Three Keys *to avoiding* *the next* Stock Market Crash

with New Constructs

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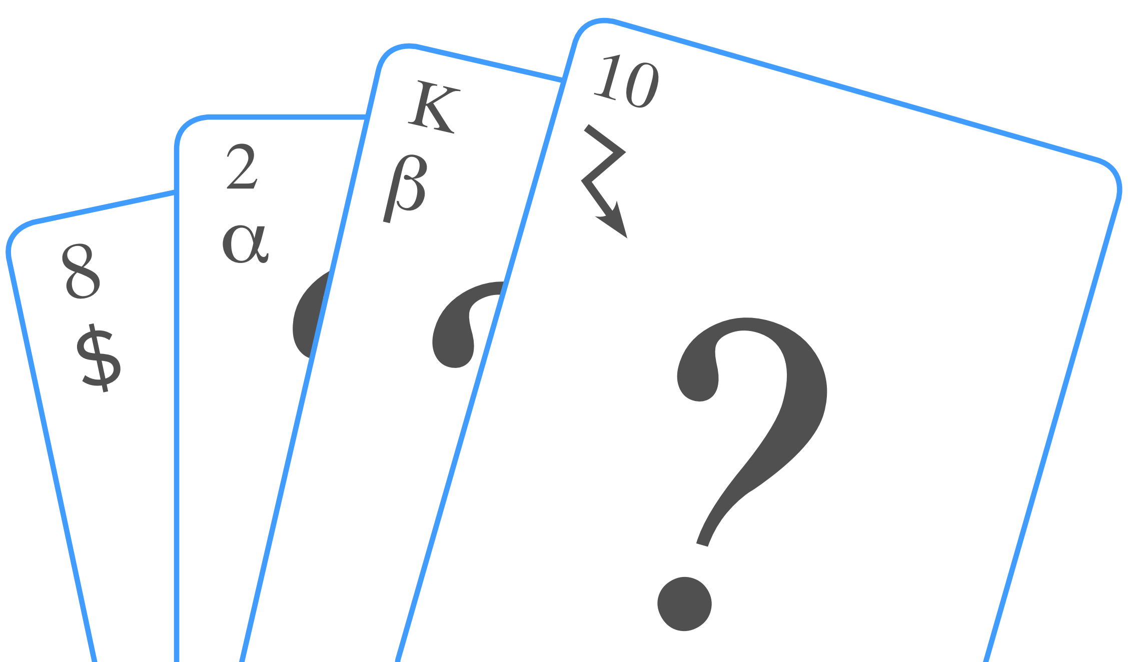
INTRODUCTION: Investing ≠ Fortune Telling

Investors are inundated with predictions every day.

BUY BUY BUY!

SELL SELL SELL!

Constant headlines and the 24/7 news cycle reinforce the idea that stock movements are correlated with these predictions.



The reality is that 99 percent of stock predictions are just noise.

News is more focused on entertainment than on providing valuable information to investors.

How can you cut through the noise?

The answer is to manage risk and reward.

Not as sexy as what you get on T.V.

But if you're not clairvoyant, you have only two options:

Gamble

Do Your Diligence

Success in the stock market is defined far more by how well you avoid downside than by how well you can catch upside.

Avoiding bad stocks with high risk is easy. Finding good stocks with low risk takes hard work. And both require discipline.

This book will teach you to do both.

It will also teach you to have enough conviction in your investments to stay the course in the face of the most bearish of market climates.

THE EASY PART: Avoiding High-Risk Downside

High-risk stocks have two characteristics:

#1 They have misleading earnings and weak but hyped business models.

#2 They are greatly overvalued.

Many “opportunists” are lured by the tremendous run-ups of social media, technology, and other speculative stocks.

Too many are lured by the belief that these stocks give them a chance to cash in on returns that can top 400% per year.

Ironically, it is these run-ups that cause the stocks to be overvalued in the first place.

The reality is that these stocks are poor investments.

Stock valuations should always be rooted in the present value of a company's expected future cash flows.

Our discounted cash flow model reveals that some of these stocks have valuations that imply their profits will grow by 25% every year for the next 25 years.

Very few — if any — companies can achieve this type of growth.

These are the kinds of stocks that make our Most Dangerous Stocks list.

With our Most Dangerous Stocks list, we go a step further and identify companies whose business models look strong on paper but are struggling underneath.

These companies are growing their reported earnings, but the underlying cash flows of the businesses — their economic earnings — are negative or declining.

Rising reported earnings disguising declining economic earnings leads investors to believe the underlying business model is better than it really is.

These companies' earnings look good to the market, so stock prices rise on a tide of expectations for strong future earnings — regardless of the true underlying cash flows.

Reported earnings and true cash flows can only diverge for so long. So what happens when these companies can no longer keep the EPS machine going?

Their stock prices tumble.

While these stocks' alluring run-ups may make them look appealing, they are in fact some of the worst investments out there.

They are far too risky and can sink an entire portfolio when reality sets in.

These stocks are ticking time bombs. You never know when they will blow up.

"The Market Timer's Hall of Fame is an empty room."

— Jane Bryant Quinn

II

THE HARD PART: Finding Low-Risk Upside

Learning to avoid

over-hyped, expensive,

and

unprofitable

companies is a critical part of managing risk — but it is also the easy part. A strong portfolio also needs reliable upside.

That is the hard part.

Low-risk/high-upside stocks have two characteristics:

#1 They are fundamentally strong, with solid profit growth and good returns on capital.

#2 These strong businesses must be mismatched with low valuations.

These low-risk/high-upside stocks are our targets. They land on our Most Attractive Stocks list.

Our Most Attractive Stocks are low-priced relative to their companies' economic (not accounting) book values. The market has low expectations for their future cash flows.

equation:

Cheap Valuation
+
Strong Business
=
Low-Risk Upside

Low expectations for a business minimizes the stock's downside, especially in the event of a market crash because the stock is already super cheap.

And when we can be certain about the strength of a company's core business, we have great confidence it can exceed the expectations that its price implies.

The diligence behind selecting our Most Attractive Stocks goes beyond the usual levels of investment research. We apply a series of adjustments to uncover the amount of real cash flow a business generates: its economic earnings.

Economic earnings provide us with the best picture of a company's profitability by incorporating all of the available data from a company's annual report.

When we combine these two characteristics — high-quality earnings and cheap valuations — we are left with low risk for downside, and a greater probability of upside.

THE CRUCIAL PART: Discipline

Avoiding high-risk downside and finding low-risk upside are the two keys to constructing a portfolio that will deliver superior returns over the long run. However, both of these lessons are useless without the discipline to stand by your guns over the long term.

Q: Why can you be disciplined?

A: Because you know that you have performed due diligence on your investments.

Real due diligence means reading through each and every page of a company's annual report. There is important information hidden in the financial footnotes and MD&A that is not available anywhere else.

Some companies' annual reports are thousands of pages long.

Our patented research technology and expert analysts parse through annual reports quickly and efficiently. We find these hidden charges and income and include them in our economic earnings calculation.

We believe that this is the best way to invest.

One of our favorite quotes is:

> **“Invest in what you know.”**
> *— Peter Lynch*

And when we make investment recommendations, we do the hard work needed to ensure that there is little — if anything — about these stocks that we don’t know.

In the next chapter, we’ll provide a few examples in which our economic earnings calculation gave us insight unavailable to the rest of the market.

These picks delivered superior returns and protected our clients’ portfolios.

AFTERWARD: Managing Your Risk Right Now

In the following three examples, you'll be able to see the importance of economic earnings and due diligence in identifying high-risk downside and low-risk upside in the stock market. We still hold positions in some of these picks.

Our tools make it easy for us and for our clients to identify red flags and hidden gems in the stock market.

In particular, our monthly Most Attractive and Most Dangerous Stocks lists highlight the best opportunities for low risk, and help you avoid the worst high-risk stocks.

CASE 1: Angie's List (ANGI)

Short Call: September 9, 2013

At the time of our call, the consistently unprofitable ANGI was trading at $20.05. This price implied that ANGI needed to grow revenue by 25% compounded annually for 15 years.

However, our careful analysis of the company's footnotes allowed us to uncover that ANGI's core business — consumer reviews using a subscription model — had been declining for years. Average revenue per user halved between 2009 and 2012.

ANGI met both criteria for high-risk downside stocks: Weak business model and expensive valuation.

The result?

DOWN -60%

CASE 2: Netsuite (N)

Short Call: January 7, 2014

At a glance, N looked healthy. Revenue had been growing at 23% compounded annually for 5 years. However, the company's net operating profit after tax (NOPAT), a key component of economic earnings, had been between -$30 million and -$15 million every year. Most of this revenue growth had taken place in the company's negative-margin Professional Services segment.

Nevertheless, N had been trading at around $103 per share. This valuation implied that the unprofitable company would immidiately achieve margins of 15% and grow revenue by 30% compounded annually for 15 years.

In this example, our economic earings calculation showed us the truth behind N's deceptive revenue growth.

DOWN -22%

CASE 3: Western Digital (WDC)

Long Call: December 4, 2012

In 2012, the market was busy focusing on the advent of cloud computing and the predicted decline of storage device manufacturers. Even great businesses like WDC — with profit growth of 48% compounded annually and a return on invested capital north of 40% — were forecasted to see a decline in profits.

Our buy recommendation was based on two facts: 1) A consistently high ROIC is the most important indicator of profitability; and 2) Great businesses like WDC rarely see 70% declines in profit, which is what WDC's then-valuation of $34 implied at the time.

WDC met both of our low-risk upside criteria: a strong business with low expectations.

UP +265%

Want more advice on how to:

I. Avoid bad stocks?

II. Find good stocks?

III. Enjoy a disciplined approach to investing?

Take a virtual tour
to see all of the benefits of our service

Click here for our Most Attractive Stocks Lists

Click here for our Most Dangerous Stocks Lists

Disclaimer: New Constructs/Novo Capital Management are short N and ANGI as of 8/4/14.

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