



## This Fund Looks Beyond Accounting Earnings to Find Value

We've long argued (and [proven empirically](#)) that there is a strong correlation between improving ROIC and increasing shareholder value. Nevertheless, the majority of mutual fund managers continue to pick stocks based on flawed metrics such as [price-to-earnings ratios](#), [return on equity](#), or [accounting book value](#).

We recommend avoiding funds with managers who consider [accounting earnings](#) as representative of "fundamentals". Instead, look for managers that not only talk about cash flows and return on invested capital ([ROIC](#))<sup>1</sup>, but use them in their investment process.

We analyze<sup>2</sup> these metrics for all the holdings of over 7,500 U.S. ETFs and mutual funds daily to identify which fund managers put their analytical money where their mouth is. Occasionally, we come across a fund whose managers diligently leverage ROIC in their investment strategy. This week we are featuring one such fund, the MainStay Epoch U.S. Small Cap Fund (MOPRX), as this week's [Long Idea](#).

### Backwards Looking Research Underrates this Fund

MOPRX has underperformed its benchmark, the iShares Russell 2000 ETF (IWM), in recent years, which helps explain its 2-Star and 3-Star ratings (depending upon share class) from Morningstar. Until recently, MOPRX has also received an Unattractive or Neutral rating when viewed through our [Predictive Risk/Reward Fund Rating](#) methodology, which analyzes all the holdings of the fund as well as its costs.

As the fund has allocated more to higher rated stocks, the fund has grown more attractive. However, backward looking fund research cannot identify such a change, as evidenced by the disconnect in ratings in Figure 1. In late September, MOPRX was upgraded to an Attractive rating, and then upgraded again to a Very Attractive rating on October 5, 2018. Higher quality holdings and below average costs mean MOPRX is more likely to outperform moving forward, something traditional fund research can't tell you.

**Figure 1: MainStay Epoch U.S. Small Cap Fund Ratings**

Ticker	Morningstar Rating	New Constructs Rating
MOPRX	2 Star	Very Attractive
MOPIX	3 Star	Very Attractive
MOTRX	2 Star	Attractive
MOVRX	3 Star	Attractive
MOPCX	2 Star	Attractive

Sources: New Constructs, LLC and company filings

### Holdings Research Reveals Stock Methodology Based on ROIC

MOPRX's subadvisor, Epoch Investment Partners, uses an investment philosophy that recognizes the flawed nature of accounting earnings, [noting](#):

*"The key to understanding a company requires a focus on the cash generation drivers of the business, not a focus on accounting terms like earnings or book value."*

Furthermore, the company believes that ROIC is correlated with increasing value:

*"If a company can invest, either internally or in an acquisition, and generate a marginal return on invested capital that is greater than its marginal cost of capital, then making that investment will increase the value of the business."*

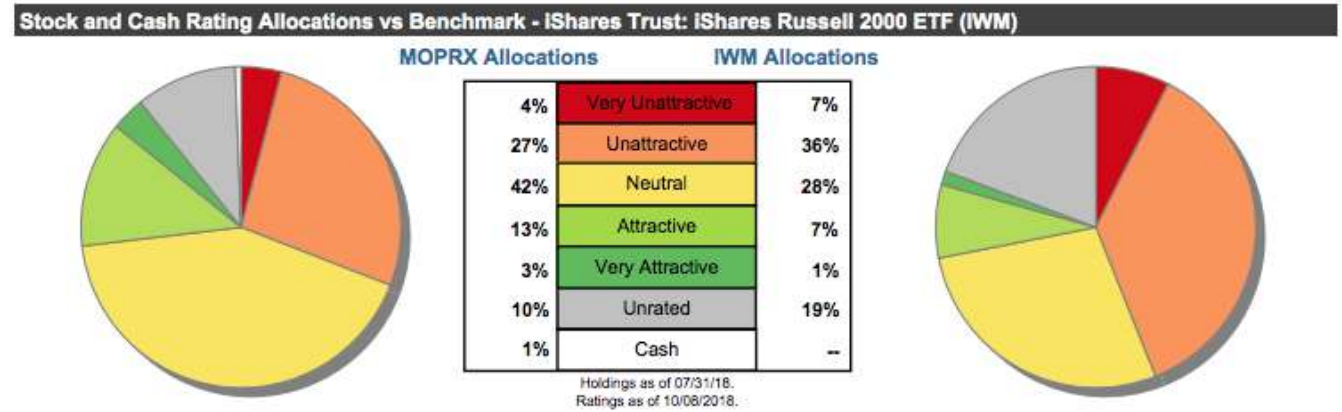
<sup>1</sup> Ernst & Young's recent white paper "[Getting ROIC Right](#)" proves the superiority of our stock research and analytics.

<sup>2</sup> Harvard Business School features our Robo-Analyst research automation technology in the case [New Constructs: Disrupting Fundamental Analysis with Robo-Analysts](#).



This investment philosophy, along with a [process](#) that assesses the quality of earnings, helps Epoch, and MOPRX, pick higher quality stocks and avoid riskier stocks compared to its peers. Figure 2 shows that MOPRX allocates a higher percentage of its assets to Attractive-or-better rated stocks and a lower percentage to Unattractive-or-worse rated stocks than its benchmark, the iShares Russell 2000 ETF (IWM).

**Figure 2: MOPRX Asset Allocation Compared to IWM**



Sources: New Constructs, LLC and company filings

Per Figure 2, MOPRX allocates 16% of its assets to Attractive-or-better rated stocks compared to just 9% for IWM. On the flip side, MOPRX allocates 31% of its assets to Unattractive-or-worse rated stocks compared to 44% for IWM.

Given this favorable allocation relative to the benchmark, MainStay Epoch U.S. Small Cap Fund appears well positioned to capture more upside with lower risk. Compared to the average mutual fund, MOPRX has a much better chance of generating the outperformance required to justify its fees.

**Superior Stock Selection Drives Superior Risk/Reward**

With a focus on ROIC and cash generation, one would expect MOPRX’s managers to excel at finding higher-quality companies (as measured by ROIC) with lower-risk valuation. Per Figure 3, they do just that.

Figure 3 contains our detailed rating for MOPRX, which includes each of the criteria we use to rate all funds under coverage. These criteria are the same for our [Stock Rating Methodology](#), because the performance of a fund’s holdings equals the performance of a fund after fees.



**Figure 3: MainStay Epoch U.S. Small Cap Fund Rating Breakdown**

**MainStay Funds Trust: MainStay Epoch US Small Cap Fund (MOPRX)** Closing Price: \$31.41 (Oct 08, 2018)  
Style: Small Cap Blend

**Analyst Notes** : Upgraded from Attractive 10/5/18 | Cause: Price Decrease: Lower Market Expectations

Risk/Reward Rating	Portfolio Management						Total Annual Costs
	Quality of Earnings		Valuation			Asset Allocation	
	Econ vs Reported EPS	ROIC	FCF Yield	Price to EBV	GAP	Cash %	
Very Unattractive	Misleading Trend	Bottom Quintile	<-5%	>3.5 or <-1	>50	>20%	>4%
Unattractive	False Positive	4th Quintile	-5%<-1%	2.4<3.5 or <-1	20<50	8%<20%	2%<4%
Neutral	Neutral EE	3rd Quintile	-1%<3%	1.6<2.4	10<20	2.5%<8%	1%<2%
Attractive	Positive EE	2nd Quintile	3%<10%	1.1<1.6	3<10	1%<2.5%	0.5%<1%
Very Attractive	Rising EE	Top Quintile	>10%	0<1.1	0<3	<1%	<0.5%
<b>Actual Values</b>							
MOPRX	Neutral EE	16%	-1%	2.1	28 yrs	<1%	1.5%
<b>Benchmarks</b>							
Style ETF (IWM)	Positive EE	5%	-1%	3.2	37 yrs	-	0.2%
S&P 500 ETF (SPY)	Positive EE	19%	2%	3.2	33 yrs	-	0.1%
Small Cap ETF (IWM)	Positive EE	5%	-1%	3.2	37 yrs	-	0.2%

Sources: New Constructs, LLC and company filings

As Figure 3 shows, MOPRX’s holdings are superior to IWM in three out of the five criteria (and equal in one) that make up our holdings analysis:

- The return on invested capital (ROIC) for MOPRX’s holdings is 16%, more than three times higher than the 5% ROIC earned by companies held by IWM.
- The price to economic book value (PEBV) ratio for MOPRX is 2.1, while the PEBV ratio for IWM is 3.2.
- Our discounted cash flow analysis reveals an average market implied growth appreciation period (GAP) of 28 years for MOPRX holdings compared to 37 years for IWM.

Ultimately, the stocks held by MOPRX generate superior cash flows compared to IWM, yet the market projects IWM stocks to grow profits by a larger amount and for a longer period of time.

**Deep Dive on a Quality Holding**

We can see how MOPRX’s methodology leads it to pick high-quality stocks by looking at one of its holdings, PetMed Express (PETS: \$30/share), which accounts for just over 1% of its portfolio.

PETS meets many of the criteria that drive MOPRX’s investment decisions. Its 78% ROIC (up from 39% in 2014) puts it in the top quintile of all 2,800+ companies under our coverage. Over the past five years, it has generated \$105 million (17% of market cap) in free cash flow and currently earns a 6% FCF yield.

At its current price of \$30/share, PETS has a price-to-economic book value (PEBV) ratio of 0.9. This ratio means the market expects PETS’ NOPAT to permanently decline by 10%. This expectation seems overly pessimistic for a firm that has grown NOPAT by 15% compounded annually over the past five years and 7% compounded annually over the last decade.

If PETS can maintain TTM NOPAT margins of 13% and grow NOPAT by just 6% compounded annually for the next decade, the stock is worth \$49/share today – a 65% upside. See the math behind this dynamic DCF scenario here.

Given the stock’s strong fundamentals and cheap valuation, it makes sense for MOPRX to overweight PETS compared to its benchmark. We featured the excellent risk/reward of this stock in our Long Idea report “Ahead of the Curve.”



By utilizing ROIC as part of its methodology and focusing on cash generation, not accounting earnings, MOPRX is able to identify highly profitable companies trading at large discounts to their fair value, such as PETS.

### **Below Average Costs Benefit Investors**

Not only does MOPRX offer high-quality stock selection, it does so at a reasonable price. The fund's [total annual costs](#) of 1.51% make it cheaper than 54% of the 844 Small Cap Blend mutual funds that we cover. Its costs are also below the Small Cap Blend mutual fund average of 1.74% but above the asset-weighted average of 0.95%.

### **The Importance of Holdings Based Fund Analysis**

While it is easy to pick a 5-Star rated fund from Morningstar, [research shows](#) such a strategy has risks and does not necessarily lead to outperformance. Smart fund investing means analyzing the holdings of each fund. Unfortunately, most investors do not realize they can get high-quality research on fund holdings and are content with investing based on past performance.

Our [Robo-Analyst technology](#) analyzes the holdings of all 892 ETFs and mutual funds in the Small Cap Blend style. The number of holdings in these ETFs and mutual funds varies from just 23 stocks to 3,266 stocks in a given fund. Our diligence on fund holdings allows us to find mutual funds, like MOPRX, with a portfolio that suggests future performance will be strong.

*This article originally published [on October 12, 2018](#).*

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

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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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