Unbounded Wealth: John’s Take 10-17-24

How to Profit this Earnings Season

My favorite season isn't Winter, Spring, Summer, or Fall. It's earnings season, the period when companies announce quarterly earnings and reset expectations for their business.

The best part is that unlike maple trees, which change colors to beautiful hues for four weeks a year, earnings season comes along four *times* a year.

A lot of money can be made *or* lost during earnings season. Stocks have violent swings up and down. There’s no shortage of action.

I love it. It’s my bread and butter.

This week, I will provide a few tips on earnings season and how to navigate it today and in the future.

But first, some background.

I became interested in deep financial statement analysis in the year 2000. Internet stocks were clearly in a Bubble, and a cursory look at the financials led me to believe there were some goofy things going on. It started with a simple question…was a sock puppet worth billions of dollars?

I landed a job with a renowned forensic accountant named Howard Schilit and cut my teeth on the deep dive required to ferret out the bullshit buried in financial reports.

Years later, I expanded my research capabilities by working for David Tice, another respected forensic analyst and noted short seller.

I developed my own tools for the trade. Unique stuff. I was consistently the top-performing analyst in the firm (my mom was proud).

Then, I realized I had never seen some of these tools elsewhere. I had certainly never read about them in a book. So, I wrote a book. It's called *What's Behind the Numbers?* It became a best seller for McGraw-Hill and the *Stock Trader Almanac* Book of the Year for 2013.

The key to the book is that it highlights *real-life* case studies I *lived* through in *real-time*. It's not hypothetical mumbo jumbo. Nearly everything else in the book segment falls short because, in real-time, there is only so much you know, and critical thinking skills are valued at a premium. Anyone can look back after the fact and say, "If you saw this, then this would happen." Nonsense! It doesn't happen in the real world!

This isn't an advertisement for my book. I make less than $1 a copy in royalties, and book sales don't change my life. That said, I am thankful and honored that anyone would ever read and engage with *anything* that I write!

Alas, this isn't about me. It's about *you*. I already know how to do this stuff, so now you can have some tools in your box as well.

What *will* change *your* life is rolling up your sleeves and analyzing the earnings reports of the stocks you own. Winning stocks take care of themselves. It's avoiding the enormous loss that really propels you to higher ground.

The big loss creates stress, anger, and anxiety.

Wall Street isn't going to help you. Here's a dirty little Wall Street secret. The highly paid analysts for the big banks don't do this work. Or at least not correctly. They're just glorified salespeople.

That's why multi-billion-dollar funds hired me.

If you're not doing this work, you don't know either. But it's not your fault. You have yet to be guided through the process. Wall Street's job is to sell, pull the wool over your eyes, and pick your pocket. Their job is not to help you become a more informed investor.

For those wanting to do a little work at home, I wanted to share three things to look for in any earnings report right off the bat. This will start you on the right path.

Tip #1: Revenue Recognition

In *What's Behind the Numbers?* I specifically focus on revenue recognition. There is a widely held belief that revenue is harder to manipulate than earnings. Not so!

Ken Fisher introduced the price/sales ratio in the 1983 book *Super Stocks*. Since earnings can be massively influenced by accounting, the price/sales ratio should provide a better valuation metric than price/earnings. James P. O'Shaughnessy—whom I also worked for and who led me to develop quantitative skills—expanded on the idea in *What Works on Wall Street*, one of the most important books of the 20th century.

Revenue can certainly be manipulated. Revenue is manipulated all the time. It's the numero uno risk because everything flows from the top down. If you see aggressive revenue recognition, **do not own the stock.**

How do you spot it?

Read the revenue recognition section of a company's SEC filings. Compare it to their other filings. Did any of the language change? Are receivable trends changing relative to sales? Does the company use percentage-of-completion accounting that might allow them to book more revenue upfront? Are they extending payment terms to incentivize customers to purchase today what otherwise would be purchased later?

These are the Matlock-type questions that need to be asked. You're prosecuting a case. Unlike a court of law, though, every company is *guilty until proven innocent.*

How does the company recognize revenue? *What* changed?

Account principles are wide and often vague. There's a lot of room for interpretation. Aggressive managers looking to boost their stock price – and fatten their pockets – will use that to their advantage. Those CEOs and CFOs don't give two shits about you.

Tip #2: Follow the Cash Flow

Cash flow is king. You cannot spend profits. Profits are accounting fiction. Cash is in the bank.

Therefore, look at the differences between the cash coming into the business versus what's being reported on the income statement as "profit." Just as importantly, look at what elements of cash flow might not be sustainable. Did a new line item on the cash statement pop up?

Was there a big change from one period to the next? Did the company make a big acquisition that boosted short-term cash flow to offset a slowdown in its business?

It's all right there waiting for you to discover it.

Tip #3: Profit Margins

Rising profit margins are good, right? Not so!

What was the *source* of the improvement in profitability? Was it due to better pricing power or an accounting maneuver? Don't take management's word for it. CEOs rank just below politicians. They lie. A lot!

How do you know whether a company reversed a reserve if you don't look? Are they playing goofy games with the inventory to boost profit margins? Read the notes to the financial statements with an eye toward what is *driving* margin improvement.

Here’s a **bonus** tip just for fun. A careful review of the balance sheet may show a big change in something that needs to be explained. For example, "other" assets. You'd think something like that wouldn't matter much. After all, "other" is vague.

Can’t be important, right? Not so!

That could be where the bodies were buried. That account that ballooned at G.E. tipped me off that G.E. no longer “brings good things to life” and was just a black box hedge fund on the precipice of total implosion.

It could be just one thing. That “thing” is buried somewhere. Often, the balance sheet is where you will find it. Again, is there something that changed in a big way? Something that looks vague? Track it down.

The easiest thing to do is to go line by line and understand what is *driving* changes in performance. Then, anything that is vague needs to be understood. Anything new that didn't show up before needs to be tracked down. Notes related to revenue, margins, inventory, "one-time" events, and reserves need to be read and understood.

Despite Enron, World Com, and a host of scams, the government hasn't stopped fraud. They never will. If someone wants to be deceptive to line their pockets, they will deceive you. Signing a statement in an SEC filing or the threat of jail isn’t going to change that.

Therefore, financial statement analysis and earnings quality work still matter. Markets change, but human nature does not. There's an endless number of ways to pull the wool over one's eyes.

There’s almost nothing new in the world of finance. *Almost*…

One day, I said to myself, "Self…if the reported earnings are mostly bogus, then the price/earnings ratio, which is the most widely used measure of valuation, is mostly bogus, too."

So, I came up with a new way to look at valuation. It's called the price/earnings quality ratio. I adjusted the earnings for the shenanigans and recalculated the valuation.

I created a model that uses a couple of dozen metrics to quickly assess the odds that a company is pulling a fast one. Then, those factors are ranked against every other stock in the universe. It's like three-dimensional chess.

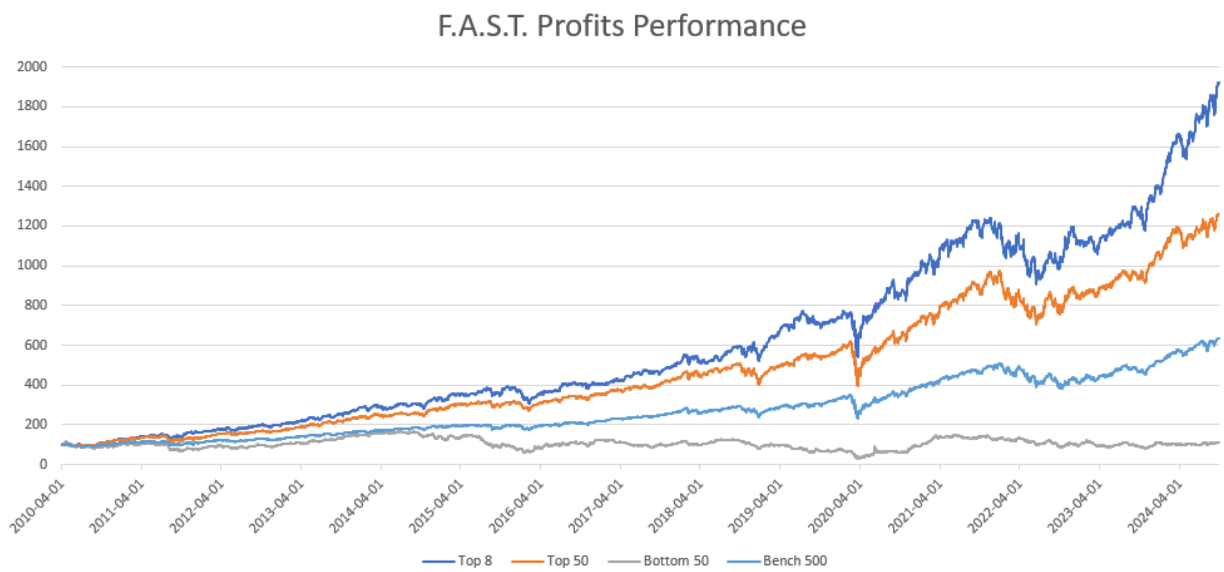
It spits out a list. I started providing that list to investment managers, who were happy to pay me eye-watering amounts for something that only a few had. That's how I became my own boss.

The model performed exceptionally well, which led to more professional opportunities for me. I have been at it for nearly 15 years.

Recently, I expanded my relationship with my good friend Harry Dent, so I made this work available to his readers. It's called the *Forensic Accounting Stock Tracker™* (FAST).

For individual investors, owning a handful of the highest-ranked stocks is enough. Just eight stocks do the trick. There's no magic in eight stocks. It could be seven. It could be ten. Anyway, like the T.V. show…*Eight is Enough*.

Here's the performance through Q3 2024 since I started my company in April 2010.



Performance by Calendar Year

Return (%)	2010*	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024**
Model	25.45	28.51	23.14	45.19	15.33	10.96	8.96	26.51	10.26	32.55	33.28	23.12	-7.65	25.72	33.71
Benchmark	8.40	1.89	15.99	32.31	13.46	1.23	12.00	21.71	-4.57	31.22	18.33	28.73	-18.18	26.18	21.85
Excess	**17.05**	**26.61**	**7.15**	**12.88**	**1.86**	**9.73**	**-3.04**	**4.80**	**14.83**	**1.32**	**14.95**	**-5.61**	**10.53**	**-0.46**	**11.86**

(*) From 04/01/10 (**) To 10/01/24

No hype.

Just returns.

Returns help, and they make life fun. More importantly, FAST™ cuts through all the B.S. and delivers a rating in an easy-to-see manner.

Take a look:

Forensic Accounting Stock Tracker
"CSI For Your Stock Portfolio"

Rank	Rank Change	Ticker	Stock Name	Overall Rank	Buybacks	Earnings Quality	Momentum	Sentiment
Column1	Column2	Column3	Column4	Column5	Column6	Column7	Column8	Column9
1	9	ORLY	O'Reilly Automotive, Inc.	A+	B+	A+	A	A
2	15	MANH	Manhattan Associates, Inc.	A+	B-	A+	A+	A+
3	8	FI	Fiserv, Inc.	A+	A-	A	A-	A-
4	23	LRCX	Lam Research Corp.	A+	B	A-	A+	A
5	0	NFLX	Netflix, Inc.	A+	B	A	A+	B+
6	-5	VRSK	Verisk Analytics, Inc.	A+	A	A+	B-	A
7	-4	HCA	HCA Healthcare, Inc.	A+	A-	A	A-	B+
8	10	PRI	Primerica, Inc.	A+	A-	B	A+	A-
9	24	JBL	Jabil, Inc.	A+	A+	B-	A	A
10	-8	MCK	McKesson Corp.	A+	B+	A-	B+	A+
11	4	CDNS	Cadence Design Systems, Inc.	A+	C	A+	A+	A
12	-3	LOPE	Grand Canyon Education, Inc.	A+	B+	A	B	A+
13	8	CTAS	Cintas Corp.	A+	C+	A+	A	A+
14	11	GWW	W.W. Grainger, Inc.	A+	B	A	A	B+
15	-2	GMS	GMS, Inc.	A+	B	B+	A	A-

The main benefit? Time. Time is your most valuable asset. Better returns with more time on your hands…

If you're interested in accessing this work, which is available to a limited few, feel free to write to me directly at jd@unboundedwealth.com, and I will be happy to share more information.

If you're not interested in potentially higher returns, less risk, a saving time, you're still welcome to contact me. I welcome questions, comments, and snide remarks. The only thing I don't do it offer personalized financial advice.

I read and respond to every email.

One earnings season isn't make or break for your portfolio. However, holding onto a stock with an enormous loss from noticeable nicks and dents in its financials is an unforced error and a costly mistake.

Don't make that mistake!

Do a little work. Arm yourself with some tools. Your account balance will thank you!

<u>THE RESULTS PRESENTED ARE NOT TYPICAL OR VERIFIED.</u> *HSD Publishing has not verified information regarding the historical trading performance presented. Subscribers' trading results have* ***<u>NOT been tracked or verified,</u>*** *past performance is not necessarily indicative of future results,* ***and the results presented in this communication are <u>NOT TYPICAL.</u>*** *Actual results will vary widely given various factors, such as experience, skill, risk mitigation practices, market dynamics, and the amount of capital deployed. Investing in securities is speculative and carries a high risk; you may lose some, all, or possibly more than your original investment.*

<u>HS DENT IS NOT AN INVESTMENT ADVISOR NOR A REGISTERED BROKER.</u> *Neither HSD Publishing nor its owners or employees is registered as a securities broker-dealer, broker, investment advisor (IA), or I.A. representative with the U.S. Securities and Exchange Commission, state securities or regulatory authority, or self-regulatory organization.*

<u>WE MAY HOLD THE SECURITIES DISCUSSED.</u> *HSD Publishing has not been paid directly or indirectly by the issuer of any security mentioned in the Services. However, HS Dent, its owners, and its employees may purchase, sell, or hold long or short positions in securities of the companies mentioned in this and future communications.*

John Del Vecchio is not an employee or partner of HSD Publishing. HSD Publishing serves solely as the marketing arm for John Del Vecchio and Unbounded Wealth: Max Profits*.*