New Constructs®
Diligence | Independence | Performance

FEATURED STOCKS
10/14/22

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

Seven new stocks made our Most Attractive list this month, while three new stocks joined the Most Dangerous list. We published October's Most Attractive and Most Dangerous stocks to members on October 5, 2022.

September Performance Recap

Our Most Attractive Stocks (-7.1%) underperformed the S&P 500 (-6.3%) from September 2, 2022 through October 3, 2022 by 0.8%. The best performing large cap stock gained 5% and the best performing small cap stock was up 9%. Overall, 20 out of the 40 Most Attractive stocks outperformed the S&P 500.

Our Most Dangerous Stocks (-5.3%) underperformed the S&P 500 (-6.3%) as a short portfolio from September 2, 2022 through October 3, 2022 by 1.0%. The best performing large cap short stock fell by 18% and the best performing small cap short stock fell by 20%. Overall, 16 out of the 39 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 1.8%.

This report leverages our cutting-edge Robo-Analyst technology to deliver proven-superior[1] fundamental research and support more cost-effective fulfillment of the fiduciary duty of care.

Our Most Attractive stocks all have high and rising return on invested capital (ROIC) and low price to economic book value ratio. Most Dangerous stocks have misleading earnings and long growth appreciation periods implied by their market valuations.

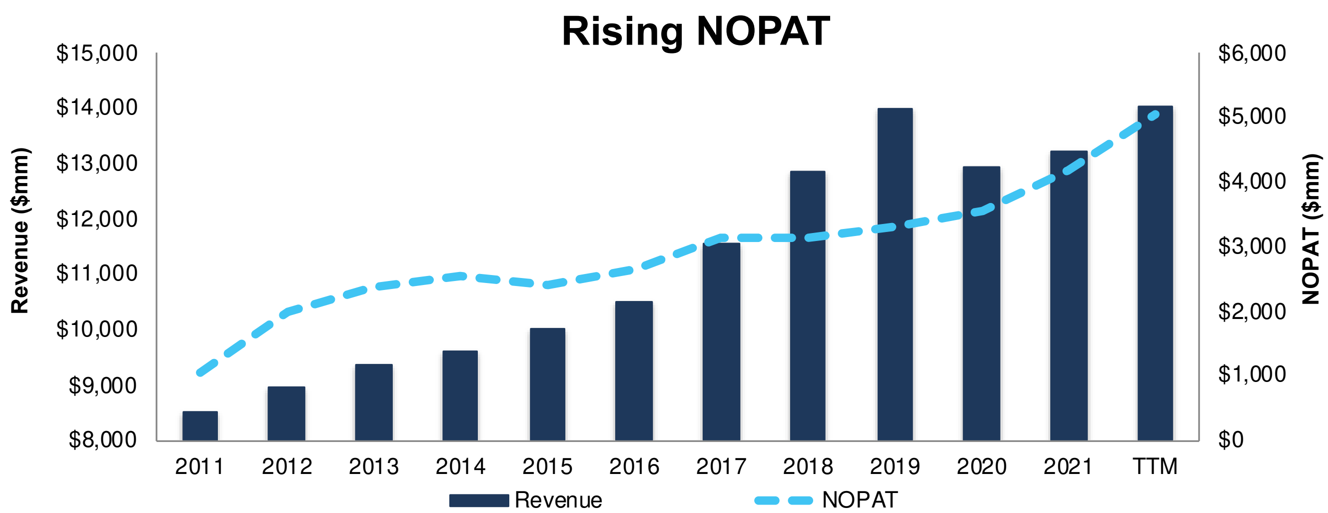
Most Attractive Stocks Feature for October: Discover Financial Services (DFS: $94/share)

Discover is the featured stock from October's Most Attractive Stocks Model Portfolio.

Discover has grown revenue and net operating profit after-tax (NOPAT) by 5% and 16% compounded annually, respectively, over the past 10 years. Discover's NOPAT margin has increased from 12% in 2011 to 36% over the trailing-twelve-months (TTM), while return on invested capital (ROIC) rose from 11% to 26% over the same time.

[1] Our research utilizes our Core Earnings, a more reliable measure of profits, as proven in Core Earnings: New Data & Evidence, written by professors at Harvard Business School (HBS) & MIT Sloan and published in The Journal of Financial Economics.

Figure 1: Revenue & NOPAT Since 2011



Sources: New Constructs, LLC and company filings

Discover Is Undervalued

At its current price of $94/share, DFS has a price-to-economic book value (PEBV) ratio of 0.5. This ratio means the market expects Discover's NOPAT to permanently decline by 50%. This expectation seems overly pessimistic for a company that has grown NOPAT by 12% compounded annually over the past five years and 16% compounded annually over the past decade.

Even if Discover's NOPAT margin falls to its 10-year average of 26% (vs. 36% TTM) and NOPAT falls 1% compounded annually for the next decade, the stock would be worth $125+/share today – a 33% upside. See the math behind this reverse DCF scenario. Should Discover 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

Below are specifics on the adjustments we made based on Robo-Analyst findings in Discover's 10-Qs and 10-Ks:

Income Statement: we made $1.6 billion in adjustments, with a net effect of removing $1.2 billion in non-operating income (9% of revenue). Clients can see all adjustments made to Discover's income statement on the GAAP Reconciliation tab on the Ratings page on our website.

Balance Sheet: we made $9.8 billion in adjustments to calculate invested capital with a net increase of $5.2 billion. One of the most notable adjustments was $6.8 billion in total reserves. This adjustment represents 51% of reported net assets. Clients can see all adjustments made to Discover's balance sheet on the GAAP Reconciliation tab on the Ratings page on our website.

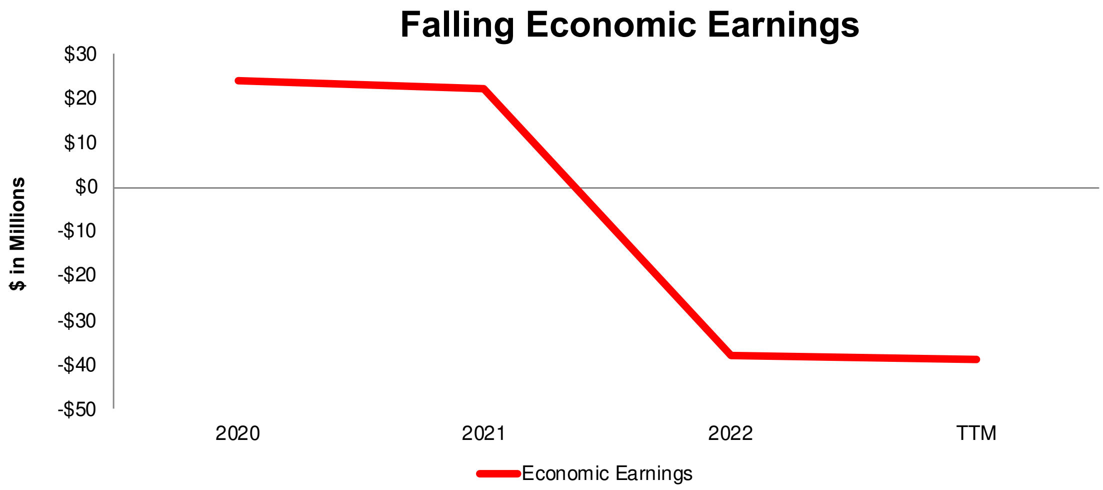
Valuation: we made $1.2 billion of adjustments all of which decreased shareholder value. The most notable adjustment to shareholder value was $1.1 billion in preferred stock. This adjustment represents 4% of Discover's market cap. Clients can see all adjustments to Discover's valuation on the GAAP Reconciliation tab on the Ratings page on our website.

Most Dangerous Stocks Feature: AeroVironment (AVAV: $80/share)

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

Since its acquisition of Arcturus, AeroVironment's economic earnings, the true cash flows of the business, have fallen from $24 million in FYE 2020 (fiscal year end was 4/30/20) to -$39 million over the TTM. AeroVironment's NOPAT margin has fallen from 10% to 2%, while invested capital turns fell from 1.6 to 0.6 over the same time. Falling NOPAT margins and invested capital turns drive AeroVironment's ROIC from 17% in FYE 2020 to 1% over the TTM.

Figure 2: Economic Earnings Since FYE 2020



Sources: New Constructs, LLC and company filings

AeroVironment Provides Poor Risk/Reward

Despite its poor fundamentals, AeroVironment's stock is priced for significant profit growth, and we believe the stock is overvalued.

To justify its current price of $80/share, AeroVironment must improve its NOPAT margin to 11% (all-time high in 2019 compared to 2% TTM) and grow NOPAT by 39% compounded annually for the next ten years. See the math behind this reverse DCF scenario. Given that AeroVironment's NOPAT fell 34% compounded annually over the past three years, we think these expectations are overly optimistic.

Even if AeroVironment can improve its NOPAT margin to 9% and grow NOPAT by 30% compounded annually for the next decade, the stock would be worth no more than $40/share today – a 50% downside to the current stock price. See the math behind this reverse DCF scenario.

Each of these scenarios also assumes AeroVironment can grow revenue, NOPAT, and FCF without increasing working capital or fixed assets. This assumption is unlikely but allows us to create truly 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

Below are specifics on the adjustments we made based on Robo-Analyst findings in AeroVironment's 10-Qs and 10-Ks:

Income Statement: we made $39 million in adjustments, with a net effect of removing $1 million in non-operating expense (<1% of revenue). Clients can see all adjustments made to AeroVironment's income statement on the GAAP Reconciliation tab on the Ratings page on our website.

Balance Sheet: we made $150 million in adjustments to calculate invested capital with a net decrease of $48 million. One of the most notable adjustments was $22 million in asset write-downs. This adjustment represented 3% of reported net assets. Clients can see all adjustments made to AeroVironment's balance sheet on the GAAP Reconciliation tab on the Ratings page on our website.

Valuation: we made $319 million in adjustments, with a net decrease to shareholder value of $117 million. Apart from total debt, the most notable adjustment to shareholder value was $101 million in excess cash. This adjustment represents 5% of AeroVironment's market cap. Clients can see all adjustments to AeroVironment's valuation on the GAAP Reconciliation tab on the Ratings page on our website.

This article originally published on October 14, 2022.

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

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

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.

We believe every investor deserves to know the whole truth about the profitability and valuation of any company they consider for investment. More details on our cutting-edge technology and how we use it are here.

DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first two days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convDiscoverence and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.