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

Fifteen new stocks made our Most Attractive list this month, while four new stocks joined the Most Dangerous list. We published August's Most Attractive and Most Dangerous stocks to members on August 3, 2023.

July Performance Recap

Our Most Attractive Stocks (+9.3%) outperformed the S&P 500 (+4.0%) last month by 5.3%. The best performing large cap stock gained 28% and the best performing small cap stock was up 23%. Overall, 32 out of the 40 Most Attractive stocks outperformed the S&P 500.

Our Most Dangerous Stocks (+7.8%) underperformed the S&P 500 (+4.0%) as a short portfolio last month by 3.8%. The best performing large cap short stock fell by 5% and the best performing small cap short stock fell by 3%. Overall, 12 out of the 32 Most Dangerous stocks outperformed the S&P 500 as shorts.

The Most Attractive/Most Dangerous Model Portfolios outperformed as an equal-weighted long/short portfolio by 1.5%.

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.

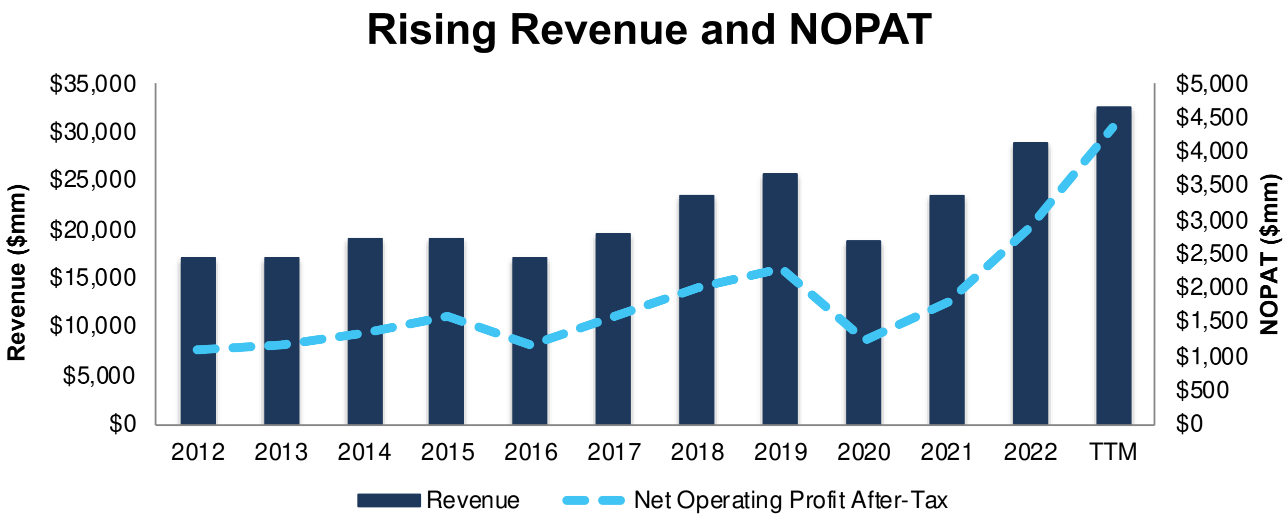
Most Attractive Stocks Feature for August: (PCAR: $85/share)

Paccar Inc. is the featured stock from August's Most Attractive Stocks Model Portfolio. We first made PACCAR Inc. (PCAR: $85/share) a Long Idea in July 2020 and the stock remains undervalued.

Paccar has grown revenue by 6% compounded annually and net operating profit after tax (NOPAT) by 14% compounded annually since 2012. Paccar's NOPAT margin increased from 7% in 2012 to 13% in the trailing twelve months (TTM), and invested capital turns rose from 2.5 to 2.7 over the same time. Rising NOPAT margins and invested capital turns drive Paccar's return on invested capital (ROIC) from 16% in 2012 to 36% in 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: Paccar's Revenue and NOPAT Since 2012



Sources: New Constructs, LLC and company filings

Paccar Is Undervalued

At its current price of $85/share, PCAR has a price-to-economic book value (PEBV) ratio of 0.7. This ratio means the market expects Paccar's NOPAT to permanently decline by 30%. This expectation seems overly pessimistic for a company that has grown NOPAT by 20% compounded annually since 2017 and 14% compounded annually since 2012.

Even if Paccar's NOPAT margin falls to 8.5% (compared to 13% in the TTM and 10% in 2022) and the company's revenue grows just 6% compounded annually through 2032, the stock would be worth $104/share today – a 22% upside. Should Paccar 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 Paccar's 10-Qs and 10-Ks:

Income Statement: we made $212 million in adjustments, with a net effect of removing $130 million in non-operating income (1% of revenue). Clients can see all adjustments made to Paccar's income statement on the GAAP Reconciliation tab on the Ratings page on our website.

Balance Sheet: we made $6.7 billion in adjustments to calculate invested capital with a net decrease of $4.5 billion. One of the most notable adjustments was $953 million in adjustments for other comprehensive income. This adjustment represents 6% of reported net assets. Clients can see all adjustments made to Paccar's balance sheet on the GAAP Reconciliation tab on the Ratings page on our website.

Valuation: we made $6.0 billion in adjustments, with a net increase in shareholder value of $5.5 billion. The most notable adjustment was $5.0 billion in excess cash. This adjustment represents 11% of Paccar's market value. Clients can see all adjustments to Paccar's valuation on the GAAP Reconciliation tab on the Ratings page on our website.

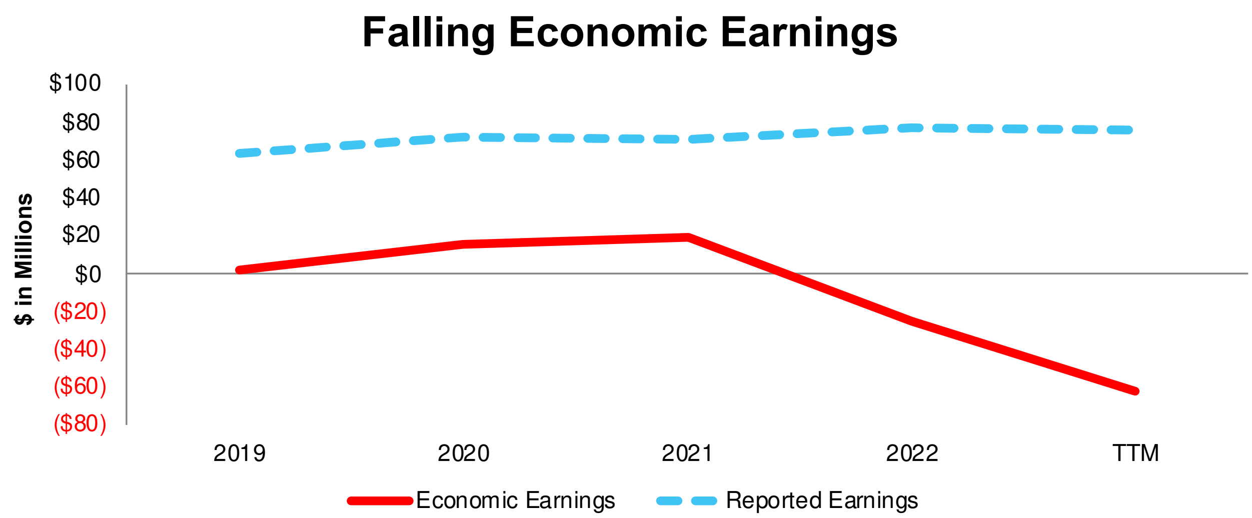
Most Dangerous Stocks Feature: Mueller Water Products (MWA: $14/share)

Mueller Water Products, in. (MWA) is the featured stock from August's Most Dangerous Stocks Model Portfolio.

Mueller Water Products' NOPAT has fallen from $113 million in 2019 to $96 million over the TTM, or 4% compounded annually. NOPAT margin has fallen from 12% in 2019 to 7% in the TTM and such falling NOPAT margins drive Mueller Water Products' ROIC from 6.2% to 4.6% over the same time.

Mueller Water Products' economic earnings, the true cash flows of the business, have fallen from $3 million in 2019 to -$62 million in the TTM. See Figure 2.

Figure 2: Mueller Water Products' Economic vs. Reported Earnings: 2019 – TTM



Sources: New Constructs, LLC and company filings

MWA Provides Poor Risk/Reward

Despite its poor fundamentals, Mueller Water Products' stock is priced for significant profit growth, and we believe the stock is overvalued.

To justify its current price of $14/share, Mueller Water Products must improve its NOPAT margin to 8% (2022 level, up from 7% over the TTM)) and grow revenue by 9% (well above 10-year CAGR of 2%) compounded annually through 2032. In this scenario, Mueller Water Products' NOPAT grows 9% compounded annually through 2032 and would equal $236 million in that year, or over 2x its highest-ever NOPAT achieved in 2019. We think these expectations are overly optimistic.

Even if Mueller Water Products maintains its NOPAT margin at TTM levels of 7% and grows revenue 5% compounded annually through 2032, the stock would be worth no more than $8/share today – a 40% downside to the current stock price.

Each of these scenarios also assumes Mueller Water Products 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 Mueller Water Products' 10-Qs and 10-K:

Income Statement: we made $45 million in adjustments, with a net effect of removing $21 million in non-operating expenses (2% of revenue). Clients can see all adjustments made to Mueller Water Products' income statement on the GAAP Reconciliation tab on the Ratings page on our website.

Balance Sheet: we made $1.0 billion in adjustments to calculate invested capital with a net increase of $727 million. One of the most notable adjustments was $804 million in asset write-downs. This adjustment represented 64% of reported net assets. Clients can see all adjustments made to Mueller Water Products' balance sheet on the GAAP Reconciliation tab on the Ratings page on our website.

Valuation: we made $587 million in adjustments, with a net decrease to shareholder value of $433 million. The most notable adjustment to shareholder value was $80 million in net deferred tax liabilities. This adjustment represents 4% of Mueller Water Products' market value. Clients can see all adjustments to Mueller Water Products' valuation on the GAAP Reconciliation tab on the Ratings page on our website.

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Disclosure: David Trainer, Kyle Guske II, Hakan Salt, and Italo Mendonça receive no compensation to write about any specific stock, style, or theme.

Questions on this report or others? Join our Society of Intelligent Investors and connect with us directly.

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.

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