



## Featured Stocks in September's Most Attractive/Most Dangerous Model Portfolios

### Recap from August's Picks

Our Most Attractive Stocks (+2.1%) underperformed the S&P 500 (+6.0%) from August 5, 2020 through September 1, 2020 by 3.9%. The best performing large cap stock gained 12% and the best performing small cap stock was up 16%. Overall, nine out of the 40 Most Attractive stocks outperformed the S&P 500.

Our Most Dangerous Stocks (+3.7%) outperformed the S&P 500 (+6.0%) as a short portfolio from August 5, 2020 through September 1, 2020 by 2.3%. The best performing large cap stock fell by 6% and the best performing small cap stock fell by 33%. Overall, 18 out of the 27 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 1.6%.

[Learn more about the best fundamental research](#)

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](#)<sup>1</sup>, which helps clients fulfill the [fiduciary duty of care](#) and make smarter investments<sup>2</sup>.

18 new stocks make our Most Attractive list this month, and 17 new stocks fall onto the Most Dangerous list this month. September's Most Attractive and Most Dangerous stocks were made available to members on September 3, 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 September: The Progressive Corp (PGR: \$94/share)

The Progressive Corp (PGR), is the featured stock from September's [Most Attractive Stocks Model Portfolio](#).

Progressive has grown revenue by 10% compounded annually and after-tax profit ([NOPAT](#)) by 13% compounded annually over the past decade. Over the past five years, Progressive has grown NOPAT by 21% compounded annually.

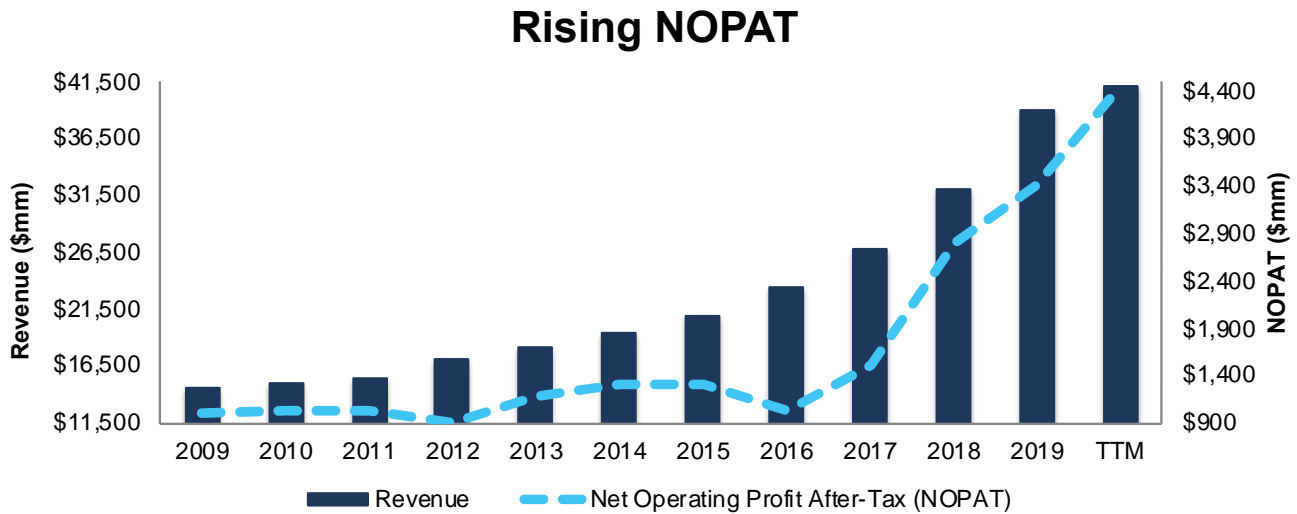
Progressive's NOPAT margin increased from 6% in 2015 to 11% over the trailing-twelve-months (TTM) while its [invested capital turns](#) improved from 2.9 to 3.3 over the same time. The combination of rising margins and invested capital turns drive Progressive's ROIC from 18% in 2015 to 36% TTM.

<sup>1</sup> Harvard Business School features the powerful impact of our research automation technology in the case [New Constructs: Disrupting Fundamental Analysis with Robo-Analysts](#).

<sup>2</sup> 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

**PGR Is Undervalued**

At its current price of \$94/share, PGR has a price-to-economic book value ([PEBV](#)) ratio of 0.6. This ratio means the market expects Progressive’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 13% compounded annually over the past two decades.

Even if Progressive’s NOPAT margin falls to 7% (five-year company average vs. 11% TTM) and the firm grows NOPAT by just 1% compounded annually for the next decade, the stock is worth \$131/share today – a 39% 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 Progressive’s 2019 10-K:

**Income Statement:** we made \$955 million of adjustments, with a net effect of removing \$525 million in [non-operating income](#) (1% of revenue). You can see all the adjustments made to Progressive’s income statement [here](#).

**Balance Sheet:** we made \$1.8 billion of adjustments to calculate invested capital with a net decrease of \$1.3 billion. One of the largest adjustments was \$380 million in [other comprehensive income](#). This adjustment represented 3% of reported net assets. You can see all the adjustments made to Progressive’s balance sheet [here](#).

**Valuation:** we made \$1.1 billion of adjustments with a net effect of decreasing shareholder value by \$985 million. The most notable adjustment to shareholder value was \$494 million in [preferred stock](#). This adjustment represents 1% of Progressive’s market cap. See all adjustments to Progressive’s valuation [here](#).



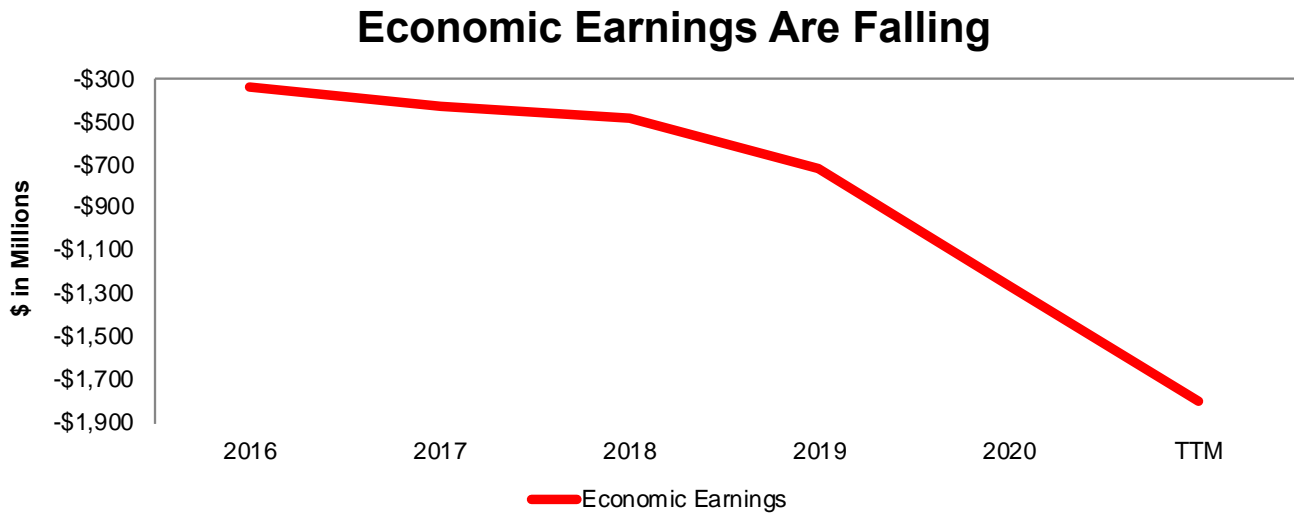
### Most Dangerous Stocks Feature: Salesforce.com Inc. (CRM: \$248/share)

Salesforce.com Inc. (CRM) is the featured stock from September's [Most Dangerous Stocks Model Portfolio](#).

We put Salesforce.com in the [Danger Zone](#) in [December 2013](#) and reiterated it in [November 2014](#) and again in [August 2018](#). While we've been wrong about the stock in the past (CRM is up 385% vs S&P 500 +87% since we first wrote on the name), its current fundamentals and valuation provide poor risk/reward.

Salesforce.com's [economic earnings](#), the true cash flows of the business, have declined from -\$337 million in 2016 to -\$1.8 billion TTM. Salesforce.com's NOPAT margin fell from 1.6% in 2016 to 1.1% TTM while the firm's invested capital turns fell from 1.0 to 0.6 over the same time. The combination of falling margins and invested capital turns drives Salesforce.com's ROIC from 1.6% in 2016 to 0.7% TTM.

**Figure 2: Economic Earnings Since 2016**



Sources: New Constructs, LLC and company filings

### CRM Provides Poor Risk/Reward

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

To justify its current price of \$248/share, Salesforce.com must achieve an 8% NOPAT margin (vs. an all-time high of 6%) and grow NOPAT by 44% compounded annually over the next decade. [See the math behind this reverse DCF scenario](#). This expectation seems overly optimistic given that Salesforce.com's NOPAT has grown by 24% compounded annually over the past decade.

Even if Salesforce.com can achieve margins of 6% (all-time high) and grow NOPAT by 30% compounded annually for the next 10 years, the stock is worth just \$89/share today, a 64% downside to the current stock price. [See the math behind this reverse DCF scenario](#).

Each of these scenarios also assumes Salesforce.com 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. For reference, Salesforce.com has increased [invested capital](#) by 78% compounded annually over the past decade.

### 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 Salesforce.com's fiscal year ended 2020 10-K:



Income Statement: we made \$1.2 billion of adjustments, with a net effect of removing \$313 million in [non-operating expenses](#) (2% of revenue). You can see all the adjustments made to Salesforce.com's income statement [here](#).

Balance Sheet: we made \$19.4 billion of adjustments to calculate invested capital with a net decrease of \$16.7 billion. One of the largest adjustments was \$8.8 billion for [midyear acquisitions](#). This adjustment represented 22% of reported net assets. You can see all the adjustments made to Salesforce.com's balance sheet [here](#).

Valuation: we made \$20.9 billion of adjustments with a net effect of increasing shareholder value by \$799 million. Apart from [total debt](#), the most notable adjustment to shareholder value was \$10.9 billion in [excess cash](#). This adjustment represents 5% of Salesforce.com's market cap. See all adjustments to Salesforce.com'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.**
- **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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