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

Recap From December's Picks

Our Most Attractive Stocks (+2.7%) outperformed the S&P 500 (+0.9%) from December 3, 2020 through January 4, 2021 by 1.8%. The best performing large cap stock gained 18% and the best performing small cap stock was up 12%. Overall, 24 out of the 40 Most Attractive stocks outperformed the S&P 500.

Our Most Dangerous Stocks (+3.6%) underperformed the S&P 500 (+0.9%) as a short portfolio from December 3, 2020 through January 4, 2021 by 2.7%. The best performing large cap stock fell by 5.4% and the best performing small cap stock fell by 11.4%. Overall, 8 out of the 25 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 0.5%.

The best fundamental data in the world, proven in The Journal of Financial Economics, drives our research. Our proprietary Robo-Analyst technology[1] scales our forensic accounting expertise (featured in Barron's) across thousands of stocks[2] to produce an unrivaled database of fundamental data.

Nine new stocks make our Most Attractive list this month, and five new stocks fall onto the Most Dangerous list this month. December's Most Attractive and Most Dangerous stocks were made available to members on January 6, 2021.

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 January: Allstate Corp (ALL: $109/share)

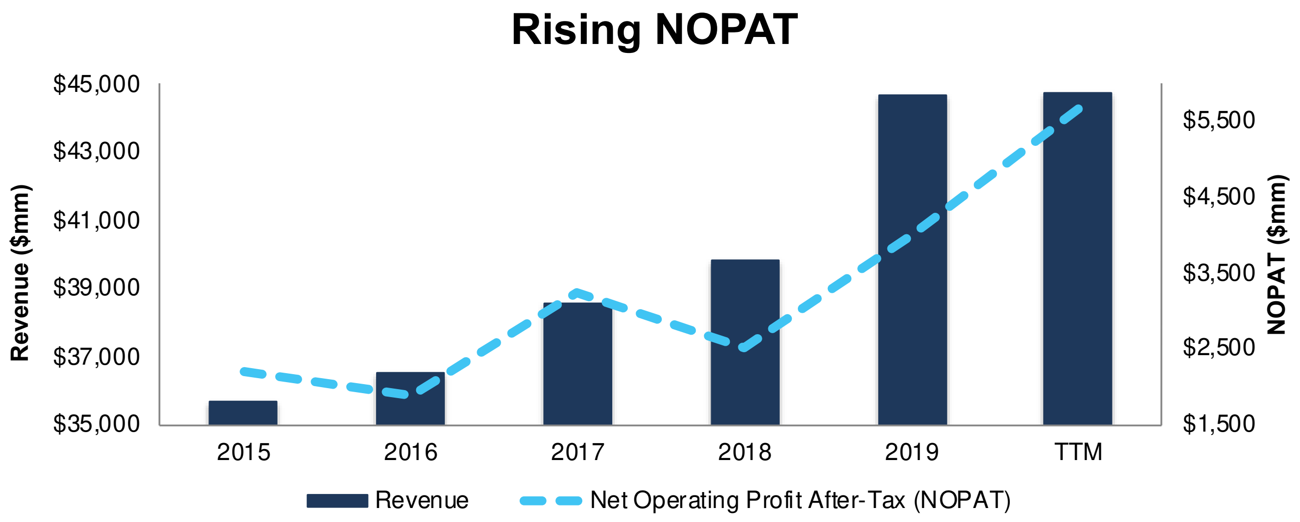
Allstate Corp is the featured stock from January's Most Attractive Stocks Model Portfolio. Allstate was also a Long Idea in May 2020 and continues to provide quality risk/reward.

Allstate has grown revenue by 5% compounded annually and net operating profit after-tax (NOPAT) by 7% compounded annually over the past five years.

The firm's NOPAT margin increased from 6% in 2015 to 13% TTM while its invested capital turns improved slightly from 1.5 to 1.7 over the same period. The combination of rising margins and invested capital turns drive Allstate's ROIC from 9% in 2015 to 22% TTM. Allstate's profitability helps the firm generate significant free cash flow (FCF). Since 2015, the firm generated $12.1 billion (27% of market cap) in cumulative FCF. Over the TTM, Allstate generated $4.5 billion in FCF.

[1] Harvard Business School features our research automation technology in the case Disrupting Fundamental Analysis with Robo-Analysts.
[2] See how our models and financial ratios are superior to Bloomberg and Capital IQ's (SPGI) analytics in the detailed appendix of this paper.

Figure 1: Revenue & NOPAT Since 2015



Sources: New Constructs, LLC and company filings

ALL Is Undervalued

At its current price of $109/share, ALL has a price-to-economic book value (PEBV) ratio of 0.3. This ratio means the market expects Allstate's NOPAT to permanently decline by 70%. This expectation seems overly pessimistic for a firm that has grown NOPAT by 7% compounded annually over the past five years.

Even if Allstate's NOPAT margin falls to 8% (compared to 13% TTM) and the firm grows NOPAT by just 2% compounded annually for the next decade, the stock is worth $265/share today – a 143% upside. See the math behind this reverse DCF scenario.

Critical Details Found in Financial Filings by Our Robo-Analyst Technology

Fact: we provide superior fundamental data and earnings models – unrivaled in the world.
Proof: Core Earnings: New Data & Evidence, forthcoming in The Journal of Financial Economics.

Below are specifics on the adjustments we make based on Robo-Analyst findings in Allstate's 10-K and 10-Q's:

Income Statement: we made $2.4 billion of adjustments, with a net effect of removing $688 million in non-operating income (2% of revenue). You can see all the adjustments made to Allstate's income statement here.

Balance Sheet: we made $5.2 billion of adjustments to calculate invested capital with a net decrease of $530 million. One of the largest adjustments was $2.6 billion in other comprehensive income. This adjustment represented 10% of reported net assets. You can see all the adjustments made to Allstate's balance sheet here.

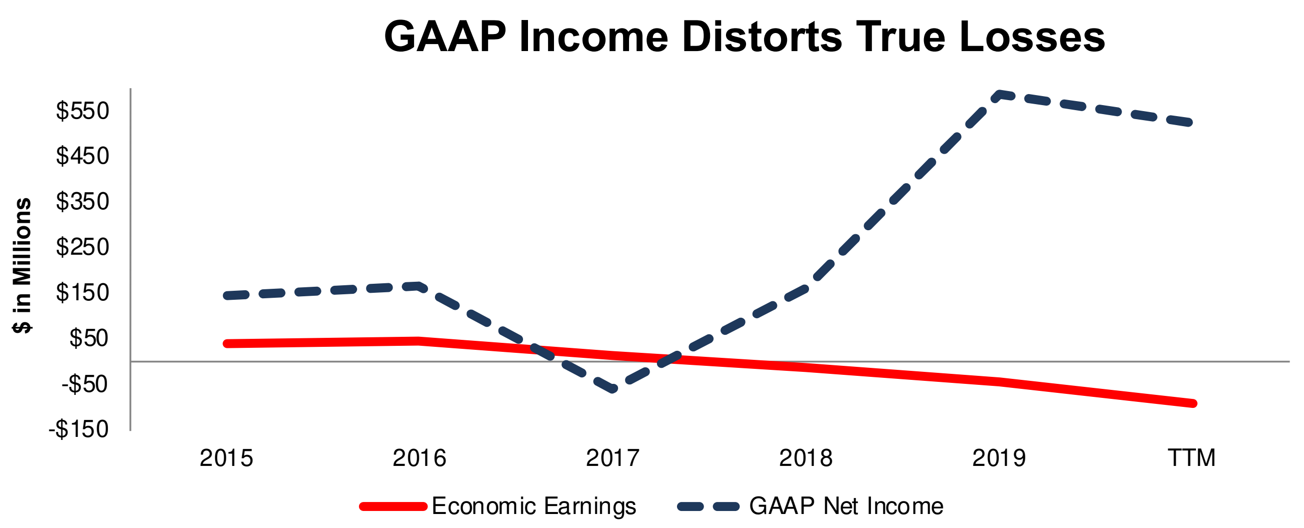
Valuation: we made $5.2 billion of adjustments with a net impact of decreasing shareholder value by $5.2 billion. There were no adjustments that increased shareholder value. The most notable adjustment to shareholder value was $2 billion in preferred stock. This adjustment represents 6% of Allstate's market cap. See all adjustments to Allstate's valuation here.

Most Dangerous Stocks Feature: Avient Corp (AVNT: $44/share)

Avient Corp (AVNT) is the featured stock from January's Most Dangerous Stocks Model Portfolio.

While Aviant's GAAP net income improved from $145 million in 2015 to $523 million TTM, the firm's economic earnings, the true cash flows of the business, fell from $38 million to -$93 million over the same time, per Figure 2. More recently, the firm's NOPAT margin fell from 6% in 2019 to 4% TTM and ROIC fell from 6% to 3% over the same time.

Figure 2: GAAP Net Income vs. Economic Earnings Since 2015



Sources: New Constructs, LLC and company filings

AVNT Provides Poor Risk/Reward

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

To justify its current price of $44/share, Avient must immediately achieve a 8% NOPAT margin (vs. all-time high of 7.2%) and grow NOPAT by 8% compounded annually for the next decade. See the math behind this reverse DCF scenario. This expectation seems overly optimistic given the firm's NOPAT has fallen by 3% compounded annually over the past five years.

Even if Avient can improve its NOPAT margin to 6% (vs. 4% TTM) and grow NOPAT by 7% compounded annually for the next 10 years, the stock is worth just $34/share today, a 23% downside to the current stock price. See the math behind this reverse DCF scenario.

Each of these scenarios also assumes Avient 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, AVNT's invested capital has grown by an average of $107 million (4% of 2019 revenue) over the past 10 years.

Critical Details Found in Financial Filings by Our Robo-Analyst Technology

Fact: we provide superior fundamental data and earnings models – unrivaled in the world.
Proof: Core Earnings: New Data & Evidence, forthcoming in The Journal of Financial Economics.

Below are specifics on the adjustments we make based on Robo-Analyst findings in Avient's 10-K and 10-Q's:

Income Statement: we made $664 million of adjustments, with a net effect of removing $408 million in in non-operating income (16% of revenue). You can see all the adjustments made to Avient's income statement here.

Balance Sheet: we made $1.7 billion of adjustments to calculate invested capital with a net increase of $176 million. One of the largest adjustments was $573 million in asset write-downs. This adjustment represented 22% of reported net assets. You can see all the adjustments made to Avient's balance sheet here.

Valuation: we made $2.5 billion of adjustments with a net effect of decreasing shareholder value by $1.6 billion. Apart from total debt, the most notable adjustment to shareholder value was $34 million in outstanding ESOs. This adjustment represents 1% of Avient's market cap. See all adjustments to Avient's valuation here.

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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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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:

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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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