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

Recap from October's Picks

Our Most Attractive Stocks (-1.1%) underperformed the S&P 500 (+1.5%) last month. Most Attractive Large Cap stock Lam Research Corp (LRCX) gained 13%. Most Attractive Small Cap stock National Presto Industries (NPK) was up 9%. Overall, 13 out of the 40 Most Attractive stocks outperformed the S&P 500 in October.

Our Most Dangerous Stocks (-1.9%) outperformed the S&P 500 (+1.5%) as a short portfolio last month. Most Dangerous Large Cap stock Supervalu Inc. (SVU) fell by 25% and Most Dangerous Small Cap Stock Del Taco Restaurants (TACO) fell by 18%. Overall, 25 out of the 40 Most Dangerous stocks outperformed the S&P 500.

The successes of the Most Attractive and Most Dangerous stocks highlight the value of our Robo-Analyst technology, which helps clients fulfill the fiduciary duty of care when making investment recommendations[1].

12 new stocks make our Most Attractive list this month and 13 new stocks fall onto the Most Dangerous list this month. November's Most Attractive and Most Dangerous stocks were made available to members on November 2, 2017.

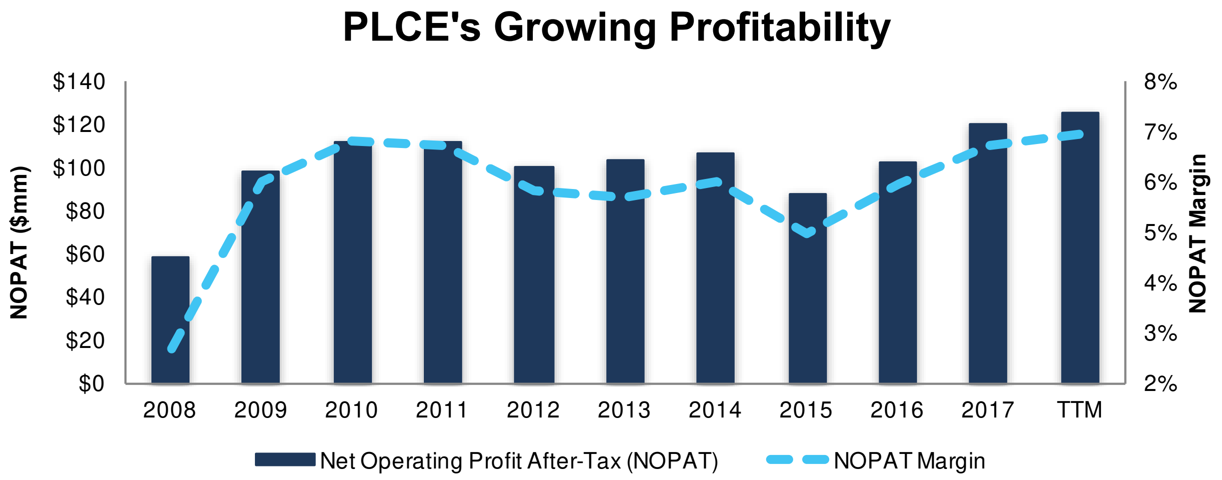
Our Most Attractive stocks have high and rising returns on invested capital (ROIC) and low price to economic book value ratios. Most Dangerous stocks have misleading earnings and long growth appreciation periods implied by their market valuations.

Most Attractive Stocks Feature for November: Childrens Place Inc. (PLCE: $111/share)

Childrens Place (PLCE), specialty retailer of children's clothing, is the featured stock from November's Most Attractive Stocks Model Portfolio.

PLCE's after-tax profit (NOPAT) has grown 8% compounded annually since 2008, largely through increased profitability. PLCE's NOPAT margin has improved from 3% in 2008 to 7% over the last twelve months (TTM), per Figure 1. In addition to margin improvement, PLCE's return on invested capital (ROIC) has improved from 4% in 2008 to 11% TTM. The company also ties long-term executive bonuses to ROIC, which earns it a spot on October's Exec Comp Aligned with ROIC Model Portfolio.

Figure 1: PLCE's Profit & Margins Since 2008



Sources: New Constructs, LLC and company filings

[1] Ernst & Young's recent white paper "Getting ROIC Right" proves the superiority of our holdings research and analytics.

PLCE Priced for Permanent Profit Decline

At its current price of $111/share, PLCE has a price-to-economic book value (PEBV) ratio of 0.9. This ratio means the market expects PLCE's NOPAT to permanently decline by 10% from current levels. This expectation seems overly pessimistic for a firm that has generated 8% compound annual NOPAT growth since 2008.

If PLCE can maintain current NOPAT margins (7%) and grow NOPAT by 3% compounded annually for the next five years, the stock is worth $150/share today – a 35% upside.

Auditable Impact of Footnotes and Forensic Accounting Adjustments

Our Robo-Analyst technology enables us to perform forensic accounting with scale and provide the research needed to fulfill fiduciary duties. In order to derive the true recurring cash flows, an accurate invested capital, and an accurate shareholder value, we made the following adjustments to Childrens Place's 2017 10-K:

Income Statement: we made $50 million of adjustments, with a net effect of removing $18 million in non-operating expense (1% of revenue). We removed $16 million in non-operating income and $34 million in non-operating expenses. You can see all the adjustments made to PLCE's income statement here.

Balance Sheet: we made $1 billion of adjustments to calculate invested capital with a net increase of $603 million. One of the largest adjustments was $554 million due to off-balance sheet operating leases. This adjustment represented 95% of reported net assets. You can see all the adjustments made to PLCE's balance sheet here.

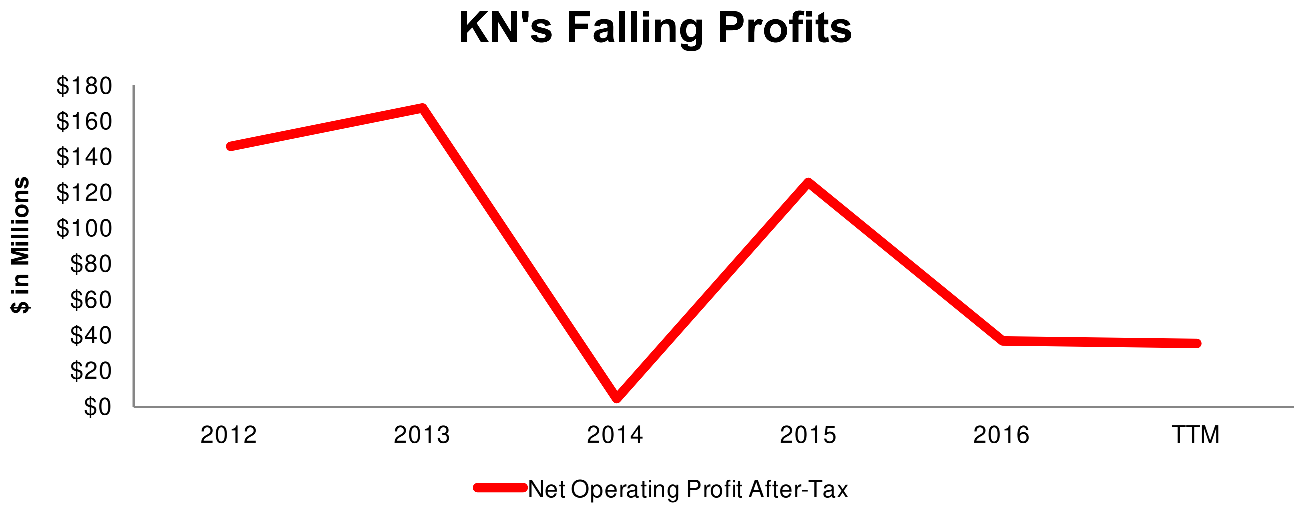
Valuation: we made $779 million of adjustments with a net effect of decreasing shareholder value by $443 million. Apart from total debt, which includes the operating leases noted above, the largest adjustment to shareholder value was $168 million in excess cash. This adjustment represents 9% of PLCE's market cap. Despite the decrease in shareholder value, PLCE remains undervalued.

Most Dangerous Stocks Feature: Knowles Corp (KN: $16/share)

Knowles Corp (KN), manufacturer of audio components for mobile devices, is the featured stock from November's Most Dangerous Stocks Model Portfolio.

Since 2012, Knowles' revenue has fallen 6% compounded annually while NOPAT has fallen 29% compounded annually, per Figure 2. The rapid deterioration in NOPAT stems from KN's falling margins, which have declined from 13% in 2012 to 4% TTM. Additionally, KN's ROIC has declined from 8% in 2012 to a bottom-quintile 2% TTM.

Figure 2: KN's NOPAT Since 2012



Sources: New Constructs, LLC and company filings

KN Presents Poor Risk/Reward Tradeoff

Despite the poor fundamentals, KN is only down 3% year-to-date and up 14% over the past year, while the S&P is up 15% and 21% over the same time frames. The slight price appreciation leaves KN with significant downside risk.

To justify its current price of $16/share, KN must maintain TTM margins (4%) and grow NOPAT by 17% compounded annually for the next decade. This expectation seems rather optimistic for a firm that has seen NOPAT fall 29% compounded annually over the past five years.

Even if KN is able to maintain margins and grow NOPAT by 9% compounded annually for the next decade, the stock is only worth $6/share today – a 63% downside.

Auditable Impact of Footnotes and Forensic Accounting Adjustments

Our Robo-Analyst technology enables us to perform forensic accounting with scale and provide the research needed to fulfill fiduciary duties. In order to derive the true recurring cash flows, an accurate invested capital, and an accurate shareholder value, we made the following adjustments to Knowles' 2016 10-K:

Income Statement: we made $121 million of adjustments, with a net effect of removing $79 million in non-operating expense (9% of revenue). We removed $21 million in non-operating income and $100 million in non-operating expenses. You can see all the adjustments made to KN's income statement here.

Balance Sheet: we made $750 million of adjustments to calculate invested capital with a net increase of $672 million. One of the largest adjustments was $411 million due to asset write-downs. This adjustment represented 30% of reported net assets. You can see all the adjustments made to KN's balance sheet here.

Valuation: we made $417 million of adjustments with a net effect of decreasing shareholder value by $387 million. The largest adjustment to shareholder value was $367 million in total debt, which includes $55 million in off-balance sheet operating leases. This lease adjustment represents 4% of KN's market cap.

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

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4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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