Don't Buy Fool's Gold

Check out this week's Danger Zone interview with Chuck Jaffe of Money Life.

The S&P 500 Technology sector generates the most Core Earnings[1] and has the highest return on invested capital (ROIC) of all 11 sectors, as we noted in Only Three S&P 500 Sector's Core Earnings Improved in 2020 and Only Two S&P 500 Sectors Have a Rising ROIC Through 3Q20.

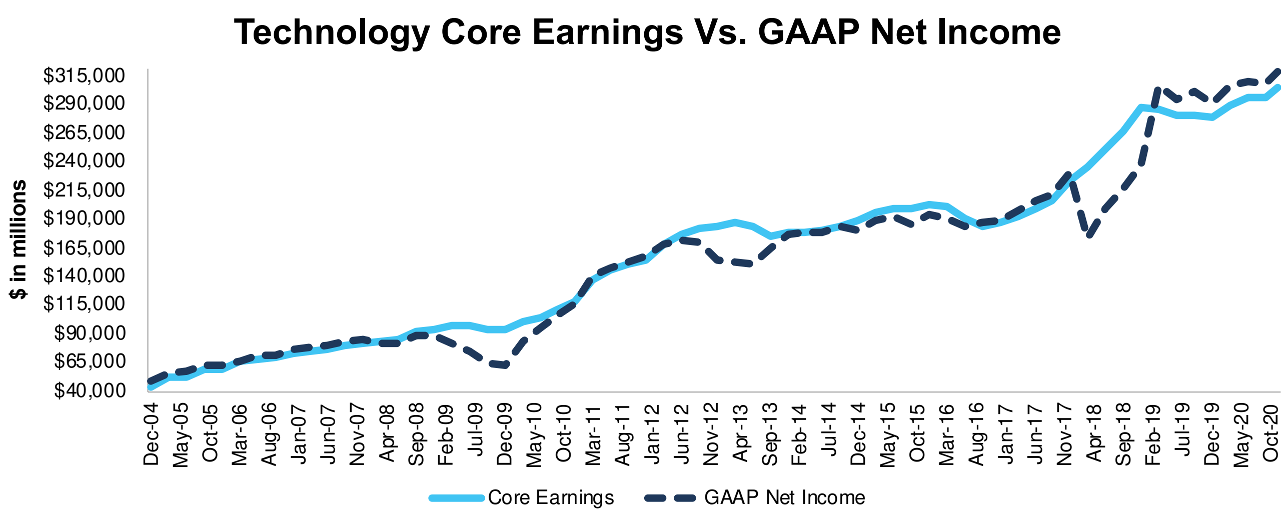
While most investors might assume the entire sector is a good investment, deeper analysis reveals it is not because only a few large companies are highly profitable.

Investors must discern, at the individual stock level, which investments are good and bad because the macro view of the sector does not apply to all stocks.

Technology Sector Looks Highly Profitable From the Surface

Figure 1 shows that not only did the Technology sector's Core Earnings rise 6% thus far in 2020, they have consistently risen since December 2004. In fact, the Technology sector's Core Earnings of $304 billion over the TTM are nearly three times that of the next closest sector, the Consumer Non-cyclicals sector at $103 billion.

Figure 1: Technology Core Earnings Vs. GAAP: 2004 – 11/17/20



Sources: New Constructs, LLC and company filings.
Our Core Earnings analysis is based on aggregated TTM data for the sector constituents in each measurement period.

Digging Deeper Reveals Fools Gold

When we look below the surface, we see that the Technology sector's Core Earnings are unevenly distributed.

From the end of 2019 through 11/17/20, the Technology sector's Core Earnings net a $16.4 billion increase. 44 firms (59% of the sector) grew Core Earnings over this time, for a total increase of $25 billion. 30 firm's saw Core Earnings decline a total of $8.6 billion.

Of the 44 firms with improved Core Earnings since the end of 2019:

[1] Our Core Earnings are a superior measure of profits, as demonstrated in Core Earnings: New Data & Evidence a paper by professors at Harvard Business School (HBS) & MIT Sloan. Recently accepted by the Journal of Financial Economics, the paper proves that our data is superior to all the metrics offered by S&P Global (SPGI).

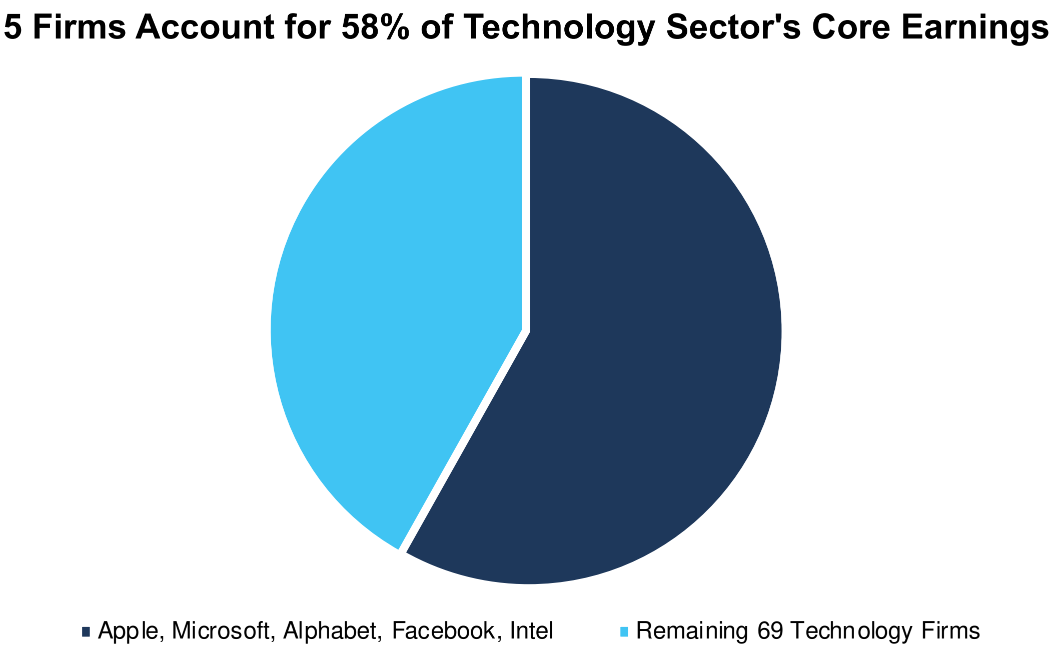
- Microsoft (MSFT), Apple (AAPL), Intel (INTC) and Facebook (FB) grew Core Earnings by $14 billion
- The remaining 40 firms grew Core Earnings by $11 billion combined.

In other words, since the end of 2019, four S&P 500 Technology firms grew Core Earnings by a greater amount than the other 40 firms with positive Core Earnings growth.

This dominance by just a few firms continues when we look at the overall Core Earnings of the entire sector and not just the change since the end of 2019. Per Figure 2, the four firms from above plus Alphabet (GOOGL) account for 58% of the Technology sector's overall Core Earnings, which leaves 69 other firms generating the remaining 42%.

Put another way, 7% of the firms in the S&P 500 Technology sector generate 58% of the sector's TTM Core Earnings.

Figure 2: Only a Few Firms Dominate Technology Sector Profitability



Sources: New Constructs, LLC and company filings.
Our Core Earnings analysis is based on aggregated TTM data for the sector constituents in the measurement period.

Diligence Matters – Fundamental Analysis Provides Insights

The Core Earnings dominance from just a few firms illustrates why investors need to perform proper due diligence before investing, whether it be an individual stock and especially a basket of stocks through an ETF or mutual fund.

Those rushing to invest in the Technology sector and doing so blindly through passive funds are allocating to a significant amount of firms with declining Core Earnings. Worst of all, investors may be unaware of this deterioration because it is often overshadowed by a few standout performers.

Our measure of Core Earnings leverages cutting-edge technology to provide clients with a cleaner and more comprehensive view of earnings[2]. Investors armed with our measure of Core Earnings have a differentiated and more informed view of the fundamentals of companies and sectors, which allows them insights to find high-quality and low-quality stocks.

Where Not to Put Your Money

[2] For 3rd-party reviews, including The Journal of Financial Economics, on the benefits of adjusted Core Earnings, historically and prospectively, across all stocks, click here and here.

Leveraging our more comprehensive view of earnings, we identified 13 stocks in our Most Dangerous Stocks for Fiduciaries series of reports that we think present abnormally high risk. Of the 13 stocks, eight are in the Technology sector, including Spotify (SPOT), Dropbox (DBX), Box (BOX), Shopify (SHOP), Snowflake (SNOW), Uber (UBER), Pinterest (PINS), and Snap (SNAP). We also recently featured DoorDash (DASH), another tech stock, that is aiming to go public at an extremely unrealistic valuation.

The stocks in Figure 4 show companies whose Core Earnings declined so far during 2020.

Selling these stocks would provide most investors with more than healthy gains to reallocate to stocks with much better long-term prospects. Nevertheless, this strategy is directed more to fiduciaries than traders, who may see the recent price performance as reason for holding these positions. Fiduciaries need more than price momentum to justify investing in a given stock.

Figure 3: Most Dangerous Stocks for Fiduciaries With TTM Core Earnings Less Than 2019

Company	Ticker
Spotify Technology	SPOT
Snap Inc.	SNAP
Beyond Meat	BYND
Carvana Co.	CVNA

Sources: New Constructs, LLC and company filings.

This article originally published on December 7, 2020.

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

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

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

DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.