New Constructs®
Diligence | Independence | Performance

DILIGENCE PAYS 2/21/17

The Real Earnings Season Starts Now

Corporate earnings season may be winding down, but the real earnings season – annual 10-K filing season – starts today.

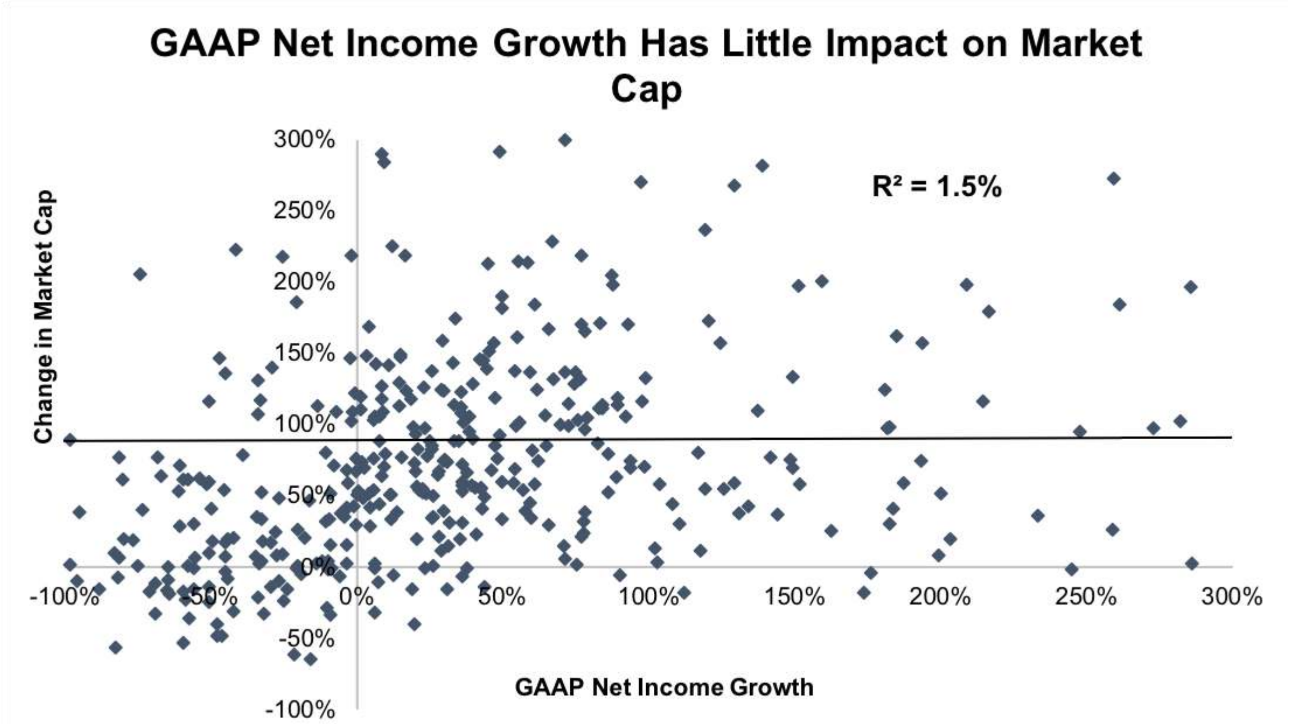
Corporate earnings announcements provide investors with limited and often misleading data. Only by reading all of the financial footnotes, which are only included in annual 10-K reports filed with the SEC, can investors know the true profits of publicly-traded companies.

Successful value investors such as Warren Buffett know that it's essential to read 10-Ks. It's the only way to reverse accounting distortions and calculate true return on invested capital (ROIC).

Reported Earnings Per Share Don't Matter

Historical data shows that reported earnings growth has a relatively limited impact on valuation, both for individual companies and the market as a whole. Figure 1 shows that GAAP net income growth over the past five years has almost no impact on the change in market cap for companies in the S&P 500.

Figure 1: GAAP Net Income Growth and Change in Market Cap Over the Past Five Years



Sources: New Constructs, LLC and company filings.

Cash is a fact. Earnings are an opinion. Investors who base their investment decisions on accounting earnings put their portfolios at risk. Advisors who make investment recommendations without performing proper due diligence are not fulfilling their fiduciary responsibilities.

Using Machine Learning to Provide Diligence at Scale

ROIC is much better than EPS at explaining changes in valuation. Unfortunately for investors, it is very difficult to calculate accurately. It's not enough to read financial statements. A rigorous calculation of ROIC must account for items that are buried in hundreds of pages of footnotes.

For a human analyst, performing this level of analysis on just a handful of companies is a daunting task. Applying that level of rigor to thousands of companies is downright impossible. That's where our technology comes in.

We use machine learning and natural language processing to automate the analysis of corporate filings. Our statistical comparison engine, which has been trained on over 120,000 human-verified filings and grows more sophisticated every day, can filter through SEC filings to recognize and tag important data, automatically building company models.

Of course, human analysts remain a vital part of the process. From mid-February through the end of March, our expert team of analysts will be coming in early and staying late to validate the data and models built by the machine and interpret unusual items that cannot be automatically processed.

This combination of computerized processing power and human expertise allows us to provide investors with the most accurate research from the "real" earnings season. Ernst & Young affirmed the superiority of our ROIC calculation in a recent white paper.

Diligence Pays

All stock research is ultimately judged on one metric: the performance of picks. Over the past year, our in-depth research has helped deliver excess returns to investors.

We introduced the Focus List model portfolio of our top-conviction Long Ideas in November. Though it's only been around for a short time, the Focus List has already demonstrated significant outperformance (6.3% return vs. 4.3% for the S&P 500).

We first recommended Lear Corp (LEA) to investors in July 2016, and the stock has been on the Focus List since its inception. LEA is up 67% since our initial long idea and 9% since it was added to the Focus List. When we first recommended LEA, we found a couple of items in the footnotes of its 2015 10-K that revealed the company was more profitable than the income statement suggested.

On page 59, we found a $6.2 million increase to the company's inventory reserve. Increasing reserves do not affect the actual cash flow of the company, but they do decrease reported profits.

On page 62, we found $5.7 million in asset write-downs hidden in operating earnings. Write-downs are a non-cash, non-recurring charge that do not impact operating cash flow.

LEA has already filed its 10-K for 2017, and it continues to earn our Very Attractive rating. On page 61 of its 2017 10-K, we found that the company increased its inventory reserve by another $15 million.

Diligence in the footnotes can also protect investors against capital losses.

The stocks in our Small Cap Most Dangerous portfolio fell by 3% in 2017 while the Russell 2000 was up 13%, for a total outperformance of 16%. In a wildly bullish year, we helped investors stay away from companies that could blow up their portfolio.

All the media buzz during "earnings" season tends to push investors into shortsighted trades. We help long-term investors create a durable competitive advantage by reading thousands of 10-Ks so they can invest with the level of diligence they've always wanted but could not get before.

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

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New Constructs® - Research to Fulfill the Fiduciary Duty of Care

Ratings & screeners on 3000 stocks, 450 ETFs and 7000 mutual funds help you make prudent investment decisions.

New Constructs leverages the latest in machine learning to analyze structured and unstructured financial data with unrivaled speed and accuracy. The firm's forensic accounting experts work alongside engineers to develop proprietary NLP libraries and financial models. Our investment ratings are based on the best fundamental data in the business for stocks, ETFs and mutual funds. Clients include many of the top hedge funds, mutual funds and wealth management firms. David Trainer, the firm's CEO, is regularly featured in the media as a thought leader on the fiduciary duty of care, earnings quality, valuation and investment strategy.

To fulfill the Duty of Care, research should be:

1. **Comprehensive** - All relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including footnotes and the management discussion & analysis (MD&A).
2. **Un-conflicted** - Clients deserve unbiased research.
3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
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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