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

Recap from April Picks

Our Most Attractive Stocks (+24.4%) outperformed the S&P 500 (+12.5%) from April 2, 2020 through May 4, 2020 by 11.9%. The best performing large cap stock gained 43% and the best performing small cap stock was up 74%. Overall, 26 out of the 40 Most Attractive stocks outperformed the S&P 500.

Our Most Dangerous Stocks (+15.4%) underperformed the S&P 500 (+12.5%) as a short portfolio from April 2, 2020 through May 4, 2020 by 2.9%. The best performing large cap stock fell by 5% and the best performing small cap stock fell by 15%. Overall, 13 out of the 26 Most Dangerous stocks outperformed the S&P 500 as shorts.

The Most Attractive/Most Dangerous Model Portfolios outperformed as an equal-weighted long/short portfolio by 9.0% last month.

Only our research utilizes the superior data and earnings adjustments featured by the HBS & MIT Sloan paper, "Core Earnings: New Data and Evidence." 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].

19 new stocks make our Most Attractive list this month, and seven new stocks fall onto the Most Dangerous list this month. May's Most Attractive and Most Dangerous stocks were made available to members on May 6, 2020.

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.

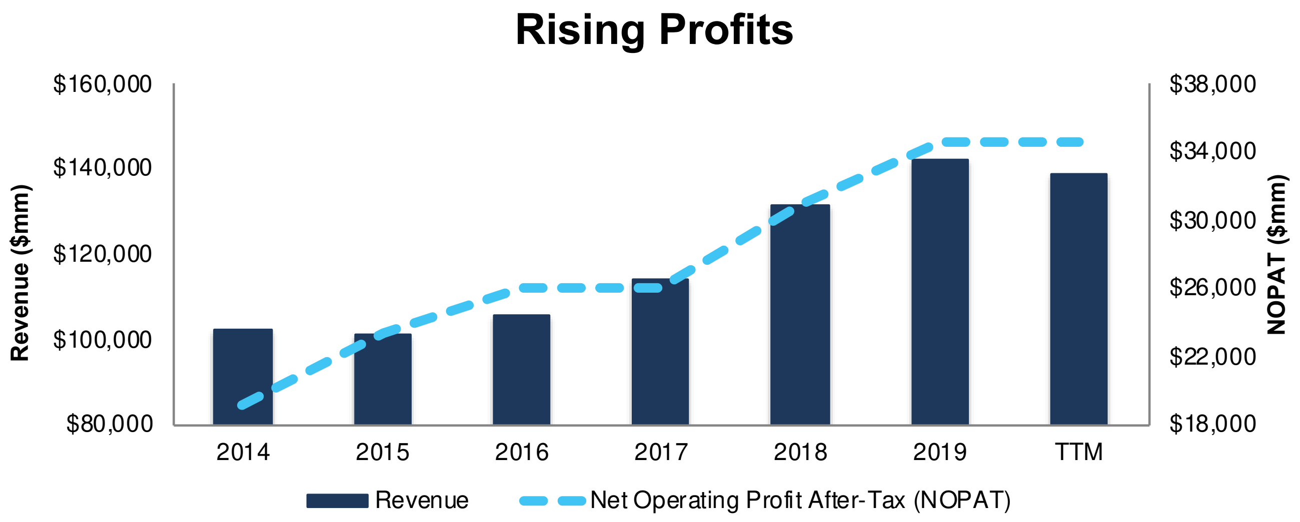
Most Attractive Stocks Feature for May: JPMorgan Chase & Company (JPM: $84/share)

JPMorgan Chase & Company (JPM) is the featured stock from May's Most Attractive Stocks Model Portfolio.

JPMorgan Chase has grown revenue by 7% compounded annually and after-tax profit (NOPAT) by 13% compounded annually over the past five years. Longer term, JPMorgan Chase has increased NOPAT by 4% compounded annually over the past decade. JPMorgan Chase's NOPAT margin increased from 19% in 2014 to 25% over the trailing-twelve-months (TTM) while its ROIC increased from 7% to 12% over the same time.

[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] This paper compares our analytics on a mega cap company to Bloomberg and Capital IQ (SPGI) in a detailed appendix.

Figure 1: Revenue & NOPAT Since 2014



Sources: New Constructs, LLC and company filings

JPM is Undervalued

At its current price of $84/share, JPM has a price-to-economic book value (PEBV) ratio of 0.6. This ratio means the market expects JPMorgan Chase's NOPAT to permanently decline by 40% over the remaining life of the firm. This expectation seems overly pessimistic for a firm that grew NOPAT by 4% compounded annually over the past decade and 10% compounded annually over the past two decades.

Even if JPMorgan Chase's NOPAT margin falls to 21% (10-year average vs 25% TTM) and the firm grows NOPAT by just 1% compounded annually for the next decade, the stock is worth $144/share today – a 71% upside. See the math behind this reverse 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 as shown in the Harvard Business School and MIT Sloan paper, "Core Earnings: New Data and Evidence".

Below are specifics on the adjustments we make based on Robo-Analyst findings in JPMorgan Chase & Company's 2019 10-K:

Income Statement: we made $6.0 billion of adjustments, with a net effect of removing $2 million in non-operating expenses (<1% of revenue). You can see all the adjustments made to JPMorgan Chase's income statement here.

Balance Sheet: we made $58.2 billion of adjustments to calculate invested capital with a net increase of $37.2 billion. One of the largest adjustments was $16.1 billion in goodwill. This adjustment represented 6% of reported net assets. You can see all the adjustments made to JPMorgan Chase's balance sheet here.

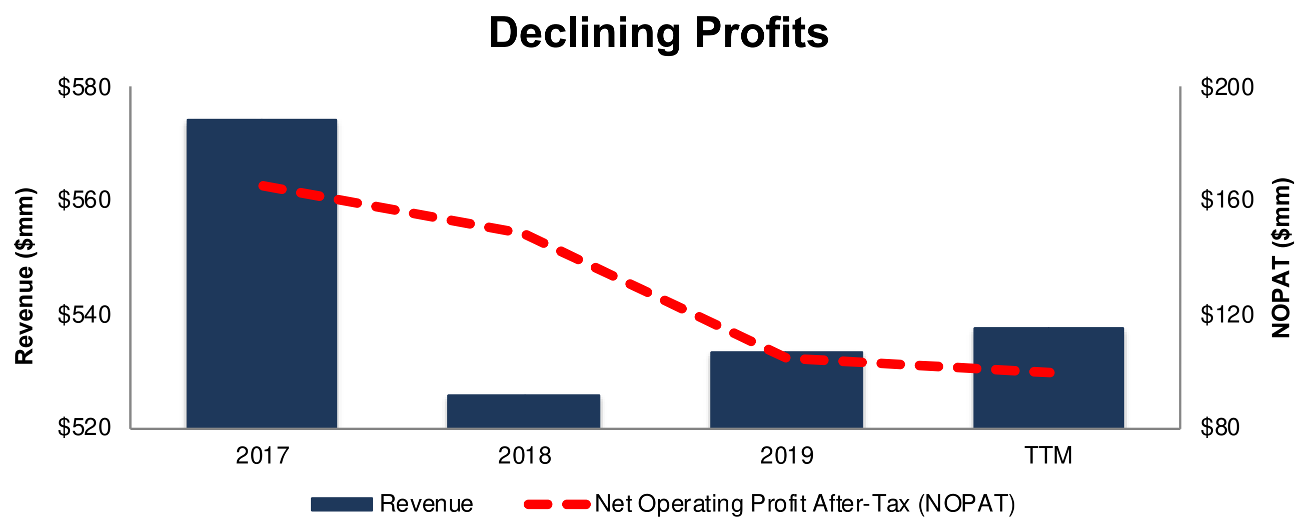
Valuation: we made $51.4 billion of adjustments with a net effect of decreasing shareholder value by $40.1 billion. Apart from total debt, the most notable adjustment to shareholder value was $30.1 billion in preferred stock. This adjustment represents 11% of JPM's market cap. See all adjustments to JPMorgan Chase's valuation here.

Most Dangerous Stocks Feature: Piedmont Office Realty Trust, Inc. (PDM: $14/share)

Piedmont Office Realty Trust, Inc. (PDM) is the featured stock from May's Most Dangerous Stocks Model Portfolio.

Piedmont Office Realty's revenue fell by 4% compounded annually from 2017 to 2019 and NOPAT declined by 21% compounded annually over the same time. Piedmont Office Realty's NOPAT margin fell from 29% in 2017 to 19% over the TTM while ROIC declined from 4% to 3% over the same time.

Figure 2: Revenue & NOPAT Since 2017



Sources: New Constructs, LLC and company filings

PDM Provides Poor Risk/Reward

Despite its deteriorating fundamentals, PDM is still priced for significant profit growth and is overvalued.

To justify its current price of $14/share, Piedmont Office Realty must achieve a 28% NOPAT margin (five-year high vs 19% TTM) and grow revenue by 6% compounded annually for the next 10 years. See the math behind this reverse DCF scenario. This expectation seems overly optimistic given that consensus estimates expect Piedmont Office Realty's revenue to fall by 3% over the next five years. Furthermore, the firm's revenue declined by 1% compounded annually since 2010, or well below the 6% compound annual growth rate required in the above scenario.

Even if Piedmont Office Realty can achieve a 24% NOPAT margin (five-year average) and grow revenue by 3% compounded annually for the next decade, the stock is worth just $5/share today, a 64% downside to the current stock price. See the math behind this reverse 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 as shown in the Harvard Business School and MIT Sloan paper, "Core Earnings: New Data and Evidence".

Below are specifics on the adjustments we make based on Robo-Analyst findings in Piedmont Office Realty Trust's 2019 10-K:

Income Statement: we made $273 million of adjustments, with a net effect of removing $125 million in non-operating income (23% of revenue). You can see all the adjustments made to Piedmont Office Realty's income statement here.

Balance Sheet: we made $267 million of adjustments to calculate invested capital with a net increase of $259 million. One of the largest adjustments was $219 million in asset write-downs. This adjustment represented 7% of reported net assets. You can see all the adjustments made to Piedmont Office Realty's balance sheet here.

Valuation: we made $2.0 billion of adjustments with a net effect of decreasing shareholder value by $2.0 billion. There were no adjustments that increased shareholder value. Apart from total debt, the largest adjustment to shareholder value was $2 million in minority interests. This adjustment represents less than 1% of Piedmont Office Realty's market cap. See all adjustments to Piedmont Office Realty's valuation here.

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Disclosure: David Trainer, Kyle Guske II, and Matt Shuler 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.

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

DISCLOSURES

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