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

Recap from July's Picks

Our Most Attractive Stocks (+2.8%) underperformed the S&P 500 (+5.3%) from July 2, 2020 through August 3, 2020 by 2.5%. The best performing large cap stock gained 23% and the best performing small cap stock was up 15%. Overall, 13 out of the 40 Most Attractive stocks outperformed the S&P 500.

Our Most Dangerous Stocks (+6.2%) underperformed the S&P 500 (+5.3%) as a short portfolio from July 2, 2020 through August 3, 2020 by 0.9%. The best performing large cap stock fell by 11% and the best performing small cap stock fell by 19%. Overall, 17 out of the 30 Most Dangerous stocks outperformed the S&P 500 as shorts.

The Most Attractive/Most Dangerous Model Portfolios underperformed as an equal-weighted long/short portfolio by 1.7%.

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 six new stocks fall onto the Most Dangerous list this month. August's Most Attractive and Most Dangerous stocks were made available to members on August 5, 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 August: Caterpillar Inc. (CAT: $142/share)

Caterpillar Inc. (CAT), is the featured stock from August's Most Attractive Stocks Model Portfolio.

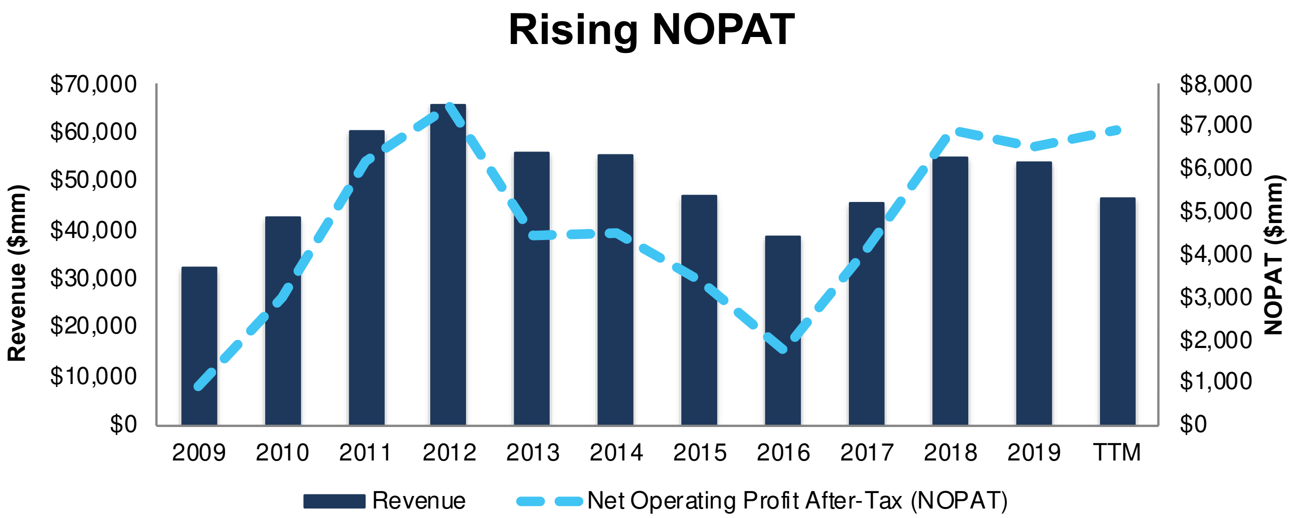
We made Caterpillar a Long Idea in May 2020 and highlighted it again in July 2020. Since May's report, the stock is up 18% while the S&P 500 is up 11%. Despite the price increase, the risk/reward in this stock is still attractive.

Caterpillar has grown revenue by 5% compounded annually and after-tax profit (NOPAT) by 22% compounded annually over the past decade. Longer term, Caterpillar has grown NOPAT by 10% compounded annually over the past two decades.

Caterpillar's NOPAT margin increased from 3% in 2009 to 15% over the trailing-twelve-months (TTM) while its invested capital turns improved from 1.1 to 1.3 over the same time. The combination of rising margins and invested capital turns drive Caterpillar's ROIC higher from 3% in 2009 to 19% TTM.

[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] Compare our analytics on a mega cap company to Bloomberg and Capital IQ's (SPGI) analytics in the detailed appendix of this paper.

Figure 1: Revenue & NOPAT Since 2009



Sources: New Constructs, LLC and company filings

CAT Is Undervalued

At its current price of $142/share, CAT has a price-to-economic book value (PEBV) ratio of 0.8. This ratio means the market expects Caterpillar's NOPAT to permanently decline by 20% over the remaining life of the firm. This expectation seems overly pessimistic for a firm that grew NOPAT by 8% compounded annually over the past five years and 22% compounded annually over the past decade.

Even if Caterpillar's NOPAT margin falls to 9% (five-year company average vs. 15% TTM) and the firm grows NOPAT by just 2% compounded annually for the next decade, the stock is worth $181/share today – a 27% 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 Caterpillar's 2019 10-K:

Income Statement: we made $1.8 billion of adjustments, with a net effect of removing $417 million in non-operating expenses (1% of revenue). You can see all the adjustments made to Caterpillar's income statement here.

Balance Sheet: we made $12.9 billion of adjustments to calculate invested capital with a net increase of $481 million. One of the largest adjustments was $2.6 billion in asset write-downs. This adjustment represented 7% of reported net assets. You can see all the adjustments made to Caterpillar's balance sheet here.

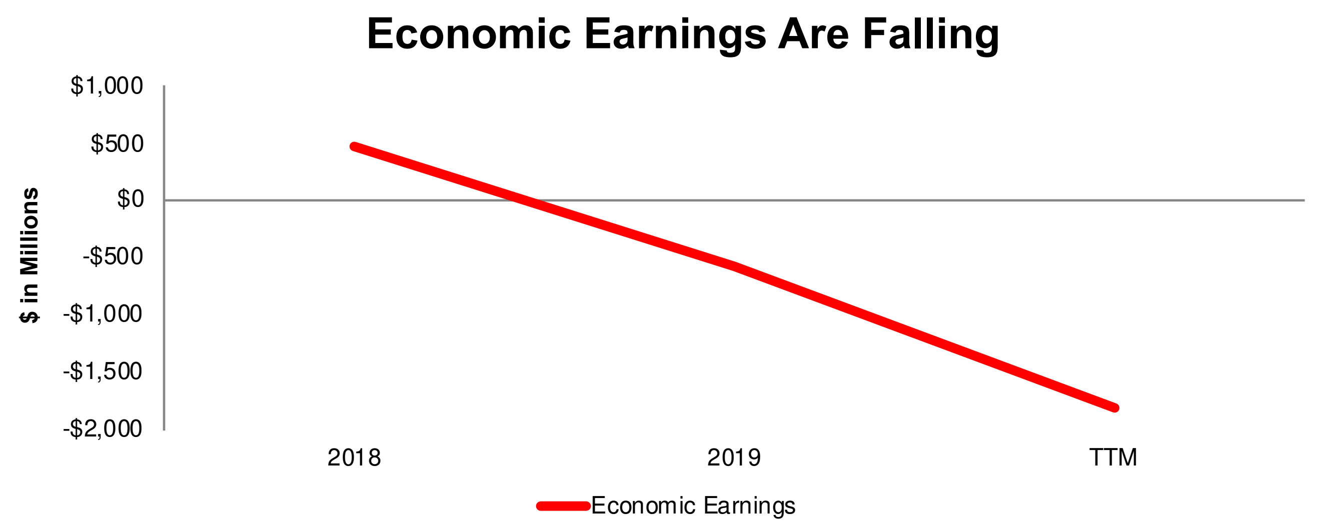
Valuation: we made $31.7 billion of adjustments with a net effect of decreasing shareholder value by $20.3 billion. Apart from total debt, the most notable adjustment to shareholder value was $5.7 billion in excess cash. This adjustment represents 7% of Caterpillar's market cap. See all adjustments to Caterpillar's valuation here.

Most Dangerous Stocks Feature: Fiserv Inc. (FISV: $99/share)

Fiserv Inc. (FISV) is the featured stock from August's Most Dangerous Stocks Model Portfolio.

The early results don't look good for Fiserv's merger with First Data Corporation in July 2019. Fiserv's economic earnings, the true cash flows of the business, have declined from $466 million in 2018 to -$1.8 billion TTM. Fiserv's NOPAT margin fell from 19% in 2018 to 9% TTM while the firm's invested capital turns fell from 0.6 to 0.3 over the same time. The combination of falling margins and invested capital turns drives Fiserv's ROIC lower from 12% in 2018 to 2% TTM.

Figure 2: Economic Earnings Since 2018



Sources: New Constructs, LLC and company filings

FISV Provides Poor Risk/Reward

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

To justify its current price of $99/share, Fiserv must achieve a 17% NOPAT margin (five-year average vs. 9% TTM) and grow NOPAT by 15% compounded annually over the next decade. See the math behind this reverse DCF scenario.

This expectation seems overly optimistic given that Fiserv's NOPAT has grown by only 9% compounded annually over the past decade.

Even if Fiserv can achieve margins of 16% (10-year average) and grow NOPAT by 11% compounded annually for the next 10 years, the stock is worth just $54/share today, a 45% downside to the current stock price. See the math behind this reverse DCF scenario.

Each of these scenarios assumes Fiserv is able to grow revenue, NOPAT, and FCF without increasing working capital or fixed assets. This assumption is unlikely, but allows us to create best-case scenarios that demonstrate how high expectations embedded in the current valuation are.

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 Fiserv's 2019 10-K:

Income Statement: we made $987 million of adjustments, with a net effect of removing $530 million in non-operating expenses (4% of revenue). You can see all the adjustments made to Fiserv's income statement here.

Balance Sheet: we made $32.3 billion of adjustments to calculate invested capital with a net decrease of $30.2 billion. One of the largest adjustments was $30.3 billion for midyear acquisitions. This adjustment represented 49% of reported net assets. You can see all the adjustments made to Fiserv's balance sheet here.

Valuation: we made $31.1 billion of adjustments with a net effect of decreasing shareholder value by $30.4 billion. Apart from total debt, the most notable adjustment to shareholder value was $4.4 billion in net deferred tax liability. This adjustment represents 7% of Fiserv's market cap. See all adjustments to Fiserv'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.

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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.**
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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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