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DILIGENCE PAYS 3/14/2017

Fed Watching Can Be A Costly Distraction

Another hike in the federal funds rate on Wednesday appears all-but certain. Experts, prediction markets, and Fed officials themselves all indicate that the central bank is ready to raise target rates 25 basis points to a range of 0.75%-1.00%.

Amidst all the clamor of another rate hike, the stock market is responding, yet again, with a hearty ¯_(ツ)_/¯. It's been over 100 days since the market experienced a 1% drop, and the S&P 500 is up 18% since the first Fed rate hike in December 2015. Strong corporate profits and the hopes of a more expansionary fiscal policy are driving the market, and the Fed is behind the curve.

Investors agonizing over the Fed should focus their efforts elsewhere. Instead of guessing where interest rates will go, read some of the thousands of annual 10-K reports that have come out in the past month. Finding red flags and hidden expenses in the footnotes is a much more profitable activity than listening to pundits argue about Janet Yellen for hours on end.

Fundamentals Are Driving This Market

First off, it's worth noting that the Fed has never truly controlled interest rates. There are plenty of historical examples where the Fed tried to push rates in one direction while long-term interest rates moved the opposite way.

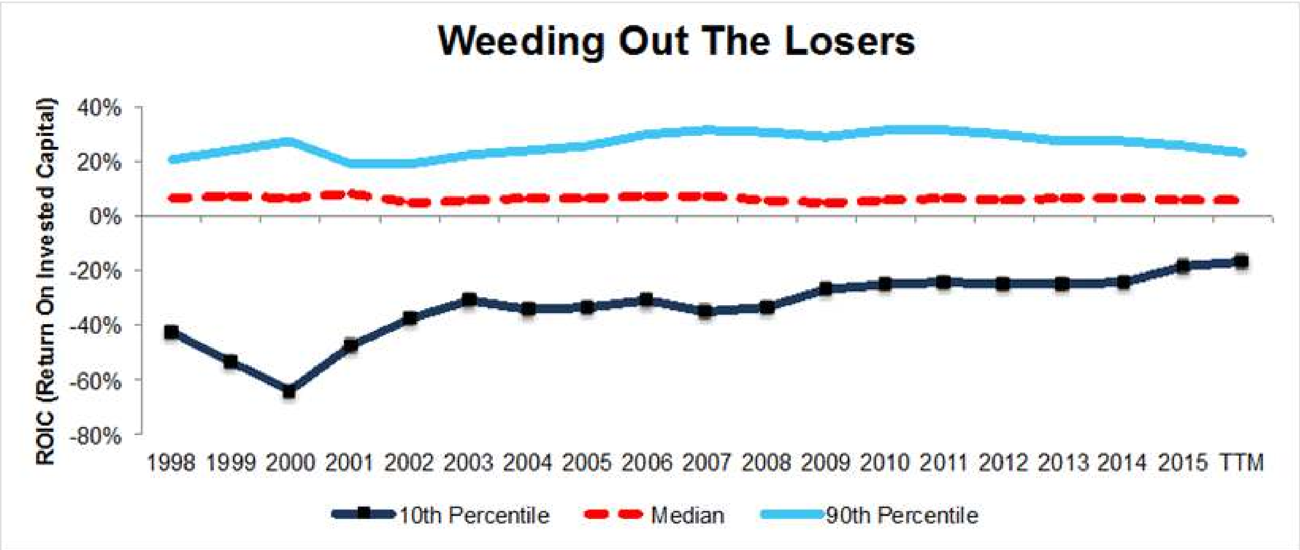
More importantly, the Fed itself says rates won't rise that much. From the minutes of the last FOMC meeting:

"*The neutral real rate—defined as the real interest rate that is neither expansionary nor contractionary when the economy is operating at or near its potential—was currently quite low and was likely to rise only slowly over time.*"

Even the Fed acknowledges that low interest rates are the new normal, and it's hard to argue with that assertion. It took eight years of near-zero rates for inflation to even come close to the Fed's 2% target, and technological innovation should continue to slow the rate of inflation even as interest rates stay low.

Another argument for high interest rates is that they prevent capital from flowing to businesses with a low return on invested capital (ROIC). Figure 1 shows how that argument falls flat as well.

Figure 1: ROIC for the 10th & 90th Percentiles and Median ROIC Companies



Sources: New Constructs, LLC and company filings.

In our analysis of roughly 3,000 publicly traded firms, we found that the ROIC for the bottom tenth percentile has been steadily rising. Even with rates near zero, the market is doing a better job than ever before at weeding out the worst performing companies.

Diligence Matters More Than Ever

As the Fed's influence on the economy wanes, the need for diligent fundamental research grows greater. At the start of the bull market, low interest rates and quantitative easing were a rising tide that lifted all boats. As we shift to a market driven by fiscal policy, correlations are breaking down.

Figure 1 reinforces the fact that the market increasingly cares about ROIC, and companies that focus on maximizing their ROIC outperform.

Accurately calculating ROIC is hard. You need to dig through hundreds of pages of footnotes to locate items such as:

- Hidden non-operating income, such as a $999 million non-operating gain we found on page 148 of AstraZeneca's annual report
- Off-balance sheet debt, such as the $198 million we found hidden on page 91 of The Habit Restaurant's 10-K
- Changes in reserves, such as the $411 million decrease we found on page 22 of US Steel's 10-K

The painstaking work of reading through 10-K's may not be as exciting as Fed speculation, but it makes you a much better investor.

This article originally published here on March 15, 2017.

Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

Don't judge a fund by its cover. Take a look inside at its holdings and understand the quality of earnings and valuation of the stocks it holds. We enable you to choose the best fund based on its stock-picking merits so you do not have to rely solely on backward-looking technical metrics.

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Our Philosophy About Research

Accounting data is not designed for equity investors, but for debt investors. Accounting data must be translated into economic earnings to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. Economic earnings are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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