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

Recap from December's Picks

Our Most Attractive Stocks (+3.1%) underperformed the S&P 500 (+3.9%) from December 4, 2019 through January 3, 2020. The best performing large cap stock gained 9% and the best performing small cap stock was up 22%. Overall, 16 out of the 40 Most Attractive stocks outperformed the S&P 500.

Our Most Dangerous Stocks (+3.3%) outperformed the S&P 500 (+3.9%) as a short portfolio from December 4, 2019 through January 3, 2020. The best performing large cap stock fell by 4% and the best performing small cap stock fell by 11%. Overall, 27 out of the 40 Most Dangerous stocks outperformed the S&P 500 as shorts.

Get the best fundamental research

Only our research utilizes the superior data and earnings adjustments featured by the HBS & MIT Sloan paper, "Core Earnings: New Data and Evidence." 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].

10 new stocks make our Most Attractive list this month, and four new stocks fall onto the Most Dangerous list this month. January's Most Attractive and Most Dangerous stocks were made available to members on January 7, 2020.

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 January: Molina Healthcare, Inc. (MOH: $143/share)

Molina Healthcare, Inc. (MOH), is the featured stock from January's Most Attractive Stocks Model Portfolio.

Over the past decade, MOH has grown after-tax profit (NOPAT) by 36% compounded annually. The firm's trailing twelve month (TTM) NOPAT is up 29% over the prior TTM period. Its NOPAT margin has averaged 2% over the past decade and is up to 5% over the TTM period. This boost in profitability is a direct result of lower medical care costs and the 2018 sale of underperforming businesses. MOH also currently earns a top-quintile return on invested capital (ROIC) of 22%.

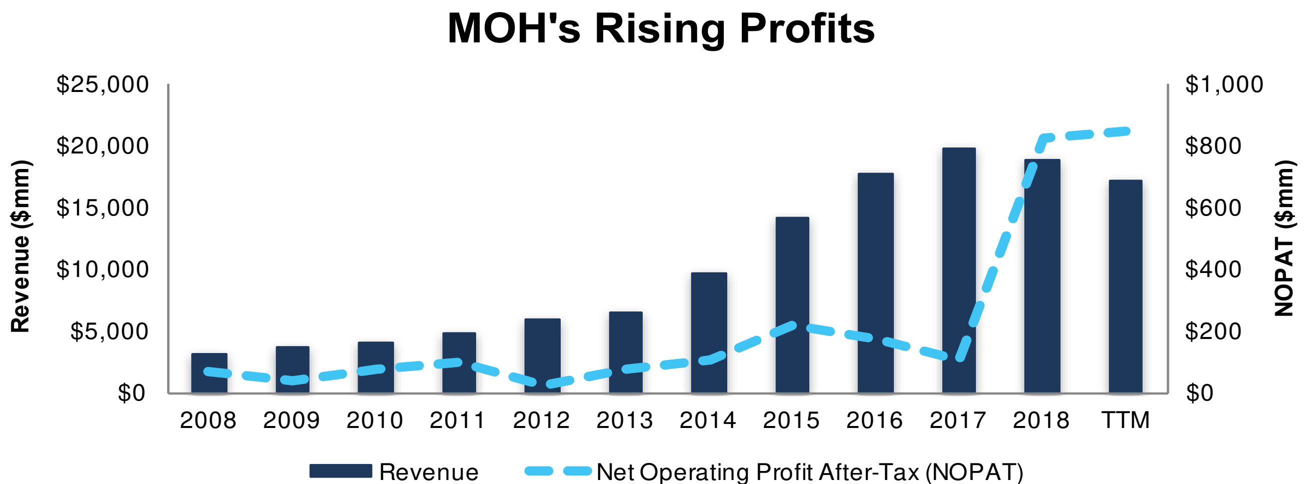
[1] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

[2] This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Important Disclosure Information is contained on the last page of this report.
The recipient of this report is directed to read these disclosures.

New Constructs®

Figure 1: MOH's Revenue & NOPAT Since 2008



Sources: New Constructs, LLC and company filings

MOH's Valuation Offers Upside Potential

At its current price of $132/share, MOH has a price-to-economic book value (PEBV) ratio of 0.7. This ratio means the market expects MOH's NOPAT to permanently decline by 30%. This expectation seems overly pessimistic for a firm that has grown NOPAT by 36% compounded annually over the past decade.

If MOH can maintain its 2018 NOPAT margin of 4% (compared to 5% TTM) and grow NOPAT by 6% compounded annually (less than half the NOPAT CAGR of 13% from 2009 to 2017) for the next decade, the stock is worth $295/share today – a 123% 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 as shown in the Harvard Business School and MIT Sloan paper, "Core Earnings: New Data and Evidence".

Below are specifics on the adjustments we make based on Robo-Analyst findings in Molina Healthcare's 2018 10-K:

Income Statement: we made $280 million of adjustments, with a net effect of removing $120 million in non-operating expenses (1% of revenue). You can see all the adjustments made to MOH's income statement here.

Balance Sheet: we made $1.2 billion of adjustments to calculate invested capital with a net increase of $958 million. One of the largest adjustments was $456 million due to asset write-downs. This adjustment represented 16% of reported net assets. You can see all the adjustments made to MOH's balance sheet here.

Valuation: we made $1.6 billion of adjustments with a net effect of decreasing shareholder value by $1.6 billion. There were no adjustments that increased shareholder value. The most notable adjustment to shareholder value was $129 million in off-balance-sheet operating leases. This adjustment represents 1% of MOH's market cap. See all adjustments to MOH's valuation here.

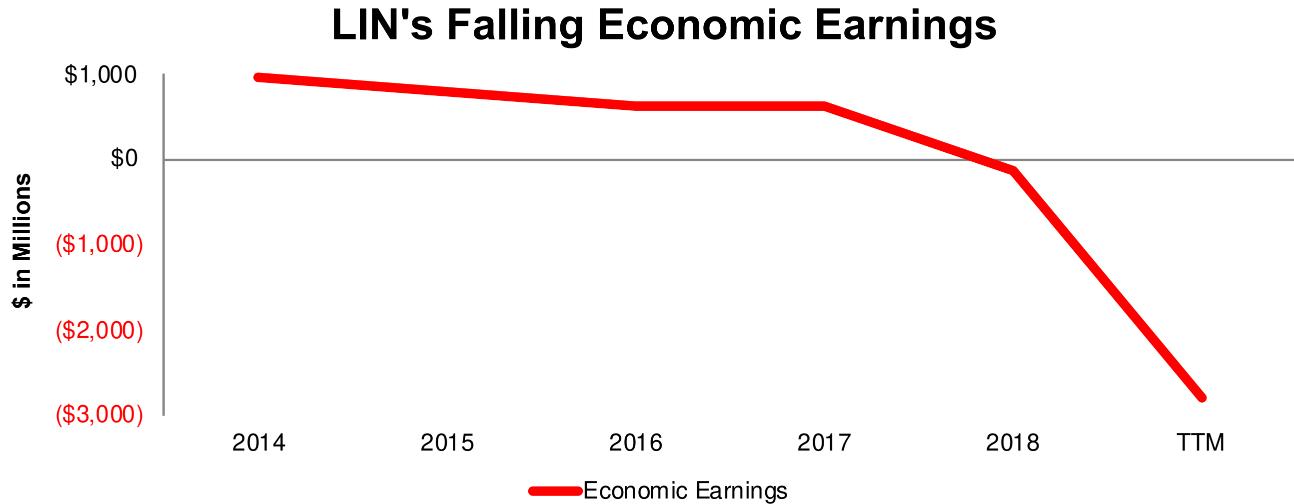
Most Dangerous Stocks Feature: Linde, PLC (LIN: $212/share)

Linde, PLC (LIN), is the featured stock from January's Most Dangerous Stocks Model Portfolio.

We previously put LIN in the Danger Zone on October 28, 2019. The stock has slightly underperformed the market (+8% vs S&P +9%) and remains overvalued.

LIN's economic earnings declined from $955 million in 2014 to -$2.8 billion TTM, per Figure 2. LIN's NOPAT margin has fallen from 17% in 2014 to 7% TTM while ROIC fell from 10% to 2% over the same time.

Figure 2: LIN's Economic Earnings Since 2014



Sources: New Constructs, LLC and company filings

LIN Provides Poor Risk/Reward

Despite its deteriorating fundamentals, LIN is still priced for significant profit growth and is overvalued.

To justify its current price of $210/share, LIN must maintain 2018 NOPAT margins of 14% (compared to 7% TTM) and grow NOPAT by 12% compounded annually for 15 years. See the math behind this reverse DCF scenario. This expectation seems overly optimistic given that LIN's NOPAT has fallen by 3% compounded annually since 2014.

Even if we assume LIN can achieve a 14% NOPAT margin and grow NOPAT by 10% compounded annually for the next decade, the stock is worth only $106/share, a 50% 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 as shown in the Harvard Business School and MIT Sloan paper, "Core Earnings: New Data and Evidence".

Below are specifics on the adjustments we make based on Robo-Analyst findings in Linde, PLC's 2018 10-K:

Income Statement: we made $4.5 billion of adjustments, with a net effect of removing $2.4 billion in non-operating income (16% of revenue). You can see all the adjustments made to LIN's income statement here.

Balance Sheet: we made $72.4 billion of adjustments to calculate invested capital with a net decrease of $49 billion. One of the largest adjustments was $50.4 billion for midyear acquisitions. This adjustment represented 63% of reported net assets. You can see all the adjustments made to LIN's balance sheet here.

Valuation: we made $27.9 billion of adjustments with a net effect of decreasing shareholder value by $24.3 billion. Apart from $14.2 billion in total debt, the largest adjustment to shareholder value was $6.9 billion in net deferred tax liability. This adjustment represents 6% of LIN's market cap. See all adjustments to LIN's valuation here.

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

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Footnotes adjustments matter. We are the ONLY source.

We provide ratings, models, reports & screeners on U.S. 3,000 stocks, 700 ETFs and 7,000 mutual funds.

HBS & MIT Sloan research reveals that:

- **Markets are inefficiently assessing earnings because no one reads the footnotes.**
- **Our technology brings the material footnotes data to market for the first time ever.**

Combining human expertise with NLP/ML/AI technologies (featured by Harvard Business School), we shine a light in the dark corners (e.g. footnotes) of hundreds of thousands of financial filings to unearth critical details.

The HBS & MIT Sloan paper, Core Earnings: New Data and Evidence, shows how our superior data drives uniquely comprehensive and independent debt and equity research.

This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Quotes from HBS & MIT Sloan professors on our research:

Get better research:

"…the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications." – page 20

Pick better stocks:

"Trading strategies that exploit cross-sectional differences in firms' transitory earnings produce abnormal returns of 7-to-10% per year." – Abstract

Avoid losses from using other firms' data:

"…many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat…" – page 14

Build better models:

"Core Earnings [calculated using New Constructs' novel dataset] provides predictive power for various measures of one-year-ahead performance…that is incremental to their current-period counterparts." – page 4

Exploit market inefficiencies:

"These results … suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures." – page 26

Fulfill fiduciary duties:

"An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A." – page 33-34

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