Featured Stock in January's Exec Comp & ROIC Model Portfolio

Four new stocks make January's Exec Comp Aligned with ROIC Model Portfolio, available to members as of January 15, 2020.

Recap from December's Picks

Our Exec Comp Aligned with ROIC Model Portfolio (-0.4%) underperformed the S&P 500 (+3.3%) from December 13, 2019 through January 13, 2020. The best performing stock in the portfolio was up 8.7%. Overall, five out of the 15 Exec Comp Aligned with ROIC Stocks outperformed the S&P from December 13, 2019 through January 13, 2020.

Only our research utilizes the superior data and earnings adjustments featured by the HBS & MIT Sloan paper, "Core Earnings: New Data and Evidence." The success of this Model Portfolio highlights the value of our Robo-Analyst technology[1], which scales our forensic accounting expertise (featured in Barron's) across thousands of stocks.

This Model Portfolio only includes stocks that earn an Attractive or Very Attractive rating and align executive compensation with improving ROIC. We think this combination provides a uniquely well-screened list of long ideas because return on invested capital (ROIC) is the primary driver of shareholder value creation.[2]

New Stock Feature for January: PACCAR Inc. (PCAR: $77/share)

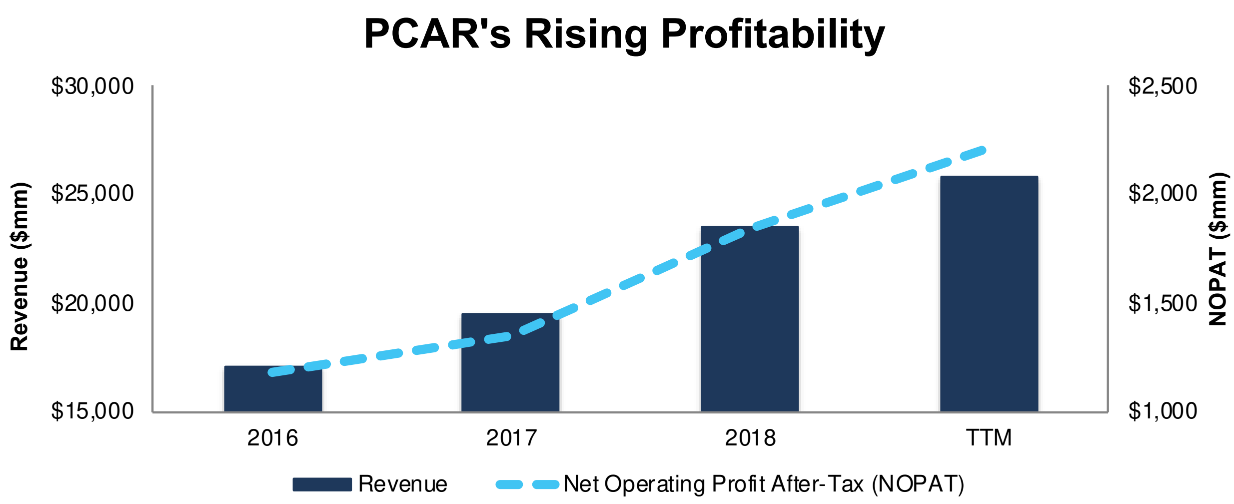
PACCAR Inc. (PCAR) is the featured stock in January's Exec Comp Aligned with ROIC Model Portfolio.

We recently highlighted PCAR as one of our Most Attractive stocks on May 9, 2019. Since then, the stock is up 11% (vs. S&P 500 up 15%) and looks even more undervalued.

Since 2016, PCAR has grown revenue by 17% compounded annually and after-tax operating profit (NOPAT) by 25% compounded annually. Trailing twelve month (TTM) NOPAT is up 23% over the prior TTM period. Profit growth has been fueled by rising NOPAT margins, which are up from 1% in 2009 to 9% TTM.

[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: PCAR Revenue & NOPAT Growth Since 2016



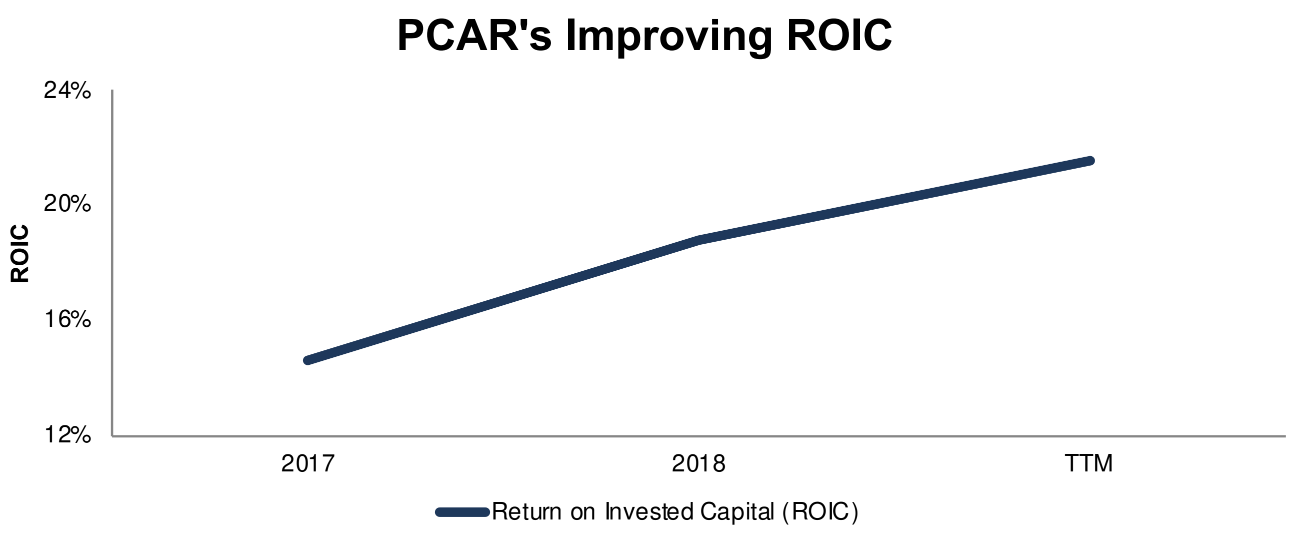
Sources: New Constructs, LLC and company filings

Executive Compensation Plan Helps Drive Shareholder Value Creation

PCAR has included return on capital as a performance metric in its executive compensation plan for over 20 years. Last year, three-year change in return on capital was one of three equally weighted metrics used to determine executives' long-term cash awards.

PCAR has improved its ROIC from 15% in 2017 to 22% TTM. PCAR's executive compensation plan lowers the risk of investing in the company's stock because we know executives' interests are tied to shareholders' interests.

Figure 2: PCAR's ROIC Since 2017



Sources: New Constructs, LLC and company filings

PCAR is Undervalued

At its current price of $77/share, PCAR has a price-to-economic book value (PEBV) ratio of 0.8. This ratio means the market expects PCAR's NOPAT to permanently decline by 20%. This expectation seems pessimistic given that PCAR has grown NOPAT by 7% compounded annually over the past decade.

If PCAR can maintain 2018 NOPAT margins of 8% (below TTM margin of 9%) and grow NOPAT by just 4% compounded annually for the next decade, the stock is worth $96/share today – a 25% 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 PCAR's 2018 10-K:

Income Statement: we made $374 million of adjustments, with a net effect of removing $354 million in non-operating income (1% of revenue). You can see all the adjustments made to PCAR's income statement here.

Balance Sheet: we made $ 5.9 billion of adjustments to calculate invested capital with a net decrease of $1.9 billion. One of the most notable adjustments was $301 million in total reserves. This adjustment represented 3% of reported net assets. You can see all the adjustments made to PCAR's balance sheet here.

Valuation: we made $4.0 billion of adjustments with a net effect of increasing shareholder value by $2.8 billion. One of the largest adjustments to shareholder value was $3.4 billion in excess cash. This adjustment represents 13% of PCAR's market cap. See all adjustments to PCAR'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.**
- **Corporate managers hide gains/losses in footnotes to manage earnings.**
- **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.

Learn more.

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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