental Value

The significant underperformance of value strategies over the past 15 years has led many investors to ask: "Is Value Investing Dead?"

As we've argued, value investing isn't dead, but one of the most popular value metrics – price to book (P/B) – is flawed and outdated. Changes in accounting rules, off-balance sheet liabilities, and the increased importance of intangible assets make P/B a poor measure of value.

The underperformance of major value index funds – such as the Russell 1000 Value ETF (IWD) – can be tied to their reliance on P/B and other unscrubbed traditional valuation metrics.

This new ETF avoids this problem by following a more comprehensive analytical process, which looks beyond traditional metrics and studies financial filings and footnotes, to identify value. The Acquirers Fund (ZIG: $27/share) this week's Long Idea.

Holdings Research Reveals Superior Stock Picking Methodology

According to Tobias Carlisle, author, investor, and founder and managing director of The Acquirers Funds:

"Acquirers Funds takes a holistic approach to valuation to understand the economic reality of each company. An important part of this process is ***a forensic-accounting diligence of the financial statements, particularly the notes and management's discussion*** *and analysis, to find information that a quantitative screen may miss."*

The Acquirers Fund's methodology is based on The Acquirer's Multiple, the valuation metric developed by Tobias Carlisle. The Acquirer's Multiple is based on two key ratios:

- Earnings before interest and taxes divided by enterprise value (EBIT/EV)
- Return on invested capital (ROIC)

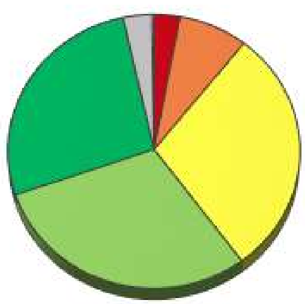
In addition to this screen, ZIG conducts a "forensic-accounting due diligence review" of potential holdings that leverages New Constructs, which embeds footnotes analysis into all research, as shown by Harvard Business School and MIT Sloan in a recent paper.

This methodology helps the fund avoid "value traps", or stocks that look cheap based on metrics such as price to book, but are actually dangerous due to the poor quality of the underlying business.

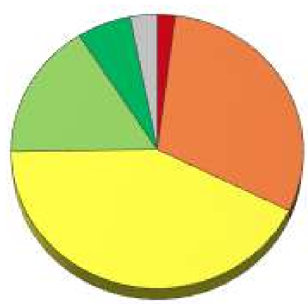
We are not surprised that a methodology focused on footnotes and the MD&A identifies holdings that rate highly by our methodology. Figure 1 shows that ZIG allocates a significantly higher percentage of its long portfolio to Attractive-or-better rated stocks and a significantly lower percentage to Unattractive-or-worse rated stocks than its benchmark, the iShares Russell 3000 ETF (IWV).

Figure 1: ZIG Long Asset Allocation Compared to IWV

Stock Rating Allocations - ZIG Long vs. IWV



ZIG Long Allocations		IWV Allocations
3%	Very Unattractive	2%
8%	Unattractive	30%
29%	Neutral	42%
30%	Attractive	16%
27%	Very Attractive	6%
3%	Unrated	3%
0%	Cash	--



Sources: New Constructs, LLC and company filings

Specifically, ZIG allocates 57% of its long portfolio to Attractive-or-better rated stocks compared to just 22% for IWV. On the flip side, ZIG allocates just 11% of its long portfolio to Unattractive-or-worse rated stocks compared to 32% for IWV.

ZIG's long portfolio includes many stocks we've featured as Long Ideas: Cummins Inc. (CMI), Oshkosh Corp (OSK), Lear Corp (LEA), Insight Enterprises (NSIT), ManpowerGroup (MAN) and Southwest Airlines (LUV). These stocks make up almost 21% of ZIG's long portfolio allocation.

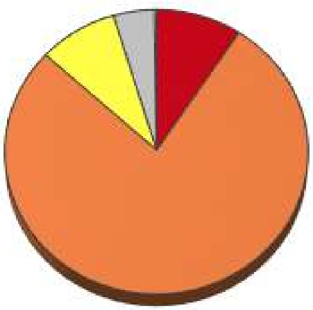
ZIG's Short Portfolio Is Even Better

ZIG runs a 130/30 long/short portfolio strategy, which means the fund allocates 130% of its AUM to long positions, offset by taking short positions worth 30% of its AUM. As a result, the fund remains net long the market, and its short positions effectively act as leverage to allow the fund to increase its exposure to its long portfolio.

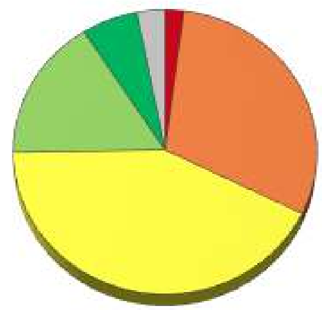
Figure 2 shows ZIG allocated 87% of its short portfolio to Unattractive-or-worse rated stocks, and it does not short any Attractive-or-better rated stocks.

Figure 2: ZIG Short Asset Allocation Compared to IWV

Stock Rating Allocations - ZIG Short vs. IWV



ZIG Short Allocations		IWV Allocations
9%	Very Unattractive	2%
78%	Unattractive	30%
9%	Neutral	42%
0%	Attractive	16%
0%	Very Attractive	6%
4%	Unrated	3%
0%	Cash	--



Sources: New Constructs, LLC and company filings

ZIG's short portfolio includes many stocks we've featured as Danger Zone Ideas: Tesla (TSLA), Netflix (NFLX), GoDaddy (GDDY), Pure Storage (PSTG), Nutanix (NTNX), FireEye (FEYE), and 8x8 (EGHT). Combined, these stocks make up almost 24% of ZIG's short portfolio allocation.

These overvalued short positions have the potential to benefit ZIG twice: first as leverage to increase returns for the long portfolio, then as a source of positive returns themselves if the stocks decline, as we believe many of them will.

Deep Dive on a Quality Long Position

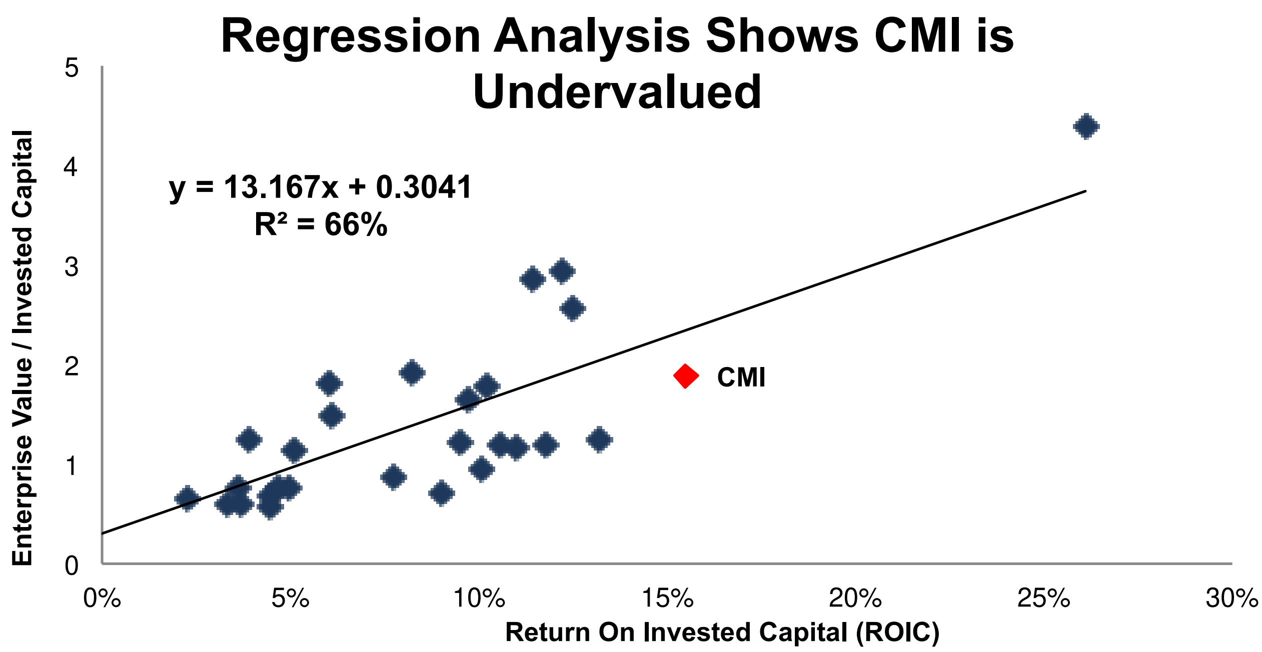
Cummins (CMI: $180/share) is an undervalued stock with positive strong free cash flow and economic profit/earnings. We first made CMI a Long Idea on November 14, 2018. Since our article, the stock has outperformed, up 23% vs. the S&P 500 up 16%.

Our long thesis focused on the company's high ROIC, which has only improved over the past year. CMI's ROIC is up from 15% at this time last year to 16% over the trailing twelve months (TTM) period.

In addition, CMI remains undervalued compared to its peers. Per Figure 3, ROIC explains 66% of the difference in valuation for the 31 Auto, Truck, and Motorcycle Parts peers[1] under coverage. Despite CMI's 16% ROIC, which is well above the 8% average of the peer group, the firm's stock trades at a discount to peers as shown by its position below the trend line.

[1] Excludes Garrett Motion (GTX), which is an extreme outlier in terms of ROIC

Figure 3: ROIC Explains 66% of Valuation for Auto, Truck, and Motorcycle Parts Stocks



Sources: New Constructs, LLC and company filings

If the stock were to trade at parity with its peers, it would be worth $230/share – 28% above the current stock price. Given the firm's rapid profit growth and superior corporate governance, one would think the stock would garner a premium valuation.

Deep Dive on a Quality Short Position

New Jersey Resources Corp (NJR: $43/share) is an overvalued stock with low and declining cash flows. As we showed in our analysis of ROIC by sector, the Utilities sector has the lowest ROIC in the market, and it's getting worse.

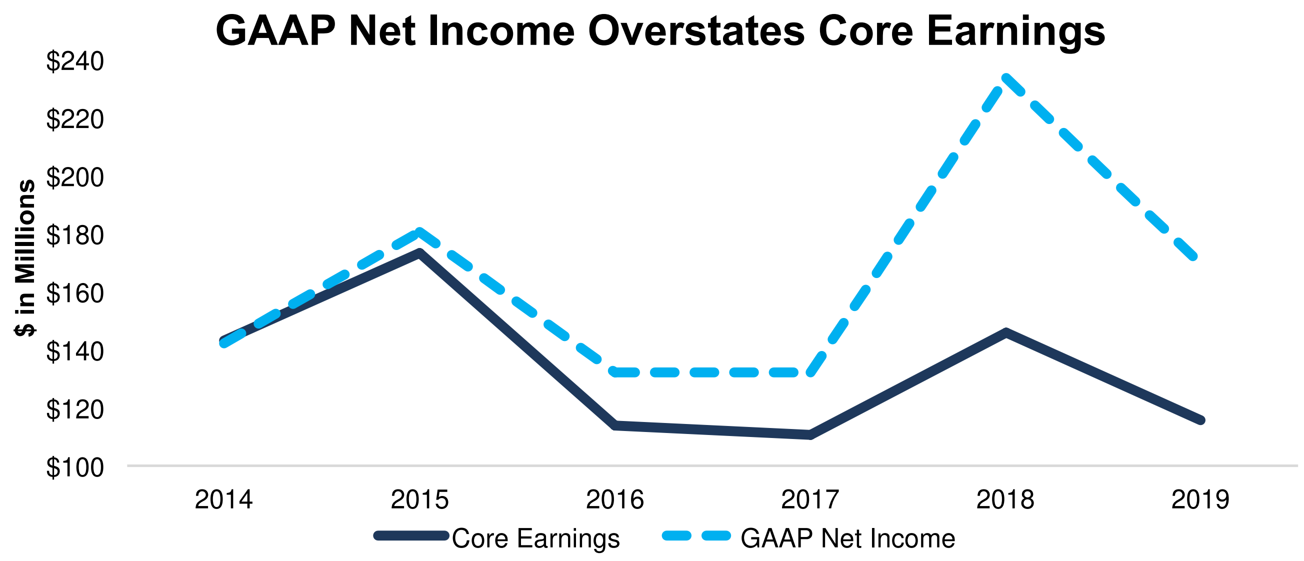
NJR's ROIC declined from 6% in 2014 to just 4% in 2019. The firm's ROIC fell below its weighted average cost of capital (WACC) in 2019, which means it now generates negative economic earnings and destroys shareholder value.

Despite this decline in fundamentals, the stock is up 46% over the past five years, only slightly lagging the broader market. Investors don't seem to appreciate just how bad this company's profits have become.

One possible reason for this disconnect is that investors are not reading the footnotes. "Core Earnings: New Data and Evidence", a recent paper from professors at Harvard Business School and MIT Sloan, shows that market participants are slow to understand the impact of non-operating items buried in the footnotes.

Because most investors don't read the footnotes, companies like NJR can mask declining earnings. Figure 4 shows that NJR's GAAP net income has grown by 4% compounded annually over the past five years, even though its core earnings have declined by 4% compounded annually over the same time.

Figure 4: NJR's Core Earnings Reveal Growing Losses



Sources: New Constructs, LLC and company filings

NJR's earnings distortion in 2019 came from three main categories:

- $41.7 million in non-recurring tax benefits
- $11.3 million in Other Income disclosed directly on the income statement
- $750 thousand from a non-operating gain on sale and pension gains buried in the footnotes

Combined, these non-operating items artificially inflated earnings by ~$54 million (2% of revenue).

As a result of these inflated earnings, NJR looks comparatively cheap with a P/E ratio of 23, which is below the Utilities sector average of 31. However, a look at the actual growth expectations implied by its cash flows tells a different story. At its current valuation of $43/share, NJR has a price to economic book value (PEBV) of 2.7, compared to 2 for the Utilities sector as a whole.

In order to justify its valuation, NJR must improve its NOPAT margin to 7% (up from 6% in 2019) and grow NOPAT by 4% compounded annually over the next 15 years. See the math behind this dynamic DCF scenario.

If NJR maintains its current margin and grows NOPAT by just 1% compounded annually (in-line with projected industry growth) over the next 15 years, the stock is worth $20/share today, a 53% downside to the current stock price. See the math behind this dynamic DCF scenario.

When the earnings distortion fades and NJR's GAAP net income falls in-line with its core earnings, we expect to see the stock trade closer to this lower valuation.

Below Average Costs Benefit Investors

Not only does The Acquirers Fund offer high-quality stock selection, it does so at a reasonable price. The fund has total annual costs of 1.04%. These costs are significantly above the 0.16% average for all the ETFs we cover. but unlike most ETFs, ZIG offers differentiated active management. When we compare ZIG to the universe of mutual funds, its costs are similar to the mutual fund average of 1.01%.

The Importance of Holdings Based Fund Analysis

Smart fund (or ETF) investing means analyzing the holdings of each mutual fund. Failure to do so is a failure to perform proper due diligence. Simply buying a mutual fund or ETF based on past performance does not necessarily lead to outperformance. Especially in the case of a new ETF like ZIG, where there's no long-term performance to analyze, investors need holdings-based diligence.

However, most investors don't realize they can already get the sophisticated fundamental research that Wall Street insiders use. Robo-Analyst technology makes footnotes diligence that identifies the real cash flows of the business accessible to all investors.

ZIG also shows how investors can apply our superior data, regardless of methodology. The Acquirers Multiple process may be different from our stock rating methodology, but it can still benefit from the application of footnotes diligence. No matter your investment process, the right data can be a key edge.

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Footnotes adjustments matter. We are the ONLY source.

We provide ratings, models, reports & screeners on U.S. 3,000 stocks, 700 ETFs and 7,000 mutual funds.

HBS & MIT Sloan research reveals that:

- **Markets are inefficiently assessing earnings because no one reads the footnotes.**
- **Corporate managers hide gains/losses in footnotes to manage earnings.**
- **Our technology brings the material footnotes data to market for the first time ever.**

Combining human expertise with NLP/ML/AI technologies (featured by Harvard Business School), we shine a light in the dark corners (e.g. footnotes) of hundreds of thousands of financial filings to unearth critical details.

The HBS & MIT Sloan paper, Core Earnings: New Data and Evidence, shows how our superior data drives uniquely comprehensive and independent debt and equity research.

This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Learn more.

Quotes from HBS & MIT Sloan professors on our research:

Get better research:

"…the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications." – page 20

Pick better stocks:

"Trading strategies that exploit cross-sectional differences in firms' transitory earnings produce abnormal returns of 7-to-10% per year." – Abstract

Avoid losses from using other firms' data:

"…many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat…" – page 14

Build better models:

"Core Earnings [calculated using New Constructs' novel dataset] provides predictive power for various measures of one-year-ahead performance…that is incremental to their current-period counterparts." – page 4

Exploit market inefficiencies:

"These results … suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures." – page 26

Fulfill fiduciary duties:

"An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A." – page 33-34

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