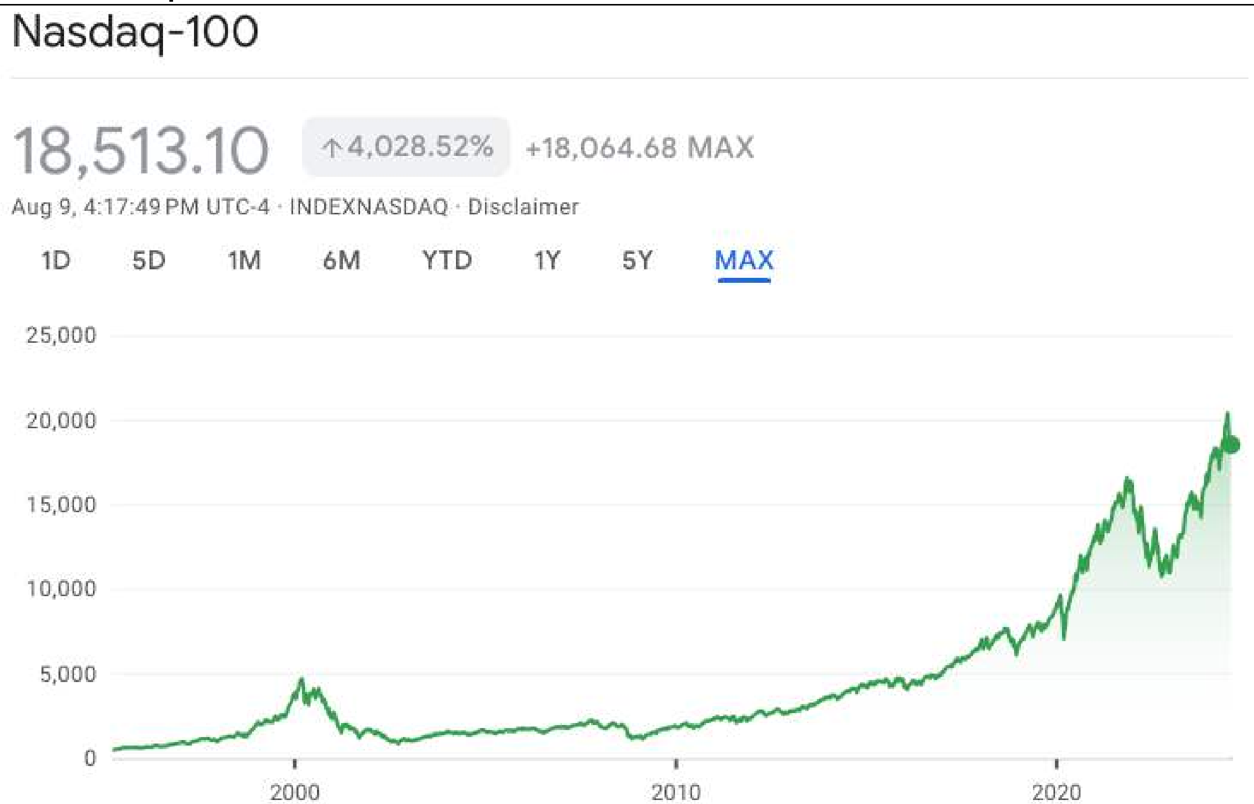
Humility Matters, Too

Given the recent instability of the market, now is the perfect time to share a universal law that most investors don't know, but need to know if they want to enjoy any sort of long-term success. It's a secret I got from my time on Wall Street about the nature of investing. The secret is based on the second law of thermodynamics. Please don't tune out just because I got super geeky there, I promise you will be a better and smarter investor when you finish reading this letter. You'll also get free research on 3 mega cap stocks and a link to join our next live podcast.

I think it's time to come back to some basic principles about life and investing. First, a little background. The market has been on an incredible run for the last 20 years. Sure, we've seen a few downdrafts, but take a look at Figure 1. Tech stocks over the last 10 years have crushed it. Note how small a blip the late 1990s' tech bubble is compared to the last several years. True, a logarithmic chart of the Nasdaq-100 is probably more appropriate. I looked at that version, and it doesn't change the message. The market feels a little too good to be true to me…and you won't hear many other people admit that.

Figure 1: Nasdaq-100 Performance Since June 1995



Sources: Google Finance

Considering the huge amount of both Fiscal and Monetary stimulus poured into our economy over the last 10 years (detailed in a prior letter here) , no one is surprised that we have an inflation problem, a very stubborn one. That inflation applies to the stock market, too. I'm sure you could name a lot of other problems as well as some very promising trends.

But, the one problem we need to keep top of mind is "entitlement". Specifically, entitlement to double digit returns on stocks in the short, medium and long term. Too many investors have grown up in a world where "buy the dip" literally works every time. They do not care why it works, just that it works. And, they do not care why stocks go up, just that they go up. If you don't believe me, just ask any meme stock investor.

The problem here is not that stocks are going up. Many stocks deserve to have gone up and to go up much more. We provide many lists of such stocks to our clients. I'm also hosting a live show on August 15, 2024 to show investors how to perform due diligence to find the best stocks – sign up here.

The problem, as shown in Figure 1, is the disproportionate outperformance of certain stocks, like the "Magnificent 7". There are too many stocks that have gone up way too much. They are priced for perfection, an impossible perfection according to our reverse DCF models. But, no one else wants to talk about that.

Unless this is your first time reading my letters, you're well aware that New Constructs is different from other research firms. We're in the business of making our clients smarter. We want you to win. And, as I will show below and have shown with empirical evidence in prior letters, most other research firms are looking out for themselves not you.

That fact is central to my message (and secret) today. Wall Street firms and advisors like to make you think everything is taken care of. Perfection is possible. They've done their diligence and scrubbed the numbers. Their ratings are reliable. And, they keep telling us that we can trust them when they say perfection is possible even though time and again, we learn that we can't trust them. Remember this scene from the movie The Big Short - more details in my last letter.

Now, here's where the second law of thermodynamics comes in. It states that

> "as one goes forward in time, the net entropy (degree of disorder) of any isolated or closed system will always increase (or at least stay the same)." Source.

Entropy is a measure of disorder and affects all aspects of our daily lives.

The stock market is not immune to the law on entropy or the second law of thermodynamics. Constant work is required to maintain order. Order is not free. Things are changing all the time. Perfection is not possible.

This law applies to the stock market and every single stock. Constant work is required to maintain good analysis of every single company. Prices change every day, new filings come out nearly every day. Yet, so many financial advisors want to portray the illusion that they've got it all under control. You can trust them. They and their firm have so many smart people, and they've covered all the bases. They have all the answers, that's why you should trust them and give them all your money.

Well, I will be the first to tell you that neither I nor New Constructs have all the answers. That's impossible. We're not perfect. We are not right all the time. No one has all the answers. We're modest enough to admit that. At New Constructs, we understand our limitations, which allows us to also understand our strengths. We will tell you what we can do and cannot do. For example, at 3 minutes and 30 seconds into my CNBC interview last Thursday, Tyler Mathisen asks me to explain why the market was down that day. My answer: "my crystal ball is in the shop." After giving Tyler and Kelly Evans some very specific answers about Intel (INTC), Meta (META) and Amazon (AMZN), I abruptly refused to pretend I could explain what was happening in the overall market. I made a few jokes at my own expense and noted that trying to explain what's happening in a market where a character like Roaring Kitty can move markets is a fool's errand.

Figure 2: Clip from My CNBC Interview

Sources: [CNBC: Three Stock Lunch]

Try finding an advisor or Wall Street insider who won't take every opportunity to prognosticate on the state and future of the market. They even have a special name for Wall Street's market prognosticators. They call them strategists. Guess what percentage of them are bullish at any given time? How many research firms have a Zombie Stock list?

Now, as you think about your money and your research, I have a few more questions for you.

Can you put a price on honesty?

Can you put a price on humility?

I think humility is absolutely essential to being a successful investor and analyst. It's as important to know what you don't know as what you do know. But, that's not how most investors think.

I will never forget the meeting I had with a portfolio manager of a $50+ billion fund back around 2005. After explaining to him what New Constructs offered, he replied with:

"**Your data probably is better. But, as long as everybody's using the same bad data, I'm OK with that**."
Source: Harvard Business School Case #118068

Not a lot of humility there. To say he does not care about having the best data means that he believes he can outperform with inferior data. That's pretty cocky. Either that or he doesn't care about outperforming. I'm not sure which is worse.

I've had many other similar meetings with "professional" investors. It's not just the sell-side Wall Street folks that should worry you, but the big money managers on the buyside are not always doing their homework either. And, they are so arrogant that they will say out loud that they do not care about diligence sometimes.

My point is that a big part of humility is recognizing how hard it is to do proper research and diligence.

Ever notice how we talk about diligence a lot, especially compared to other firms. Other firms would prefer you keep thinking the music will never stop, perfection is possible, and stocks will just keep going because….well that's what stocks do.

Are you the type to believe that stocks will just continue to go up forever? Do you think that fundamentals matter? If you've read this far, my guess is the answers to the last two questions are "no" and "yes".

We're very focused on one thing at New Constructs: delivering superior fundamental research. As I've mentioned before, there are few signs out there that we are good at what we aim to do:

1. #1 ranked stock picker on Sum Zero for 39 months straight.
2. Three prestigious institutions published papers proving our research is superior.

Now, the biggest question I have for you is whether **you're ok with using the same bad data as everyone else?**

Don't think there's bad data out there? Let me provide more examples.

A recent MarketWatch article featured return on invested capital (ROIC) research from FactSet (FDS) and allows us another real-time opportunity to compare our research to a competitor's. On July 16, 2024, we highlighted alarming differences between our research and Morningstar's.

As with Morningstar, there are very large differences between our research and FactSet's. For example:

- FactSet shows VeriSign's (VRSN) 10-year Average ROIC is 232%, and we show 4%.
- FactSet shows Lennox International's (LII) 10-year Average ROIC is 37%, and we show 19%.
- FactSet shows Ubiquiti's (UI) 10-year Average ROIC is 58%, and we show 110%.

More details in Figure 3.

Figure 3: 10-Year Average ROIC: New Constructs vs. FactSet

Ticker	Company Name	FactSet 10yr Average ROIC	New Constructs 10yr Average ROIC	Difference
VRSN	VeriSign Inc.	232%	4%	228%
LII	Lennox International Inc.	37%	19%	18%
YUM	Yum Brands Inc.	41%	27%	14%
AZO	AutoZone Inc.	40%	28%	12%
ITW	Illinois Tool Works Inc.	23%	14%	9%
WSM	Williams-Sonoma Inc.	29%	21%	8%
ADP	Automatic Data Processing Inc.	34%	27%	7%
ORLY	O'Reilly Automotive Inc.	33%	27%	6%
TXN	Texas Instruments Inc.	32%	26%	6%
LSTR	Landstar System Inc.	30%	25%	5%
CHE	Chemed Corp.	25%	22%	3%
ODFL	Old Dominion Freight Line Inc.	25%	21%	3%
FAST	Fastenal Co.	27%	25%	2%
RHI	Robert Half Inc.	32%	32%	0%
AMAT	Applied Materials Inc.	25%	29%	-4%
EXPD	Expeditors International of Washington	27%	36%	-9%
NVR	NVR Inc.	28%	38%	-9%
LRCX	Lam Research Corp.	26%	41%	-15%
NTAP	NetApp Inc.	24%	39%	-15%
UI	Ubiquiti Inc.	58%	110%	-52%

Sources: New Constructs, LLC and FactSet data from here

We also see very large differences in the 3-Year Average ROICs from FactSet compared to our research. For example:

- FactSet shows VeriSign's (VRSN) 3-year Average ROIC is 285%, and we show 4%.
- FactSet shows Lennox International's (LII) 3-year Average ROIC is 43%, and we show 24%.
- FactSet NVR's (NVR) 3-year Average ROIC is 34%, and we show 55%.

See Figure 4.

Figure 4: 3-Year Average ROIC: New Constructs vs. FactSet

Ticker	Company Name	FactSet 3yr Average ROIC	New Constructs 3yr Average ROIC	Difference
VRSN	VeriSign Inc.	285%	4%	281%
LII	Lennox International Inc.	43%	24%	19%
ITW	Illinois Tool Works Inc.	31%	16%	15%
ORLY	O'Reilly Automotive Inc.	42%	32%	10%
YUM	Yum Brands Inc.	43%	33%	10%
ADP	Automatic Data Processing Inc.	44%	34%	9%
WSM	Williams-Sonoma Inc.	42%	32%	9%
AZO	AutoZone Inc.	43%	33%	9%
LSTR	Landstar System Inc.	36%	30%	7%
ODFL	Old Dominion Freight Line Inc.	34%	30%	3%
CHE	Chemed Corp.	26%	24%	3%
TXN	Texas Instruments Inc.	32%	30%	2%
FAST	Fastenal Co.	30%	29%	1%
UI	Ubiquiti Inc.	64%	63%	1%
RHI	Robert Half Inc.	33%	36%	-3%
AMAT	Applied Materials Inc.	36%	40%	-5%
EXPD	Expeditors International of Washington	31%	40%	-9%
NTAP	NetApp Inc.	30%	40%	-10%
LRCX	Lam Research Corp.	37%	48%	-11%
NVR	NVR Inc.	34%	55%	-21%

Sources: New Constructs, LLC and FactSet data from here

The main takeaways from these comparisons are:

1. Our proprietary fundamental data makes our stock research very different – in a very good way.
2. Given the recent market volatility, investors need reliable stock research now more than ever.

Over the last several weeks, we've given out a lot of free data and stock picks because we hope to earn your business by showing the value we deliver. We also hope that you see the humility in our service to you and the betterment of the capital markets.

Want more details?

As always, we are 100% transparent in all of our research, reports, ratings, and models. We regularly review our work and research on Long Ideas and Danger Zone Ideas with clients. We want you to know how much work we do! Here's some ways to keep in touch with us:

1. Join my live training on how beat Wall Street and find the best stocks on August 15th at 5pmET. Register here.
2. Free live Podcast every month. The next one is on Friday, September 13th, register here. The last one was August 9th. Get free replays in our online community.
3. Join our online community (use this form to sign up for free). Ask questions and make friends! Lots of humble investors talking to each other is a good thing.
4. Monthly Let's Talk Long Ideas webinars where we do deep dives into our research, analytics, reverse DCF models and ideas for our Professional and Institutional clients. Our next one is on August 14th at 5:00pmET. Replays are here for our Professional and Institutional clients.

If this message resonated with you and you want to start your investing future with us - schedule a meeting with us here.

Diligence matters,

David

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

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It's Official: We Deliver 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. The stock market is missing footnotes – and only we have that critical data.
2. Legacy fundamental datasets suffer from significant inaccuracies, omissions, and biases.
3. Our proprietary drives novel alpha. Our measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

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

Ernst & Young 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 Harvard Business School. 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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