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

Recap From November's Picks

Our Most Attractive Stocks (+6.9%) outperformed the S&P 500 (+6.4%) from November 4, 2020 through December 1, 2020 by 0.5%. The best performing large cap stock gained 33% and the best performing small cap stock was up 28%. Overall, 23 out of the 40 Most Attractive stocks outperformed the S&P 500.

Our Most Dangerous Stocks (+13.4%) underperformed the S&P 500 (+6.4%) as a short portfolio from November 4, 2020 through December 1, 2020 by 7%. The best performing large cap stock fell by 7% and the best performing small cap stock fell by 10%. Overall, 11 out of the 29 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 3.3%.

Only our research utilizes the superior data and earnings adjustments featured by the HBS & MIT Sloan paper, "Core Earnings: New Data and Evidence" (accepted for publication in The Journal of Financial Economics). 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].

16 new stocks make our Most Attractive list this month, and six new stocks fall onto the Most Dangerous list this month. December's Most Attractive and Most Dangerous stocks were made available to members on December 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 December: State Street Corp (STT: $73/share)

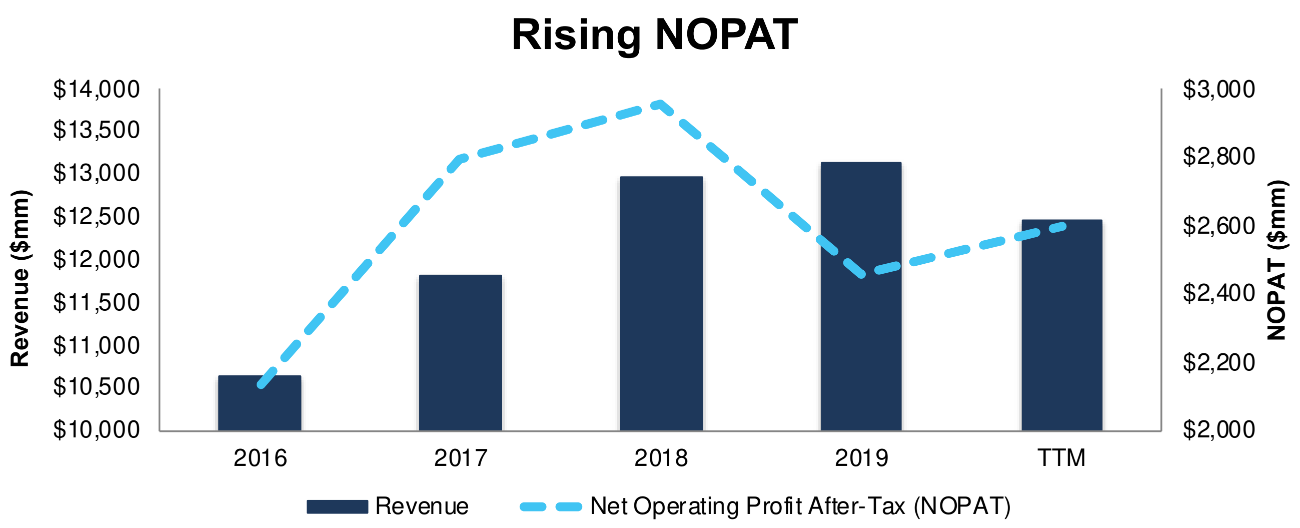
State Street Corp (STT) is the featured stock from December's Most Attractive Stocks Model Portfolio.

State Street has grown revenue by 7% compounded annually and net operating profit after-tax (NOPAT) by 5% compounded annually since 2016. Longer term, the firm has grown NOPAT by 10% compounded annually over the past two decades.

The firm's NOPAT margin increased slightly from 20% in 2016 to 21% TTM while its invested capital turns improved from 2.44 to 2.46 over the same period. The combination of rising margins and invested capital turns drive State Street's ROIC from 9% in 2016 to 10% TTM. State Street's profitability helps the firm generate significant free cash flow (FCF). Since 2016, the firm generated $7.1 billion (26% of market cap) in cumulative FCF.

[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 2016



Sources: New Constructs, LLC and company filings

STT Is Undervalued

At its current price of $73/share, STT has a price-to-economic book value (PEBV) ratio of 0.7. This ratio means the market expects State Street's NOPAT to permanently decline by 30%. This expectation seems overly pessimistic for a firm that has grown NOPAT by 10% compounded annually over the past two decades.

Even if State Street's NOPAT margin falls to 18% (10-year low, compared to 21% TTM) and the firm grows NOPAT by just 2% compounded annually for the next decade, the stock is worth $111/share today – a 52% 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 State Street's 10-K and 10-Q's:

Income Statement: we made $486 million of adjustments, with a net effect of removing $452 million in non-operating expenses (4% of revenue). You can see all the adjustments made to State Street's income statement here.

Balance Sheet: we made $5.6 billion of adjustments to calculate invested capital with a net increase of $1.8 billion. One of the largest adjustments was $2.9 billion in deferred tax assets. This adjustment represented 12% of reported net assets. You can see all the adjustments made to State Street's balance sheet here.

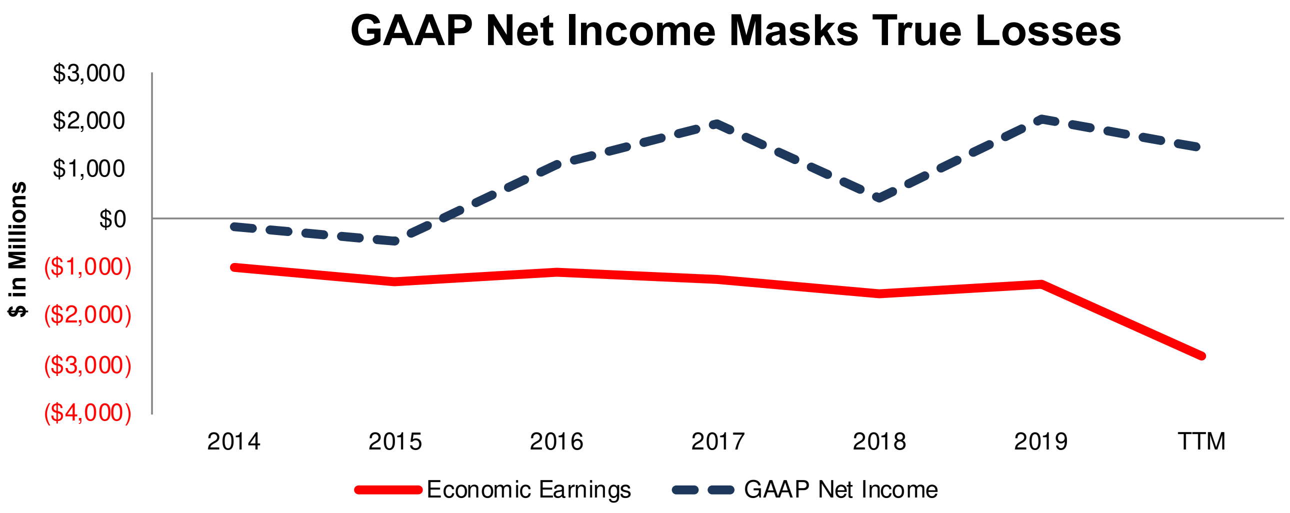
Valuation: we made $3.8 billion of adjustments all of which decreased shareholder value. There were no adjustments that increased shareholder value. The most notable adjustment to shareholder value was $2.5 billion in preferred capital. This adjustment represents 9% of State Street's market cap. See all adjustments to State Street's valuation here.

Most Dangerous Stocks Feature: MGM Resorts International (MGM: $30/share)

MGM Resorts (MGM) is the featured stock from December's Most Dangerous Stocks Model Portfolio.

While MGM Resorts' GAAP net income improved from -$150 million in 2014 to $1.5 billion TTM, the firm's economic earnings, the true cash flows of the business, fell from -$969 million to -$2.8 billion over the same time, per Figure 2. More recently, the firm's NOPAT margin fell from 12% in 2019 to -8% TTM and ROIC fell from 4% to a bottom quintile -1% over the same time.

Figure 2: GAAP Net Income vs. Economic Earnings Since 2014



Sources: New Constructs, LLC and company filings

MGM Provides Poor Risk/Reward

Despite its poor fundamentals, MGM is still priced for significant profit growth and is overvalued.

To justify its current price of $30/share, MGM Resorts must achieve a 9% NOPAT margin (equal to the firm's 10-year average, compared to -8% TTM) and grow NOPAT by 10% compounded annually over the next decade. See the math behind this reverse DCF scenario. This expectation seems overly optimistic given the firm's inability to grow create shareholder value in a strong economy and that consensus estimates imply MGM Resort's revenue will actually fall 1% compounded annually through 2023.

Even if MGM Resorts can improve its NOPAT margin to 12% (equal to 2019) grow revenue and NOPAT 5% compounded annually for the next 10 years, the stock is worth just $19/share today, a 37% downside to the current stock price. See the math behind this reverse DCF scenario.

Each of these scenarios also assumes MGM Resorts 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, MGM Resorts' invested capital has grown by an average of $1.7 billion (13% of 2019 revenue) per year since 2015.

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 MGM Resorts' 10-K and 10-Q's:

Income Statement: we made $4.8 billion of adjustments, with a net effect of removing $556 million in in non-operating income (8% of revenue). You can see all the adjustments made to MGM Resorts' income statement here.

Balance Sheet: we made $10.1 billion of adjustments to calculate invested capital with a net increase of $4.2 billion. One of the largest adjustments was $5.7 billion for asset write-downs. This adjustment represented 19% of reported net assets. You can see all the adjustments made to MGM Resorts' balance sheet here.

Valuation: we made $35.1 billion of adjustments with a net effect of decreasing shareholder value by $26.6 billion. Apart from total debt, the most notable adjustment to shareholder value was $4.9 billion in minority interests. This adjustment represents 33% of MGM Resorts' market cap. See all adjustments to MGM Resorts' valuation here.

This article originally published on December 11, 2020.

Disclosure: David Trainer, Kyle Guske II, Alex Sword, and Matt Shuler receive no compensation to write about any specific stock, style, or theme.

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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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