New Constructs®
Diligence | Independence | Performance

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

Recap from September's Picks

Our Most Attractive Stocks (+2.1%) outperformed the S&P 500 (-1.2%) from September 5, 2019 through October 1, 2019. The best performing large cap stock gained 14% and the best performing small cap stock was up 14% as well. Overall, 32 out of the 40 Most Attractive stocks outperformed the S&P 500.

Our Most Dangerous Stocks (+1.0%) underperformed the S&P 500 (-1.2%) as a short portfolio from September 5, 2019 through October 1, 2019. The best performing large cap stock fell by 14% and the best performing small cap stock fell by 12%. Overall, 13 out of the 40 Most Dangerous stocks outperformed the S&P 500 as shorts.

The successes of these model portfolios highlight the value of our machine learning and AI Robo-Analyst technology[1], which helps clients fulfill the fiduciary duty of care and make smarter investments[2].

12 new stocks make our Most Attractive list this month, and six new stocks fall onto the Most Dangerous list this month. October's Most Attractive and Most Dangerous stocks were made available to members on October 3, 2019.

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.

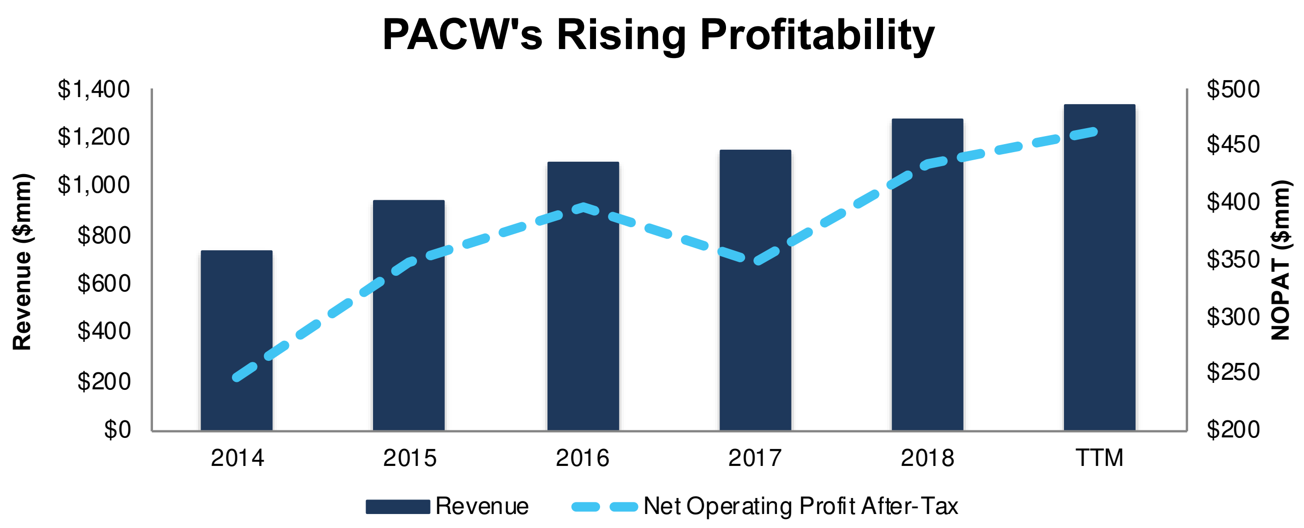
Most Attractive Stocks Feature for October: PacWest Bancorp (PACW: $36/share)

PacWest Bancorp (PACW) is the featured stock from October's Most Attractive Stocks Model Portfolio.

Since 2014, PACW's revenue and after-tax profit (NOPAT) have grown by 15% compounded annually. PACW's trailing twelve month (TTM) NOPAT is up 16% over the prior TTM period. NOPAT margin has improved from 34% in 2014 to 35% TTM while its return on invested capital (ROIC) improved from 7% to 8% over the same time.

[1] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.
[2] This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Figure 1: PACW's Revenue & NOPAT Since 2014



Sources: New Constructs, LLC and company filings

PACW Valuation Offers Upside Potential

At its current price of $36/share, PACW has a price-to-economic book value (PEBV) ratio of 0.7. This ratio means the market expects PACW's NOPAT to permanently decline by 30%. This expectation seems overly pessimistic for a firm that has grown NOPAT by 15% compounded annually since 2014 and 29% compounded annually since 2000.

If PACW can maintain TTM NOPAT margins (35%) and grow NOPAT by just 2% compounded annually for the next decade, the stock is worth $50/share today – a 39% upside. See the math behind this reverse DCF scenario.

Critical Details Found in Financial Filings by Our Robo-Analyst Technology

As investors focus more on fundamental research, research automation technology is needed to analyze all the critical financial details in financial filings. Below are specifics on the adjustments we make based on Robo-Analyst findings in PacWest Bancorp's 2018 10-K:

Income Statement: we made $54 million of adjustments, with a net effect of removing $27 million in non-operating income (2% of revenue). You can see all the adjustments made to PACW's income statement here.

Balance Sheet: we made $1.2 billion of adjustments to calculate invested capital with a net increase of $1.1 billion. One of the largest adjustments was $818 million due to asset write-downs. This adjustment represented 17% of reported net assets. You can see all the adjustments made to PACW's balance sheet here.

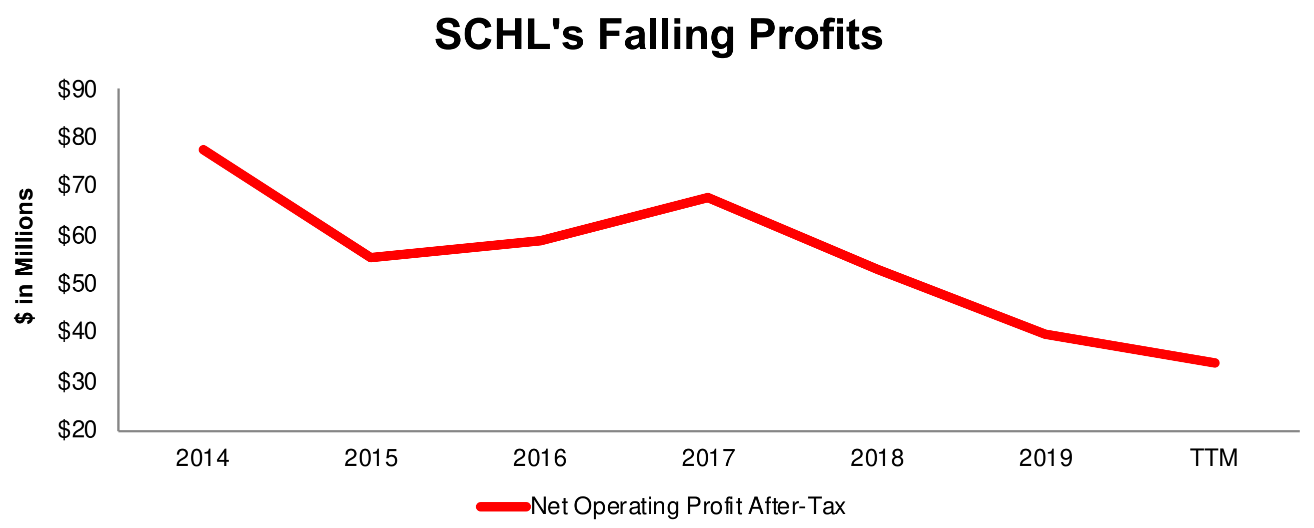
Valuation: we made $135 million of adjustments with a net effect of decreasing shareholder value by $135 million. There were no adjustments that increased shareholder value. The largest adjustment to shareholder value was $135 million in off-balance sheet operating leases. This adjustment represents 3% of PACW's market cap. See all adjustments to PACW's valuation here.

Most Dangerous Stocks Feature: Scholastic Corporation (SCHL: $37/share)

Scholastic Corporation (SCHL) is the featured stock from October's Most Dangerous Stocks Model Portfolio.

Since 2014, SCHL's NOPAT has declined by 13% compounded annually. TTM NOPAT is down 35% over the prior TTM period, per Figure 2. NOPAT margin has fallen from 4% in 2014 to 2% TTM while ROIC fell from 6% to 2% over the same time.

Figure 2: SCHL's NOPAT Since 2014



Sources: New Constructs, LLC and company filings

SCHL Provides Poor Risk/Reward

Despite its declining cash flows, SCHL is priced for significant profit growth.

To justify its current price of $37/share, SCHL must achieve NOPAT margins of 4% (double TTM margins of 2%) and grow NOPAT by 7% compounded annually for the next 15 years. See the math behind this reverse DCF scenario. This expectation seems overly optimistic given that SCHL's NOPAT has significantly declined over the past five years and currently sits at its lowest level since 1998.

Even if we assume SCHL can achieve 3% NOPAT margins and grow NOPAT by 4% compounded annually for the next decade, the stock is worth only $24/share today – a 35% downside. See the math behind this reverse DCF scenario.

Critical Details Found in Financial Filings by Our Robo-Analyst Technology

As investors focus more on fundamental research, research automation technology is needed to analyze all the critical financial details in financial filings. Below are specifics on the adjustments we make based on Robo-Analyst findings in Scholastic Corporation's 2019 10-K:

Income Statement: we made $44 million of adjustments, with a net effect of removing $24 million in non-operating expenses (1% of revenue). You can see all the adjustments made to SCHL's income statement here.

Balance Sheet: we made $732 million of adjustments to calculate invested capital with a net increase of $132 million. One of the largest adjustments was $178 million due to asset write-downs. This adjustment represented 13% of reported net assets. You can see all the adjustments made to SCHL's balance sheet here.

Valuation: we made $269 million of adjustments with a net effect of decreasing shareholder value by $37 million. The largest adjustment to shareholder value was $116 million in excess cash. This adjustment represents 9% of SCHL's market cap. See all adjustments to SCHL's valuation here.

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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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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.

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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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