



# Bringing Integrity to the Capital Markets

David B. Trainer

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The recipient of this report is directed to read these disclosures.**

# Agenda

- I. Who We Are**
- II. Our Goals**
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  - IV. Media Coverage...New Constructs' Reputation and Bio for David Trainer**

# Part I

## Who We Are

Independent Equity Research

## Who We Are

### Independent Financial Experts w/ Proprietary Database

#### Company Profile:

Independent research firm that focuses on quality of earnings and discounted cash flow valuation analysis for U.S. public companies based on a proprietary financial database.

#### Expertise

- **Forensic Accounting:** understanding how companies manipulate GAAP.
- **Data Gathering:** sourcing data directly from the SEC - like having XBRL for the past 10 years - PLUS - the Notes to the Financial Statements.
- **Modeling:** measuring real, economic profits and valuation.
- **Valuation:** better data + better models = better information.
- **Stock-Picking:** we have unique insights into what drives the market. Appendix 4 has details.

#### Research Business

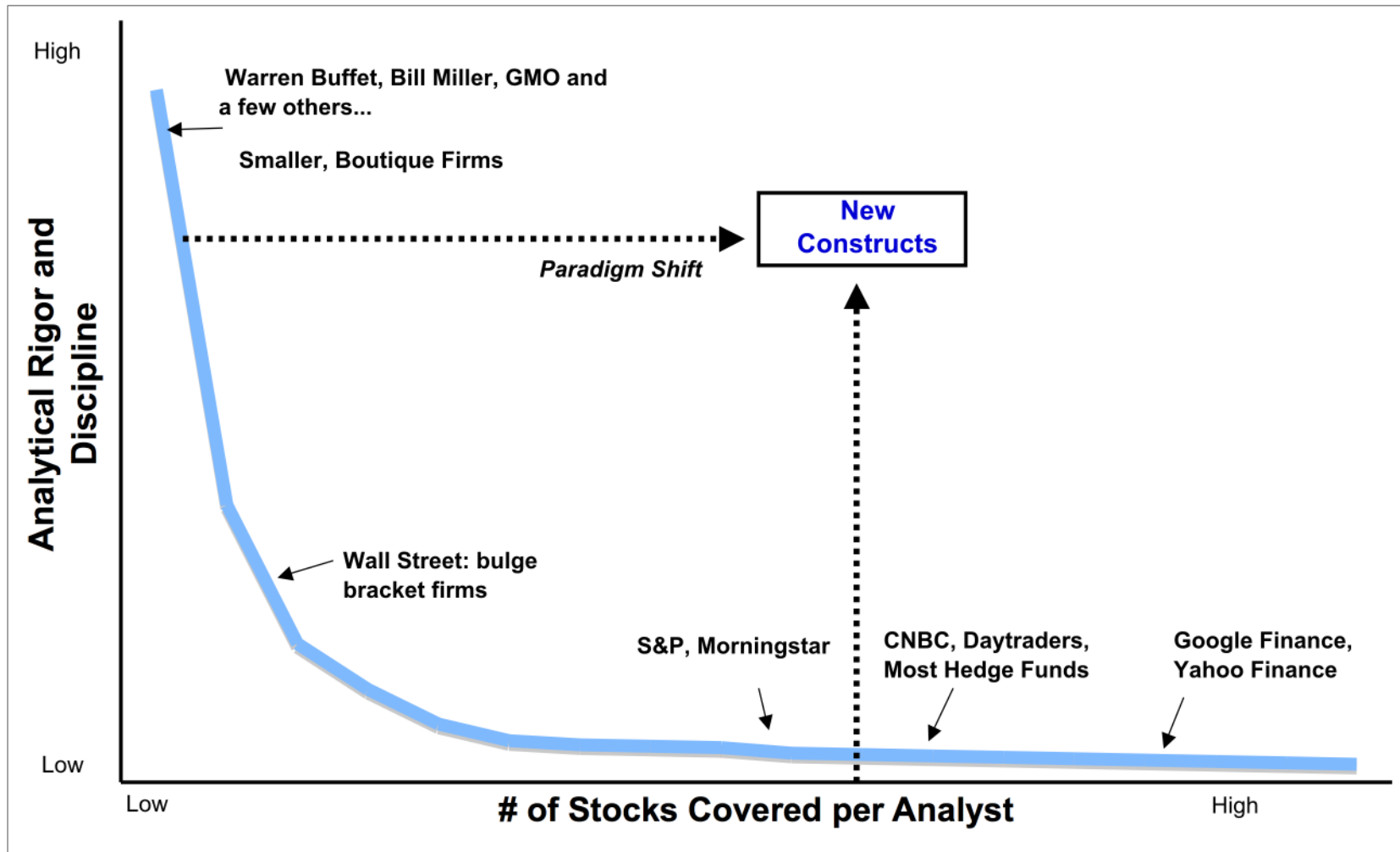
- Research reports, data feeds, interactive modeling and screening tools.
- Institutional and retail customers
- Reputation for high integrity and stock-picking success. Appendix 5 has details.

#### Hedge Fund

- Long/short US equity fund that leverages New Constructs' proprietary research.

# Analytical Rigor Need Not Be Sacrificed

## Covering All Companies Completely



## Part II

# Our Goals

Bring Integrity to the Capital Markets  
Earn Your Support

# Integrity Is Critical To Confidence in Markets

## Owners Must Trust Agents of Capital

### Integrity of Capital Markets Depends on:

1. **Accountability:** for completeness and accuracy of reported financials - companies need to know that their filings are reviewed with a fine-tooth comb to ensure they are deterred from Enron-type misreporting.
2. **Accuracy:** of profitability measurement - investors need to know they can trust the profitability measures provided by the market. Reported Earnings and Income Statements have never (and were never intended) to fulfill this purpose. In reality, "earnings" are manipulated and "managed" to dupe investors more often than not.
3. **Transparency:** of valuation and profitability measures - Wall Street has created myriad approaches to valuation in order to confuse investors. In truth, there is only one true way to value any asset - measure the present value of its future cash flows.

Superior allocation of capital is the single greatest driver of American prosperity and improvements in standards of living.

# Market Integrity Is Under Siege

## Intelligent Exploitation Trumps Intelligent Allocation

### Threats To Integrity of Capital Markets:

1. **Omission of required disclosures** - such as entire sections of the Financial Footnotes. See Appendix 1 for actual examples.
2. **Unethical assumptions used in the calculation of earnings** - such as volatility estimates that are far below their true level in order to reduce the cost of option expense reported in earnings. See Appendix 1 for actual examples.
3. **Exploitation of grey areas in accounting** - such as the use of operating leases to hide debt off-balance sheet. See Appendix 1 for actual examples.
4. **Misrepresentation of profitability** - the heavy reliance on reported EPS could be mitigated by offering a more comprehensive and standardized measure of profitability for all U.S. stocks. See Appendix 1 for actual examples.
5. **Executive Compensation Pegged to Inaccurate Measures of Profitability** - inappropriate incentives lead to inappropriate behavior.

These threats undermine Accountability, Accuracy and Transparency.



# Part III

## How We Can Help

Solutions from an “Insider’s” Perspective  
Expertise and Track Record

# Defending Market Integrity

"Sunlight is said to be the best of disinfectants."

## Perform a complete review of Annual Reports every year:

1. Identify and track where companies omit and mis-state financial information.
2. Identify unethical assumptions used in the calculation of earnings.

## Put investors on equal footing with Wall Street "Insiders":

1. Present investors with the assumptions hidden behind the numbers - even if it is legal and conforms, investors may not like it. Either way, they deserve to know.
  - Identify key financial facts buried in the Notes to the Financial Statements.
2. Offer investors a standard, true measure of profitability - otherwise, they are forced to rely on information from those try to sell them stock (sell-side research and issuer releases and conference calls).
  - Based on the complete set of financial information available
  - Standard for all companies
  - More accurate representation of the true underlying cash flows of the business

## Hold Executives Accountable for their True Performance:

1. Create compensation benchmarks based on standard measure of profitability - publish reports on how current pay packages are aligned with true profitability for each industry group.
2. Identify companies where pay appears to be out of line - make companies accountable/defend their policies.

# Complementing Current Regulatory Efforts

## 25+ Years Experience Decoding Wall Street Propaganda

### New Constructs Has Given the Market since 2003:

- 1. Increased Accountability via:**
  - Completely reviewing over 30,000 annual reports.
  - Identifying of omissions and unethical assumptions - see Appendix 1.
  
- 2. Unprecedented Accuracy of Profitability via:**
  - Forensic Expertise: understanding how companies manipulate GAAP.
  - Publishing “economic earnings” for over 3000 stocks over past decade.
  
- 3. Unrivalled Transparency via:**
  - Quantifying future cash flows required to justify stock prices.
  - Presenting all data and assumptions behind earnings and valuation calculations.
  
- 4. Tools For Making Informed Investment Decisions:**
  - Cutting-edge forensic accounting research on stock options, off-balance sheet debt, pension, write-offs, etc.
  - Sophisticated modeling and screening tools; quick, directed access to key data buried in 10Ks.
  
- 5. Good Stock-Picking Advice:**
  - Institutional Investor Magazine Ranked New Constructs #1 for stock-picking amongst all research firms.
  - See Performance of Most Attractive and Most Dangerous Stocks reports.

# Part IV

## Appendices

- 1. Examples of Omissions and Mis-Statments, Unethical Assumptions and Misleading Disclosures**
- 2. Economic vs. Accounting Earnings**
- 3. Stock-Picking Track Record**
- 4. Media Coverage - Insights Into New Constructs' Reputation**

# Appendix 1

## Examples of Omissions and Mis-Statements, Unethical Assumptions and Misleading Disclosures

## Examples of Omissions and Mis-Statements

### Missing Disclosures: Option Valuation Assumptions

- Over the last 11 years, we found 257 filings that omitted disclosing the assumptions used to calculate the Fair Value of the Employee Stock Options they granted that year.

Example:

NAV (Navistar International Corp.) 2008 10K  
Assumptions used to calculate the Fair Value NOT DISCLOSED  
# of options granted as % of Basic Shares Outstanding: 10%

### Mis-Statements: Earnings Do Not Up Add On the Income Statement:

- Over the last 5 years, we found 10 Income Statements that do not add up due to issues other than rounding.
- We found 14 over the last 11 years.

Example 1:

FAF (First American Corp) 2008 10K  
Reported Net Income: -\$26,320,000  
Calculated Net Income: -\$36,320,000  
Difference: \$10,000,000 or 28% of Net Income

Example 2:

GCO (Genesco Inc) 2008 10K  
Reported Net Income: \$6,885,000  
Calculated Net Income: \$6,668,000  
Difference: \$217,000 or 3% of Net Income

### Mis-Statements: Balance Sheets Do Not Always Balance:

- Over the last 11 years, we found 20 Balance Sheets that do not balance due to issues other than rounding:
  - 11 due to the components of assets not adding up to the total value listed
  - 9 due to the components of liabilities not adding up to the total value listed

Example:

SLG (SL Green Realty Corp.) 2007 10K  
Listed total assets: \$11,430,078  
Listed total liabilities & equity: \$11,406,016

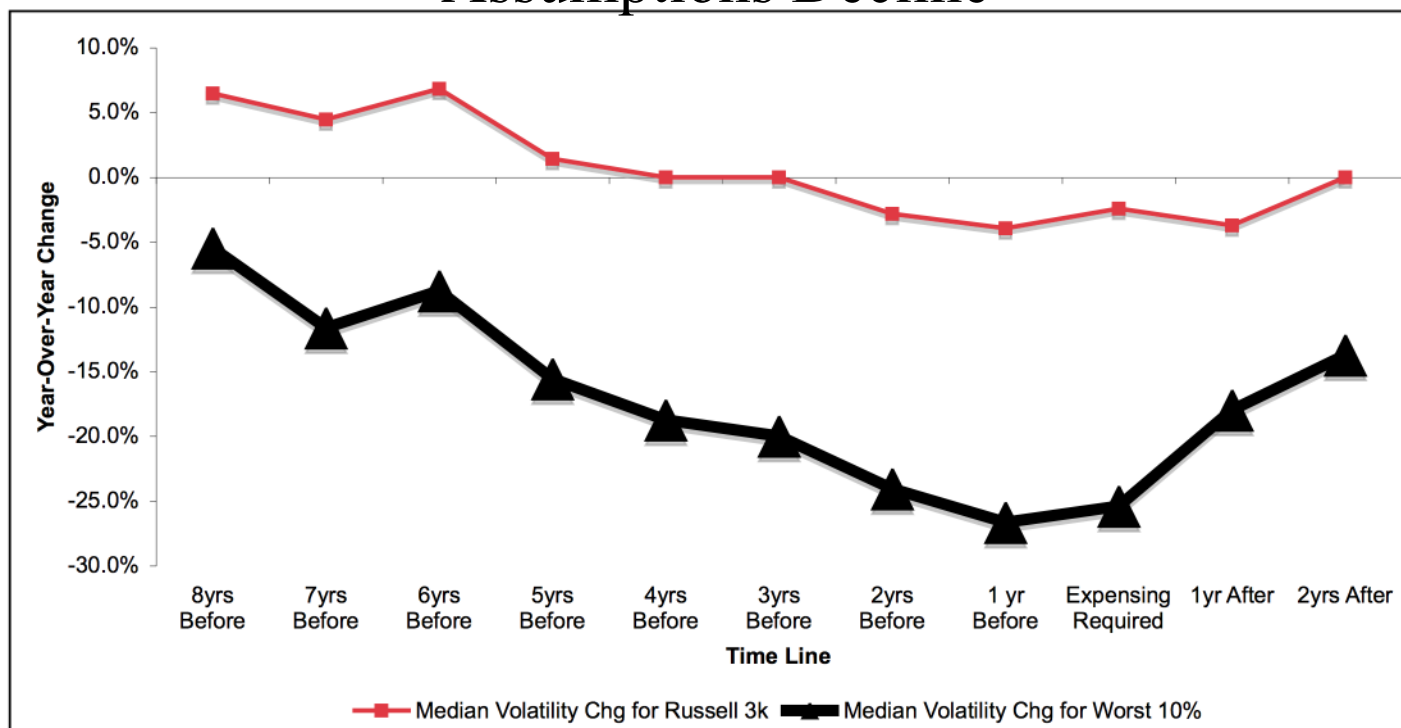
Companies need to know their 10K is read cover-to-cover every year.

# Examples of Unethical Assumptions

## Understating Volatility Assumption Used to Determine Option Expense

- Volatility is the most important input to the option valuation model.
- A change in the volatility assumption will yield the same percentage change in the value of the option (e.g., a decrease in expected volatility from 30 percent to 27 percent will reduce estimated option value and option expense by 10 percent).
- Approximately 20% of all companies in the Russell 3000 have stock option expenses that are greater than 5% of their total revenues.

## Option Expenses Plunge As Volatility Assumptions Decline

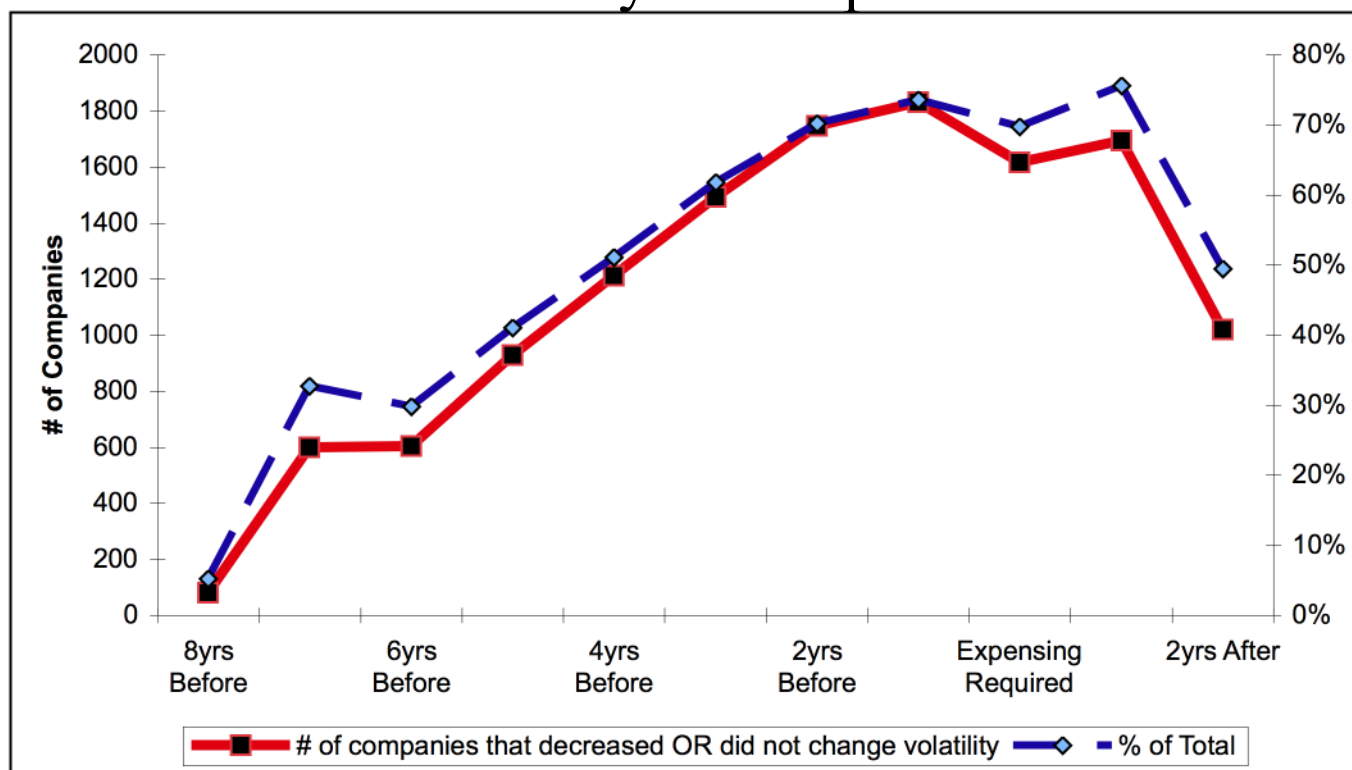


# Examples of Unethical Assumptions

## Is It Wrong If Everyone Does It?

- Management has significant discretion in estimating volatility.
- 2008 was one of the most volatile years for the stock market in history (the VIX was up 78% in 2008).
- Despite this record volatility, over half of companies (52%) decreased or did not change their volatility assumptions during 2008.

## Nearly All of the Russell 3000 Lowered Volatility Assumptions





## Examples of Misleading Disclosures

### Preferred Stock Understated - Overstating Equity Values

- Over the last 3 years, we found 18 companies that under-reported Preferred Stock on their balance sheets. 15 occurred in 2008.
- Understating preferred stock is misleading because it makes the value of common equity appear larger than it is.

#### Example 1:

ELTP (Elite Pharmaceuticals) 2008 10K  
Reported Preferred Stock: \$276  
Actual Value of Preferred Stock: \$28,792,669  
Difference in value is 188% of Total Assets

#### Example 2:

EPEX (Edge Petroleum) 2008 10K  
Reported Preferred Stock: \$29,000  
Actual Value of Preferred Stock: \$143,750,000  
Difference in value is 40% of Total Assets

### Off-Balance Sheet Debt - Hidden Liabilities:

- Operating Leases allow companies to move large chunks of debt off their balance sheets.
- 80% of Russell 3K companies use operating leases.
- 40% of Russell 3K companies have off-balance sheet debt that is larger than their reported debt.
- Nearly 10% of Russell 3k companies have off-balance Sheet debt that is more than 5% of their market value.

#### Example 1:

T (AT&T) 2008 10K  
Off-Balance Sheet Debt: \$17,189,084,944  
Equals 12% of Market Value

#### Example 2:

WAG (Walgreens) 2008 10K  
Off-Balance Sheet Debt: \$21,775,068,870  
Equals 60% of Market Value

## Examples of Misleading Disclosures

### Value of Outstanding Options - Hidden Liabilities:

- Outstanding option liabilities represent future claims to common equity. These values are not found anywhere in company filings. They must be derived based on several data points found in the Notes to the Financial Statements.
- Nearly all Russell 3K companies have a material option liability
- 8% of Russell 3K companies have option liabilities greater than 5% of market value
- 6% of Russell 3K companies have option liabilities greater than 10% of total assets

#### Example 1:

WTM (White Mountain Insurance Group Ltd) 2008 10K  
Outstanding Option Liability After-Tax: \$770,074,377  
Equals 28% of Market Value

#### Example 2:

CY (Cypress Semiconductor Corp.) 2008 10K  
Outstanding Option Liability After-Tax: \$143,788,000  
Equals 24% of Market Value

### Write-Downs Accumulated - Hidden Liabilities:

- Accumulated Write-downs After-Tax represent the value of assets that management has written-off over time.
- These values are not captured on balance sheets though they are an important indicator of management's ability to create value.
- Nearly all Russell 3K companies have a material option liability
- 19% of Russell 3K companies have Accumulated Write-downs After-Tax greater than 25% of Total Assets
- 5% of Russell 3K companies have Accumulated Write-downs After-Tax greater than 100% of Total Assets

#### Example 1:

ARBA (Ariba Inc) 1998 - 2008 10Ks  
Accumulated Write-downs After-Tax: \$1,714,348,000  
Equals 273% of Total Assets

#### Example 2:

BRCM (Broadcom Corp.) 1998 - 2008 10K  
Accumulated Write-downs After-Tax: \$4,154,666,848  
Equals 110% of Total Assets

# Appendix 2

## Economic vs. Accounting Earnings

# The Core Problem

## GAAP Offers Insufficient Information

- Actual profitability of businesses is obscured
- Valuation metrics based on GAAP metrics are misleading
- When EPS and Cash Flow diverge, the market follows cash

Traditional P&L	Economic P&L
Revenues	Revenues
- operating expenses	- operating expenses
	- <b>Cost of ESOs</b>
= pretax earnings	= pretax earnings
- taxes	- taxes
= Reported Profit	= Profit
	- <b>capital charge</b>
	= Economic Profit

## Lifting the Corporate Veil

We Gather Items in the Notes to Rectify GAAP financials

- Restructuring charges
- Goodwill amortization
- Unrecorded Goodwill
- Unconsolidated Subsidiaries
- Minority Interests
- Unrealized Gains/Losses
- Employee Stock Options
- Operating Leases
- Loan Loss Reserves
- LIFO Reserves
- Excess Cash
- Pension Over/Under Funding

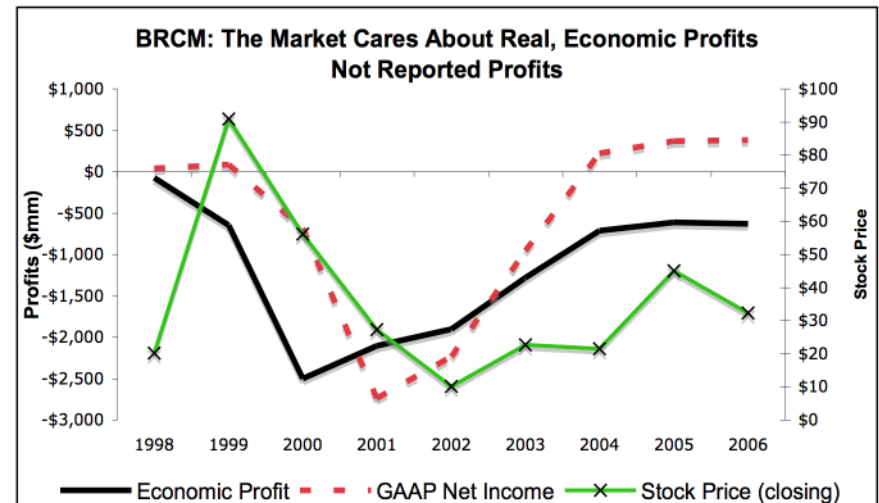
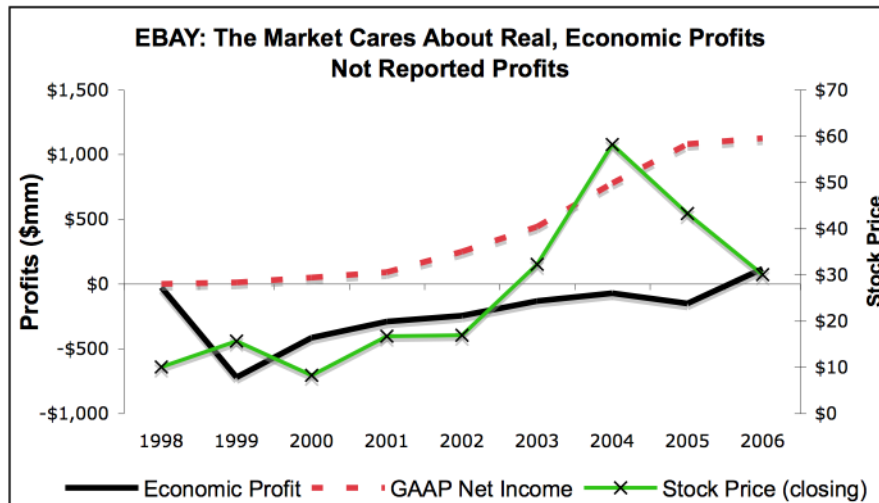
### Information Sources: ONLY 10Ks and Annual Reports

- Income Statement, Balance Sheet, Cash Flow Statement and the ***Notes to the Financial Statements*** – must cover all 4 bases to ensure investment decision are made with full diligence.
- Compustat and Marketguide databases can not meet our data standards or needs.

# Economic Facts Revealed

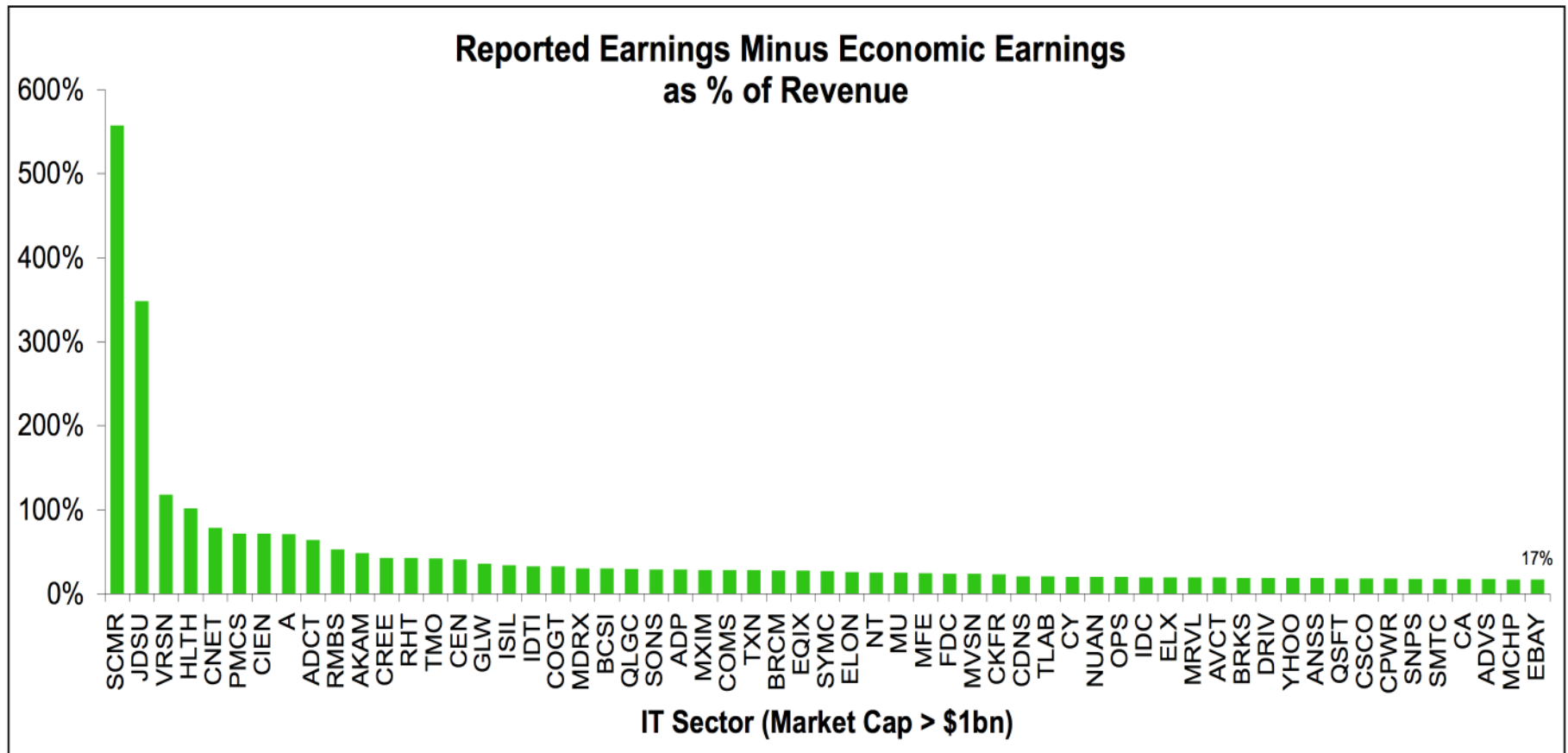
## The True Profitability of Companies

- Translate accounting data into economic information.
- Reconciling accounting rules with economic principles.
- Accounting rules were created by accountants for creditors, not equity investors.
- Analyzing the economics of businesses – quickly and easily.



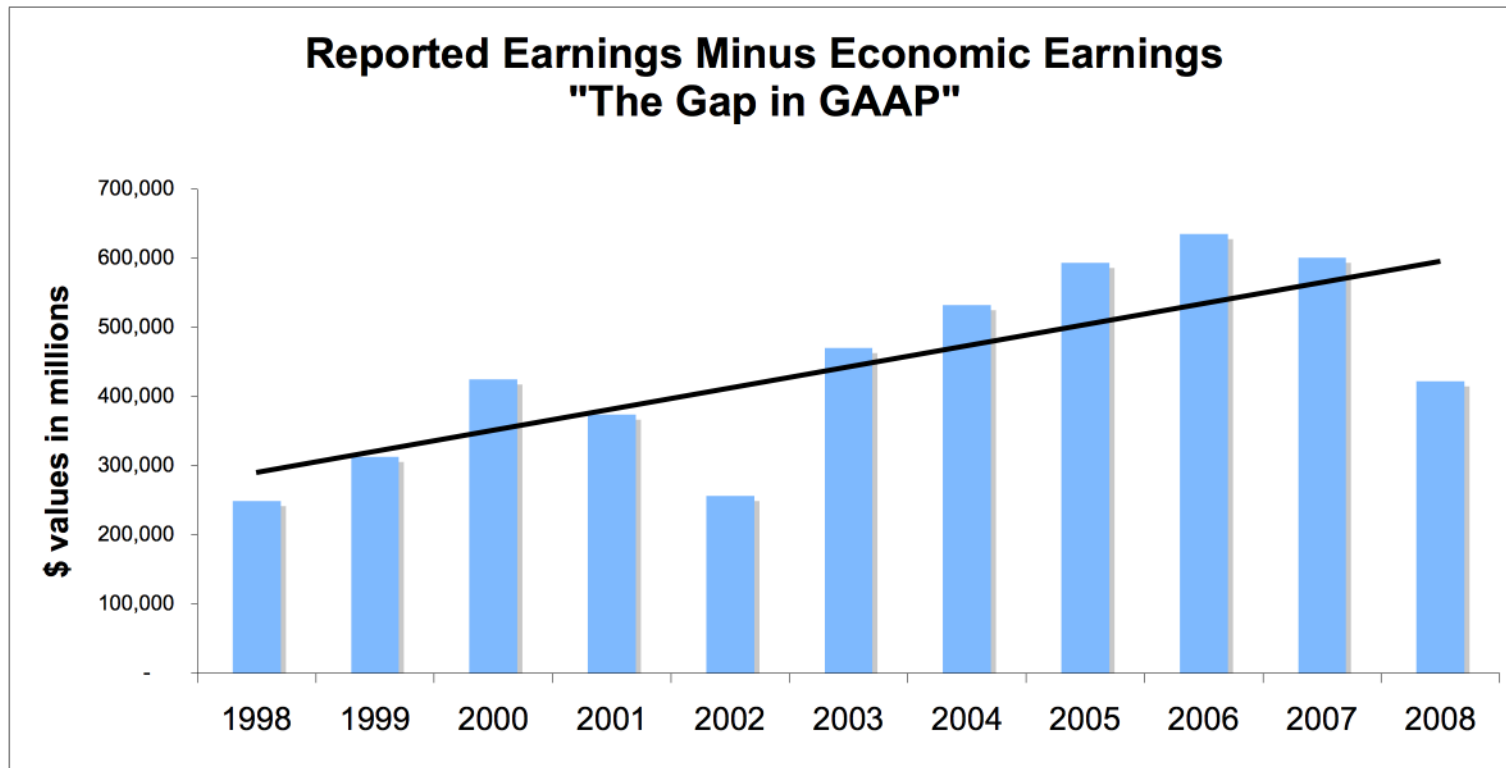
# IT Sector/Industry Perspectives

## Real Versus 'Reported' Earnings



# Market Perspectives: the S&P 500

## Real Versus 'Reported' Earnings



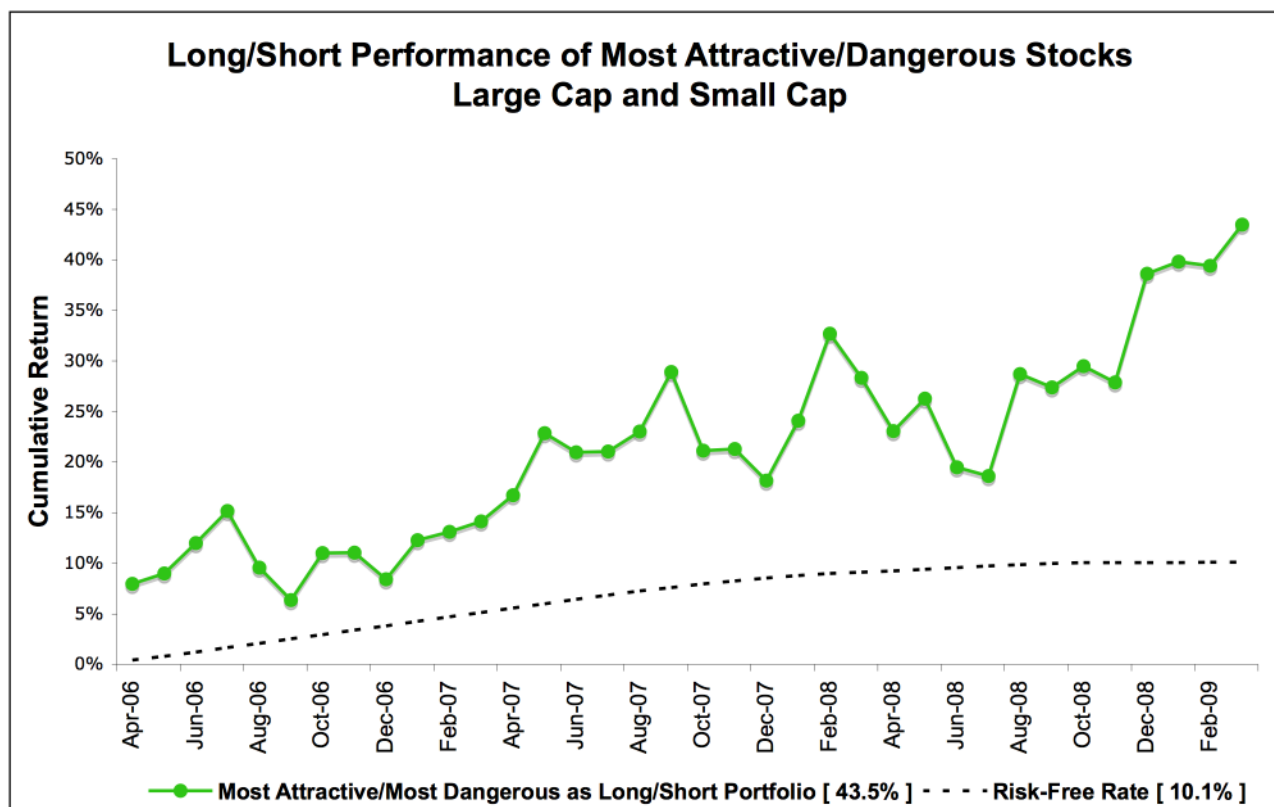


# Appendix 3

## Stock-Picking Track Record

# Most Attractive/Dangerous - documented picks

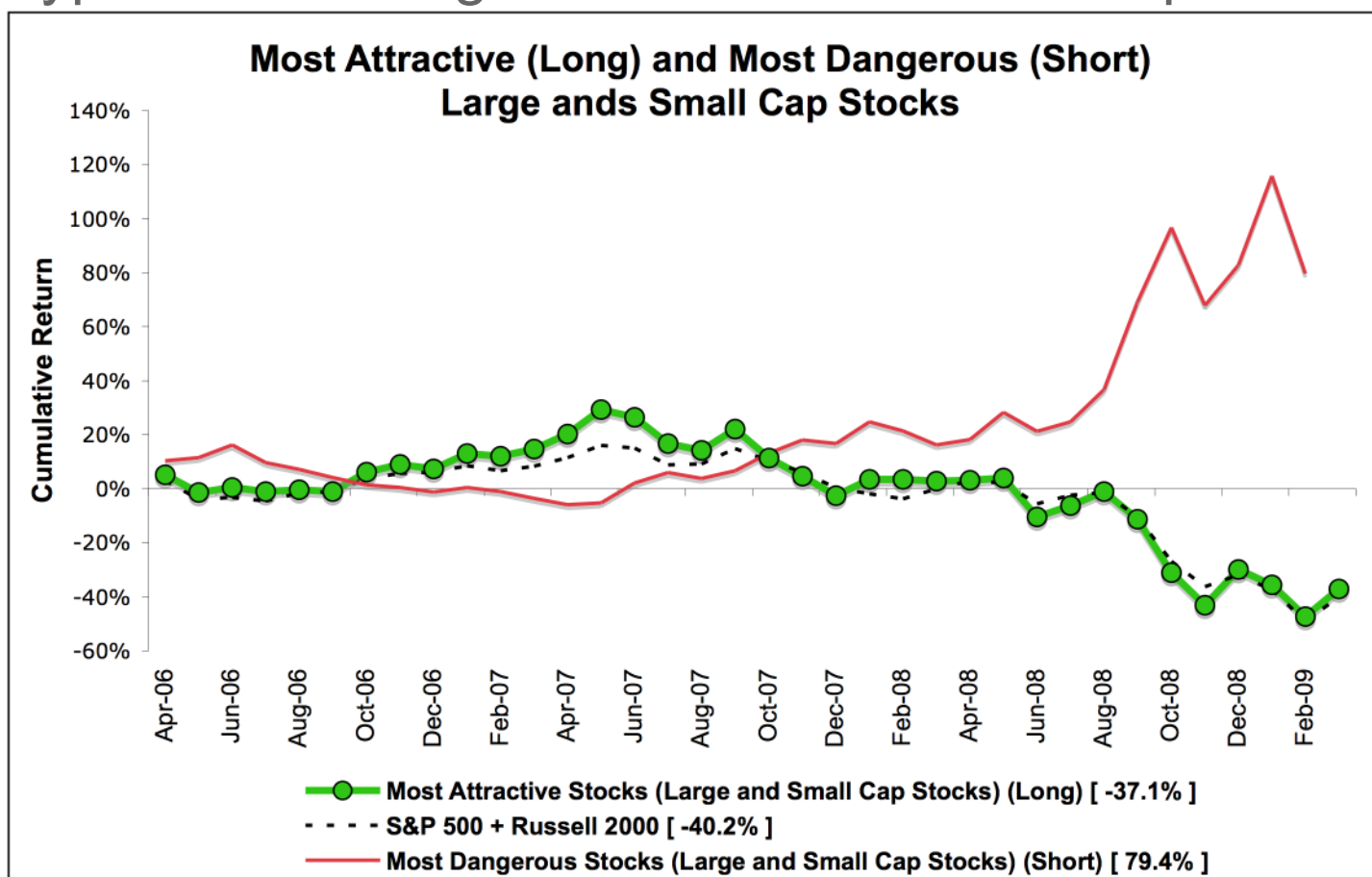
## Hypothetical Long/Short Portfolio: Apr 4, 06 - April 5, 09



This graph represents the historical performance of a hypothetical portfolio of securities consisting of the stocks listed in New Constructs’ “40 Most Attractive Stocks” and “40 Most Dangerous Stocks” lists. This chart does not account for transaction costs, dividends, rebates or fees taken by the General Partner. The chart assumes equal-weighted holdings in all 80 stocks and assumes that the holdings will be updated upon the publication of new reports. Accordingly, the chart shown herein does not necessarily indicate overall portfolio performance that has been or may be expected to be achieved. Past performance is not an indication of future results.

# Most Attractive/Dangerous - 4/4/06 to 4/5/09

## Hypothetical Long and Short Portfolios Outperform



This graph represents the historical performance of a hypothetical portfolio of securities consisting of the stocks listed in New Constructs' "40 Most Attractive Stocks" and "40 Most Dangerous Stocks" lists. This chart does not account for transaction costs, dividends, rebates or fees taken by the General Partner. The chart assumes equal-weighted holdings in all 80 stocks and assumes that the holdings will be updated upon the publication of new reports. Accordingly, the chart shown herein does not necessarily indicate overall portfolio performance that has been or may be expected to be achieved. Past performance is not an indication of future results.

# Appendix 4

## Media Coverage - Insights Into New Constructs' Reputation Bio for David Trainer

# New Constructs Has Strong Reputation Integrity and Success Work Together

## Sample of Media Coverage:

1. "Footnote Fanatic" Forbes Magazine:  
<http://www.forbes.com/forbes/2006/0109/061.html>
2. "Stock Options\_ Old Game, New Tricks" BusinessWeek:  
[http://www.businessweek.com/magazine/content/05\\_51/b3964060.htm](http://www.businessweek.com/magazine/content/05_51/b3964060.htm)
3. "3 Ways Companies Bury Debt" MSN:  
<http://articles.moneycentral.msn.com/Investing/CompanyFocus/3WaysCompaniesBuryTheirDebt.aspx>
4. CNBC Interview featuring our unique focus on the Notes to Financial Statements:  
<http://www.newconstructs.com/nc/news/display.htm?newsItemId=402880a90d2e1ecc010d3198e9487ebc>
5. CNBC Interview featuring misleading nature of reported earnings:  
<http://www.newconstructs.com/nc/news/display.htm?newsItemId=402880a90d7638c0010d7a2b2ee40002>
6. CNBC Interview highlighting stock-picking success:  
<http://www.newconstructs.com/nc/news/display.htm?newsItemId=402880a90d951ead010d98a3b57b0002>

## David Trainer - abridged Bio

*A veteran investment strategist and corporate finance consultant, Mr. Trainer specializes in interpreting accounting rules and translating their impact on the underlying economics of business performance and valuation.*

Mr. Trainer has been a regular guest on CNBC's Squawk on the Street where he shares his insights on the Most Attractive and Most Dangerous Stocks in the market. Major news publications (incl. Forbes, Wall Street Journal, New York Times, Fortune, CBS MarketWatch and Business Week) often reference Mr. Trainer's expertise on topics ranging from forensic accounting, options expense, valuation, quality of earnings, and interpretation of accounting rules and the Notes the Financial Statements. He has also been a guest lecturer in the finance and investing classes at Columbia Business School, the Graduate School of Business at University of Chicago, and Vanderbilt's Owen Graduate School of Management. Mr. Trainer is a member of the Chartered Financial Analysts Institutes' Distinguished Speakers Lecture Series. This program selects speakers to meet with and present to CFA Societies around the country. Mr. Trainer also serves on the FASB and IASB special working group for reviewing changes to accounting rules regarding operating leases.

His stock-picking success has been well-documented, including features on CNBC and in Institutional Investor Magazine, which highlighted New Constructs for being ranked #1 for stock-picking amongst all research firms.

Prior to founding New Constructs in 2002, Mr. Trainer spent over 6 years as a stock analyst on Wall Street. In 1996, he joined Credit Suisse First Boston where he created an economic (as opposed to accounting)-based earnings model and brand for CSFB equity research. He spearheaded the effort to apply consistent economic earnings analysis (a.k.a. 'EVA') across all industries globally. In 1997, Mr. Trainer developed and managed the Value Dynamics Framework project, a separate business for CSFB across three continents. This business, the precursor to CSFB-HOLT, established CSFB's economic earnings research franchise around the world.

In 1999, Mr. Trainer transitioned these skills into equity research coverage of the financial services sector for CSFB. In addition to applying a value-based approach to consumer finance, asset management and broker-dealer firms, he developed a proprietary valuation framework that linked customer satisfaction to the valuation of credit card companies.

In November of 2000, Mr. Trainer joined Epoch Partners (acquired by Goldman Sachs in July 2001) where he covered the Customer Relationship Management Software industry. While at Epoch, he developed a proprietary framework that specifically quantified the ROI of Customer Relationship Management Software products. Prior to Wall Street, Mr. Trainer was an executive compensation consultant with Arthur Andersen. In 1994, Mr. Trainer earned his B.S. in International Business from Trinity University in San Antonio, TX.

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