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

**Recap From September's Picks**

Our Most Attractive Stocks (-4.7%) outperformed the S&P 500 (-5.2%) from September 2, 2021 through October 4, 2021 by 0.5%. The best performing large cap stock gained 19% and the best performing small cap stock was up 6%. Overall, 22 out of the 40 Most Attractive stocks outperformed the S&P 500.

Our Most Dangerous Stocks (-3.0%) underperformed the S&P 500 (-5.2%) as a short portfolio from September 2, 2021 through October 4, 2021 by 2.2%. The best performing large cap stock fell by 10% and the best performing small cap stock fell by 25%. Overall, 11 out of the 33 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 0.9%.



More reliable & proprietary fundamental data, 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.

Six new stocks make our Most Attractive list this month, and six new stocks fall onto the Most Dangerous list this month. October's Most Attractive and Most Dangerous stocks were made available to members on October 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 October: Omnicom Group (OMC: $74/share)

Omnicom Group is the featured stock from October's Most Attractive Stocks Model Portfolio. We also made Omnicom a Long Idea in May 2020 and reiterated our opinion on the stock in April 2021.

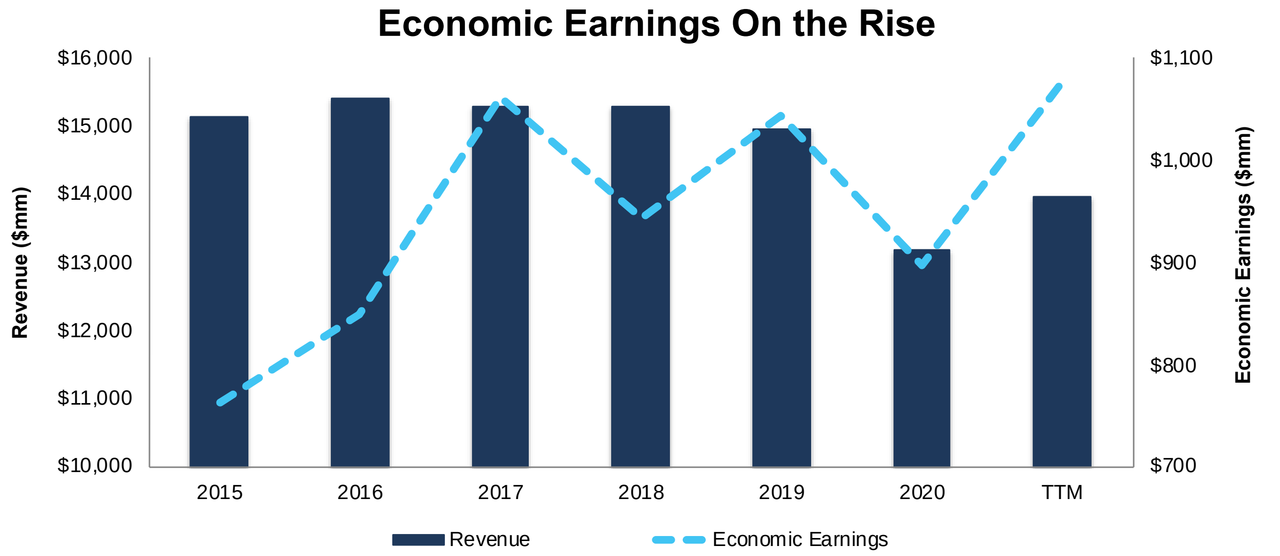
Omnicom has grown revenue by 1% compounded annually and net operating profit after-tax (NOPAT) by 2% compounded annually over the last decade.

The company's NOPAT margin increased from 9% in 2015 to 11% over the trailing twelve months (TTM), while invested capital turns remained flat at 1.3 over the same period. Rising margins help drive Omnicom's ROIC from 12% in 2015 to 14% TTM.

Over the past five years, Omnicom generated $8.3 billion (52% of market cap) in cumulative free cash flow (FCF). Over the TTM, Omnicom has generated $2.2 billion in FCF. The company's economic earnings, or the true cash flows of the business, have grown from $763 million in 2015 to $1.1 billion over the TTM. See Figure 1.

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

**Figure 1: Revenue & Economic Earnings Since 2015**




Sources: New Constructs, LLC and company filings

### OMC Is Undervalued

At its current price of $74/share, OMC has a price-to-economic book value (PEBV) ratio of 0.5. This ratio means the market expects Omnicom's NOPAT to permanently decline by 50%. This expectation seems overly pessimistic for a company that has grown NOPAT by 5% compounded annually over the past two decades.

Even if Omnicom's NOPAT margin falls to 8% (equal to 20-year low, compared to 11% TTM) and the company's NOPAT grows by just 1% compounded annually for the next decade, the stock is worth $131/share today – a 77% upside. See the math behind this reverse DCF scenario. Should Omnicom grow profits more in line with historical levels, the stock has even more upside.

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

Fact: we provide more reliable 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 Omnicom's 10-K and 10-Qs:

Income Statement: we made $1.0 billion in adjustments, with a net effect of removing $359 million in non-operating expenses (3% of revenue). You can see all the adjustments made to Omnicom's income statement here.

Balance Sheet: we made $8.2 billion in adjustments to calculate invested capital with a net decrease of $1.8 billion. One of the most notable adjustments was $1.2 billion in goodwill adjustments. This adjustment represented 10% of reported net assets. You can see all the adjustments made to Omnicom's balance sheet here.

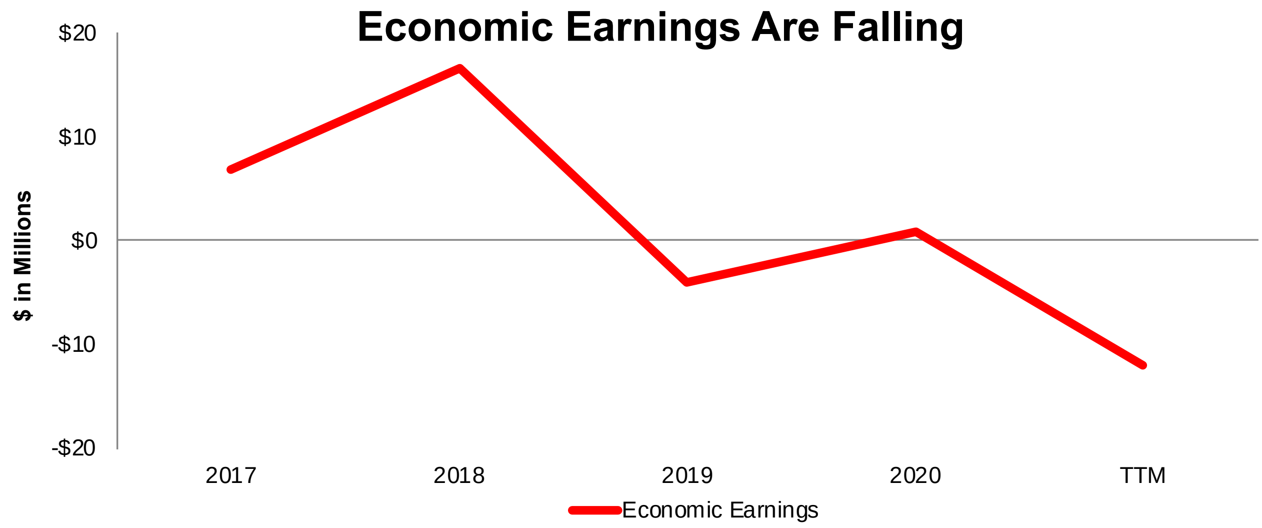
Valuation: we made $12.4 billion in adjustments, with a net effect of decreasing shareholder value by $5.0 billion. Other than total debt, one of the most notable adjustments to shareholder value was $3.7 billion in excess cash. This adjustment represents 5% of Omnicom's market cap. See all adjustments to Omnicom's valuation here.

## Most Dangerous Stocks Feature: AppFolio Inc. (APPF: $125/share)

AppFolio Inc. (APPF) is the featured stock from October's Most Dangerous Stocks Model Portfolio.

AppFolio's economic earnings, the true cash flows of the business, fell from $7 million in 2017 to -$12 million over the TTM. The company's NOPAT margin fell from 7% in 2017 to <1% TTM, while invested capital turns fell from 4.0 to 1.9 over the same time. Falling NOPAT margins and invested capital turns drive AppFolio's ROIC from 27% in 2017 to <1% TTM.

**Figure 2: Economic Earnings Since 2017**




Sources: New Constructs, LLC and company filings

**APPF Provides Poor Risk/Reward**

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

To justify its current price of $125/share, AppFolio must improve its NOPAT margin to 12% (above all time high of 11%, compared to >1% TTM) and grow NOPAT by 43% compounded annually for the next decade. See the math behind this reverse DCF scenario. Given that AppFolio's NOPAT fell from $10 million in 2017 to >$1 million over the TTM, we think these expectations are overly optimistic.

Even if AppFolio can achieve a NOPAT margin of 12% and grow NOPAT by 31% compounded annually for the next decade, the stock is worth just $61/share today – a 51% downside to the current stock price. See the math behind this reverse DCF scenario. Should AppFolio's NOPAT grow at a slower rate or, even worse, continue its downward trend, the stock has even more downside.

Each of these scenarios also assumes AppFolio 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**

Fact: we provide more reliable 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 AppFolio's 10-K and 10-Qs:

Income Statement: we made $232 million in adjustments, with a net effect of removing $146 million in in non-operating income (47% of revenue). You can see all the adjustments made to AppFolio's income statement here.

Balance Sheet: we made $188 million in adjustments to calculate invested capital with a net decrease of $187 million. One of the most notable adjustments was $12 million in deferred tax assets. This adjustment represented 4% of reported net assets. You can see all the adjustments made to AppFolio's balance sheet here.

Valuation: we made $290 million in adjustments with a net effect of increasing shareholder value by $3 million. The most notable adjustment to shareholder value was $147 million in excess cash. This adjustment represents 3% of AppFolio's market cap. See all adjustments to AppFolio'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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## *It's Official: We Offer the Best Fundamental Data in the World*

Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

**Best Fundamental Data in the World**

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

**Superior Models**

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [ as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

**Superior Stock Ratings**

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

Our mission is to provide the best fundamental analysis of public and private businesses in the world and make it affordable for all investors, not just Wall Street insiders.

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