Position Close Update: General Electric (GE)

General Electric (GE) – Closing Long Position – flat vs. S&P down 2%

We made General Electric a Long Idea in December 2019 in our article "Two Stocks That Should Beat Earnings Expectations."

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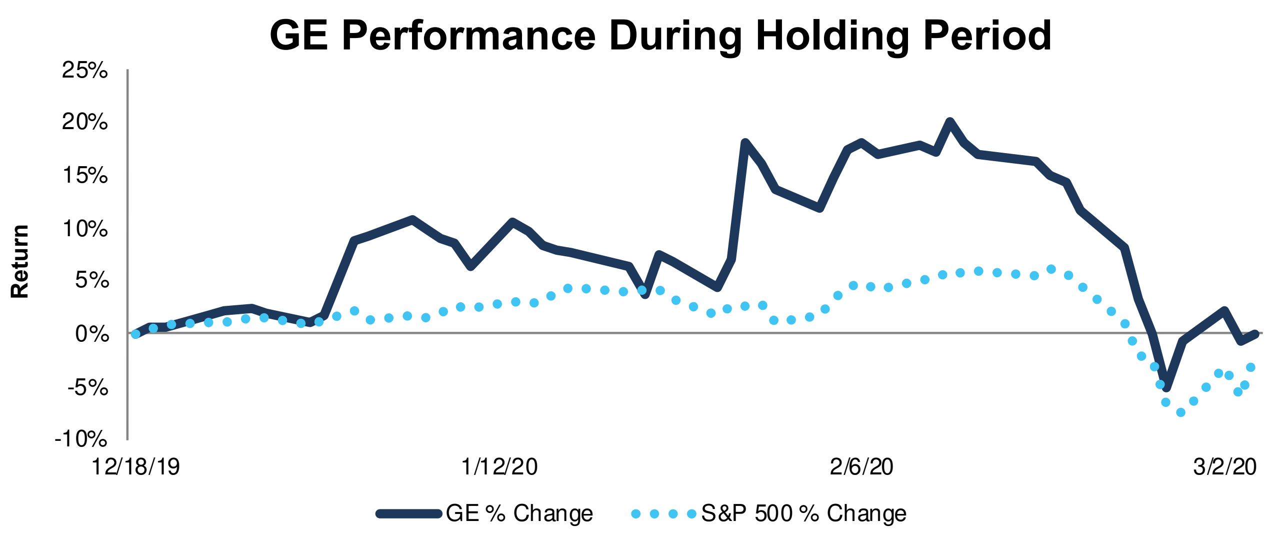
In our article, we pointed out that, due to unusual non-operating expenses, GE's GAAP net income significantly understated its core earnings[1]. As a result of this earnings distortion, GE earned our "Beat" Earnings Distortion Score (as featured on CNBC Squawk Box), which indicated the stock was more likely to beat consensus expectations. Sure enough, GE beat both revenue and earnings expectations when it reported 4Q19 results on January 29, 2020. The stock jumped 10% that day, but the boost was short lived.

We also noted in our article that we weren't optimistic about the company's longer-term prospects. Its low return on invested capital (ROIC) was well below the Industrials sector average and its valuation looked expensive. After parsing its 2019 10-K on February 25, 2020, we downgraded GE to Very Unattractive.

During the 77 day holding period, GE outperformed as a long position, as it was flat, compared to a 2% drop for the S&P 500. GE's declining ROIC and expensive stock price lead us to close out this short-term call.

Figure 1: GE vs. S&P 500 – Price Return – Successful Long Call



Sources: New Constructs, LLC and company filings
Note: Gain/Decline performance analysis excludes transaction costs and dividends.

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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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[1] Our Core earnings are a superior measure of profits, as demonstrated in In Core Earnings: New Data & Evidence a paper by professors at Harvard Business School (HBS) & MIT Sloan. The paper empirically shows that our data is superior to IBES "Street Earnings", owned by Blackstone (BX) and Thomson Reuters (TRI), and "Income Before Special Items" from Compustat, owned by S&P Global (SPGI).

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Footnotes adjustments matter. We are the ONLY source.

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"…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

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"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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