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

Nine new stocks made our Most Attractive list this month, while three new stocks joined the Most Dangerous list. We published January's Most Attractive and Most Dangerous stocks to members on January 5, 2023.

December Performance Recap

Our Most Attractive Stocks (-2.4%) outperformed the S&P 500 (-2.8%) from December 7, 2022 through January 3, 2023 by 0.4%. The best-performing large cap stock gained 4% and the best-performing small cap stock was up 8%. Overall, 24 out of the 40 Most Attractive stocks outperformed the S&P 500.

Our Most Dangerous Stocks (-1.5%) underperformed the S&P 500 (-2.8%) as a short portfolio from December 7, 2022 through January 3, 2023 by 1.3%. The best-performing large cap short stock fell by 8% and the best-performing small cap short stock fell by 21%. Overall, 13 out of the 40 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%.

Buy the Most Attractive Stocks Model Portfolio

Buy the Most Dangerous Stocks Model Portfolio

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.

All of our Most Attractive stocks 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.

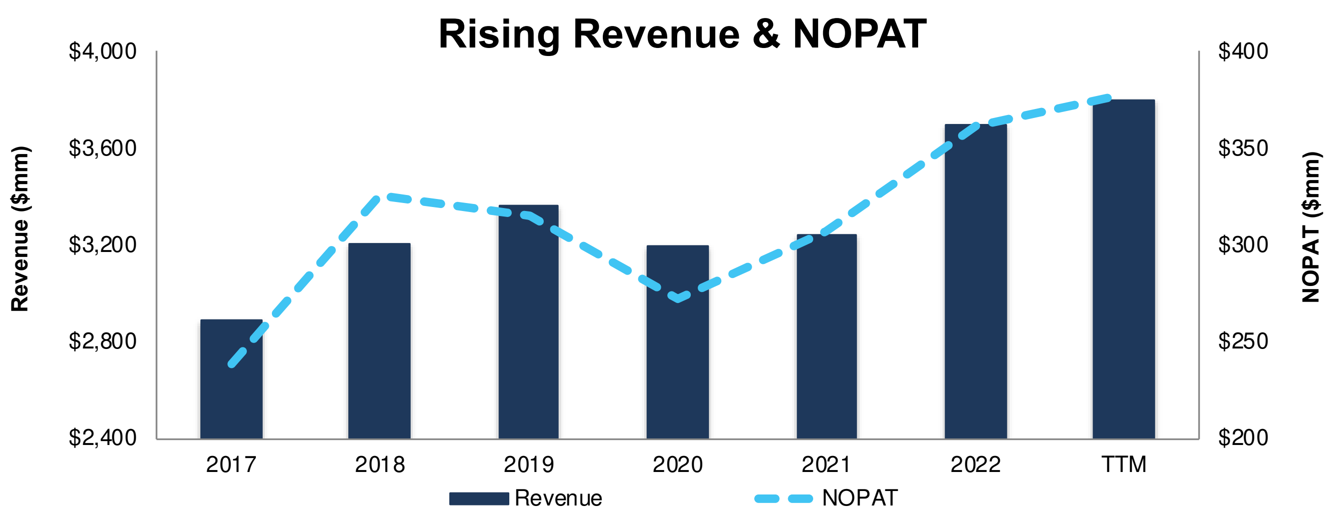
Most Attractive Stocks Feature for January: MSC Industrial Direct Co, Inc. (MSM: $80/share)

MSC Industrial is the featured stock from January's Most Attractive Stocks Model Portfolio.

MSC Industrial has grown revenue by 5% compounded annually and net operating profit after tax (NOPAT) by 9% compounded annually since fiscal 2017 (FYE is 9/2/17). The company's NOPAT margin has increased from 8% in fiscal 2017 to 10% over the trailing-twelve-months (TTM) while invested capital turns rose from 1.5 to 1.6 over the same time. Rising NOPAT margins and invested capital turns drive MSC Industrial's return on invested capital (ROIC) from 13% in fiscal 2017 to 16% over the TTM.

[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: MSC Industrial Revenue and NOPAT Since Fiscal 2017



Sources: New Constructs, LLC and company filings

MSC Industrial Is Undervalued

At its current price of $80/share, MSM has a price-to-economic book value (PEBV) ratio of 0.8, which means the market expects MSC Industrial's NOPAT to permanently decline by 20%. This expectation seems overly pessimistic for a company that has grown NOPAT by 9% compounded annually since fiscal 2017 and 14% compounded annually since fiscal 2002.

Even if MSC Industrial maintains its TTM NOPAT margin of 10% and grows revenue just 3% compounded annually for the next decade, the stock would be worth $115+/share today – a 44% upside. In this scenario, MSC Industrial's NOPAT would grow 3% compounded annually for the next 10 years. See the math behind this reverse DCF scenario. Should MSC Industrial 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 MSC Industrial's 10-Qs and 10-Ks:

Income Statement: we made $56 million in adjustments, with a net effect of removing $20 million in non-operating expenses (1% of revenue). Clients can see all adjustments made to MSC Industrial's income statement on the GAAP Reconciliation tab on the Ratings page on our website.

Balance Sheet: we made $766 million in adjustments to calculate invested capital with a net increase of $648 million. One of the most notable adjustments was $55 million in mid-year acquisitions. This adjustment represents 3% of reported net assets. Clients can see all adjustments made to MSC Industrial's balance sheet on the GAAP Reconciliation tab on the Ratings page on our website.

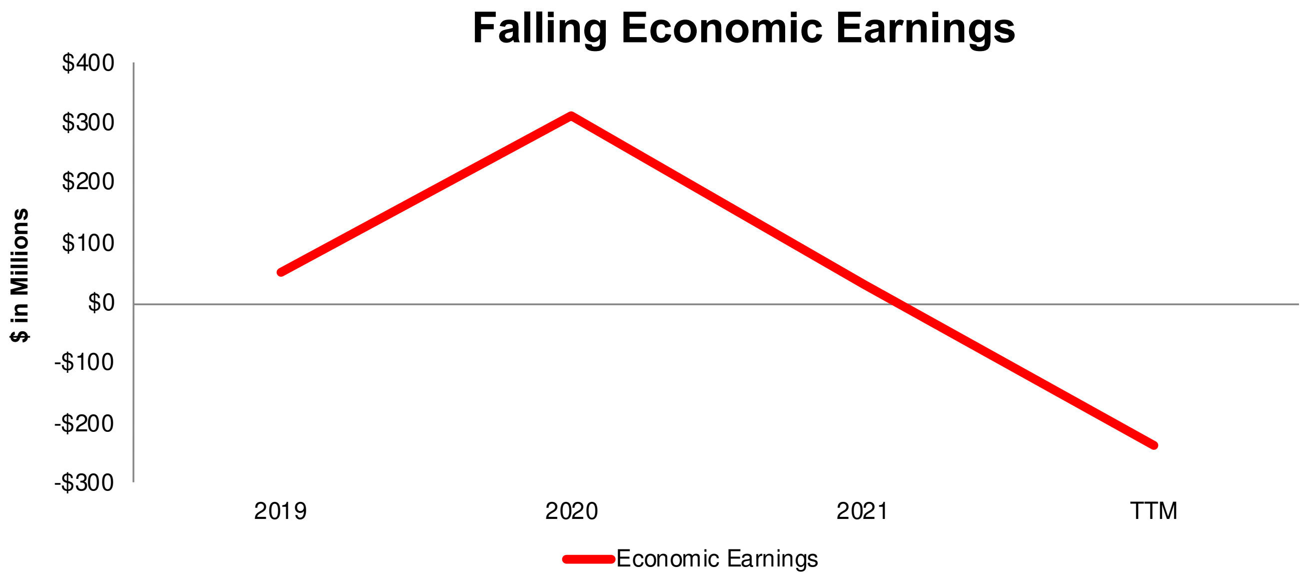
Valuation: we made $974 million in adjustments, all of which decreased shareholder value. Apart from total debt, the most notable adjustment was $115 million in deferred tax liabilities. This adjustment represents 3% of MSC Industrial's market cap. Clients can see all adjustments to MSC Industrial's valuation on the GAAP Reconciliation tab on the Ratings page on our website.

Most Dangerous Stocks Feature: Vertiv Holdings Co (VRT: $15/share)

Vertiv Holdings Co (VRT) is the featured stock from January's Most Dangerous Stocks Model Portfolio.

Vertiv's economic earnings, the true cash flows of the business, have fallen from $52 million in 2019 to -$236 million over the TTM. Over the same time, Vertiv's NOPAT margin has fallen from 5% to 1%, while invested capital turns fell from 1.4 to 1.1. Falling NOPAT margins and invested capital turns drive Vertiv's ROIC from 7% in 2019 to 1% over the TTM.

Figure 2: Vertiv Holdings Economic Earnings Since 2019



Sources: New Constructs, LLC and company filings

Vertiv Offers Poor Risk/Reward

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

To justify its current price of $15/share, Vertiv must improve its NOPAT margin to 5% (compared to 1% in the TTM) and grow revenue by 13% compounded annually for the next 10 years. In this scenario, Vertiv's NOPAT would grow 13% compounded annually over the next decade. See the math behind this reverse DCF scenario. Given that Vertiv's NOPAT has fallen 41% compounded annually since 2019, we think these expectations are overly optimistic.

Even if Vertiv improves its NOPAT margin to 4% and grows revenue by 10% compounded annually for the next decade, the stock would be worth no more than $5/share today – a 67% downside to the current stock price. See the math behind this reverse DCF scenario.

Each of these scenarios also assumes Vertiv can 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 the high expectations embedded in the current valuation.

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 Vertiv's 10-Qs and 10-Ks:

Income Statement: we made $315 million in adjustments, with a net effect of removing $110 million in non-operating expenses (2% of revenue). Clients can see all adjustments made to Vertiv's income statement on the GAAP Reconciliation tab on the Ratings page on our website.

Balance Sheet: we made $2.0 billion in adjustments to calculate invested capital with a net decrease of $1.8 billion. One of the most notable adjustments was $1.6 billion in mid-year acquisitions. This adjustment represented 32% of reported net assets. Clients can see all adjustments made to Vertiv's balance sheet on the GAAP Reconciliation tab on the Ratings page on our website.

Valuation: we made $3.6 billion in adjustments, all of which decreased shareholder value. Apart from total debt, the most notable adjustment to shareholder value was $109 million in deferred tax liabilities. This adjustment represents 2% of Vertiv's market cap. Clients can see all adjustments to Vertiv's valuation on the GAAP Reconciliation tab on the Ratings page on our website.

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Disclosure: David Trainer, Kyle Guske II, Matt Shuler, and Italo Mendonça 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.

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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.

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