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

Eleven new stocks made our Most Attractive list this month, while five new stocks joined the Most Dangerous list. We published July's Most Attractive and Most Dangerous stocks to members on July 7, 2023.

June Performance Recap

Our Most Attractive Stocks (+4.5%) outperformed the S&P 500 (+3.8%) last month by 0.7%. The best performing large cap stock gained 17% and the best performing small cap stock was up 19%. Overall, 19 out of the 40 Most Attractive stocks outperformed the S&P 500.

Our Most Dangerous Stocks (+1.3%) outperformed the S&P 500 (+3.8%) as a short portfolio last month by 2.5%. The best performing large cap short stock fell by 17% and the best performing small cap short stock fell by 9%. Overall, 21 out of the 32 Most Dangerous stocks outperformed the S&P 500 as shorts.

The Most Attractive/Most Dangerous Model Portfolios outperformed as an equal-weighted long/short portfolio by 3.2%.

This report leverages our cutting-edge Robo-Analyst technology to deliver proven-superior[1] fundamental research and support more cost-effective fulfillment of the fiduciary duty of care.

All of our Most Attractive stocks have high (and rising) return on invested capital (ROIC) and low price to economic book value ratio. Most Dangerous stocks have misleading earnings and long growth appreciation periods implied by their market valuations.

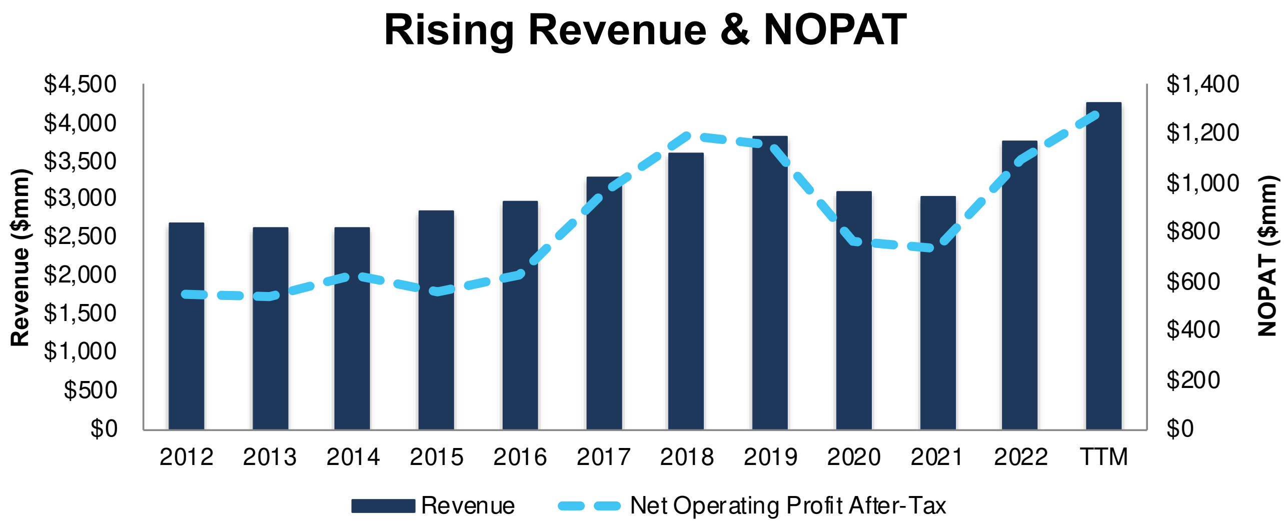
Most Attractive Stocks Feature for July: Comerica Inc. (CMA: $45/share)

Comerica Inc. is the featured stock from July's Most Attractive Stocks Model Portfolio.

Comerica has grown revenue by 5% compounded annually and net operating profit after tax (NOPAT) by 9% compounded annually since 2012. Comerica's NOPAT margin increased from 20% in 2012 to 31% in the trailing twelve months (TTM), and invested capital turns rose from 0.3 to 0.5 over the same time. Rising NOPAT margins and invested capital turns drive Comerica's return on invested capital (ROIC) from 6% in 2012 to 14% in the TTM.

[1] Our research utilizes our Core Earnings, a more reliable measure of profits, as proven in Core Earnings: New Data & Evidence, written by professors at Harvard Business School (HBS) & MIT Sloan and published in The Journal of Financial Economics.

Figure 1: Comerica's Revenue and NOPAT Since 2012



Sources: New Constructs, LLC and company filings

Comerica Is Undervalued

At its current price of $45/share, CMA has a price-to-economic book value (PEBV) ratio of 0.4. This ratio means the market expects Comerica's NOPAT to permanently decline by 60%. This expectation seems overly pessimistic for a company that has grown NOPAT by 6% compounded annually since 2017 and 9% compounded annually since 2012. We think the depressed stock price is impounding more bad news or potential dilution than will occur.

Even if Comerica's NOPAT margin falls to 20% (ten-year low compared to 31% in the TTM) and the company's revenue grows just 1% compounded annually through 2032, the stock would be worth $66/share today – a 47% upside. In this scenario, CMA's NOPAT would decline 3% compounded annually through 2032. Should Comerica grow profits more in line with historical levels, the stock has even more upside.

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

Below are specifics on the adjustments we made based on Robo-Analyst findings in Comerica's 10-Qs and 10-Ks:

Income Statement: we made $429 million in adjustments, with a net effect of removing $27 million in non-operating income (1% of revenue). Clients can see all adjustments made to Comerica's income statement on the GAAP Reconciliation tab on the Ratings page on our website.

Balance Sheet: we made $7.5 billion in adjustments to calculate invested capital with a net increase of $3.4 billion. One of the most notable adjustments was $3.7 billion in adjustments for other comprehensive income. This adjustment represents 72% of reported net assets. Clients can see all adjustments made to Comerica's balance sheet on the GAAP Reconciliation tab on the Ratings page on our website.

Valuation: we made $1.6 billion in adjustments, with a net decrease in shareholder value of $121 million. The most notable adjustment was $759 million in overfunded pensions. This adjustment represents 13% of Comerica's market value. Clients can see all adjustments to Comerica's valuation on the GAAP Reconciliation tab on the Ratings page on our website.

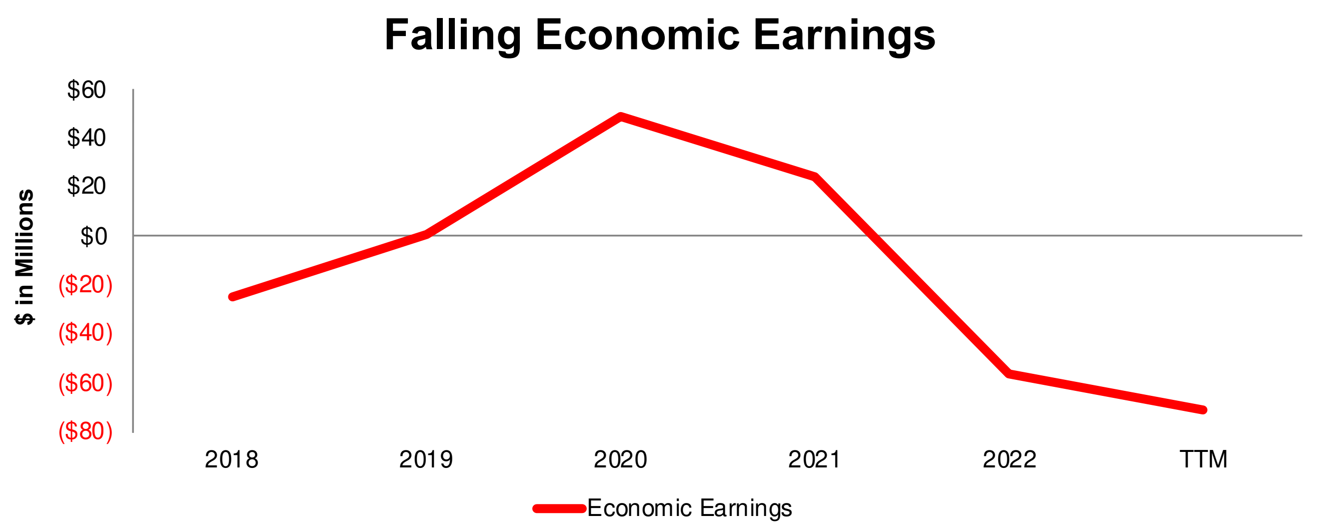
Most Dangerous Stocks Feature: Chegg Inc. (CHGG: $9/share)

Chegg Inc. (CHGG) is the featured stock from July's Most Dangerous Stocks Model Portfolio.

Chegg's NOPAT has fallen from $21 million (first positive NOPAT in company history) in 2019 to just $3 million over the TTM. NOPAT margin has fallen from 5% in 2019 to <1% in the TTM while invested capital turns fell from at 1.3 to 0.8 over the same time. Falling NOPAT margins and invested capital turns drive Chegg's ROIC from 7% in 2019 to 0% over the TTM.

Chegg's economic earnings, the true cash flows of the business, have fallen from <$1 million in 2019 to -$71 million in the TTM. See Figure 2.

Figure 2: CHGG Economic Earnings Since 2018



Sources: New Constructs, LLC and company filings

CHGG Provides Poor Risk/Reward

Despite its poor fundamentals, CHGG's stock is priced for significant profit growth, and we believe the stock is overvalued.

To justify its current price of $9/share, CHGG must improve its NOPAT margin to 5% (10x its TTM margin) and grow revenue by 10% compounded annually for the next decade. In this scenario, Chegg's NOPAT grows 24% compounded annually through 2032 and would equal $95 million in that year, or 1.3x its highest-ever NOPAT achieved in 2020. We think these expectations are overly optimistic.

Even if Chegg improves its NOPAT margin to 4.7% (5-year average) and grows NOPAT 16% compounded annually for the next decade, the stock would be worth no more than $5.50/share today – a 29% downside to the current stock price.

Each of these scenarios also assumes CHGG can grow revenue, NOPAT, and FCF without increasing working capital or fixed assets. This assumption is unlikely but allows us to create best case scenarios that demonstrate the high expectations embedded in the current valuation.

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

Below are specifics on the adjustments we made based on Robo-Analyst findings in Chegg's 10-Qs and 10-K:

Income Statement: we made $274 million in adjustments, with a net effect of removing $259 million in non-operating income (34% of revenue). Clients can see all adjustments made to Chegg's income statement on the GAAP Reconciliation tab on the Ratings page on our website.

Balance Sheet: we made $1.5 billion in adjustments to calculate invested capital with a net decrease of $1.3 billion. One of the most notable adjustments was $168 million in deferred tax assets. This adjustment represented 7% of reported net assets. Clients can see all adjustments made to Chegg's balance sheet on the GAAP Reconciliation tab on the Ratings page on our website.

Valuation: we made $2.2 billion in adjustments, with a net increase to shareholder value of $36 million. The most notable adjustment to shareholder value was $1.1 billion in excess cash. This adjustment represents 97% of Chegg's market value. Clients can see all adjustments to Chegg's valuation on the GAAP Reconciliation tab on the Ratings page on our website.

This article was originally published on July 11, 2023.

Disclosure: David Trainer, Kyle Guske II, Hakan Salt, and Italo Mendonça receive no compensation to write about any specific stock, style, or theme.

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It's Official: We Offer the Best Fundamental Data in the World

Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

Our mission is to provide the best fundamental analysis of public and private businesses in the world and make it affordable for all investors, not just Wall Street insiders.

We believe every investor deserves to know the whole truth about the profitability and valuation of any company they consider for investment. More details on our cutting-edge technology and how we use it are here.

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