

CORNERSTONE MACRO

Economics, Policy, Strategy & Technicals

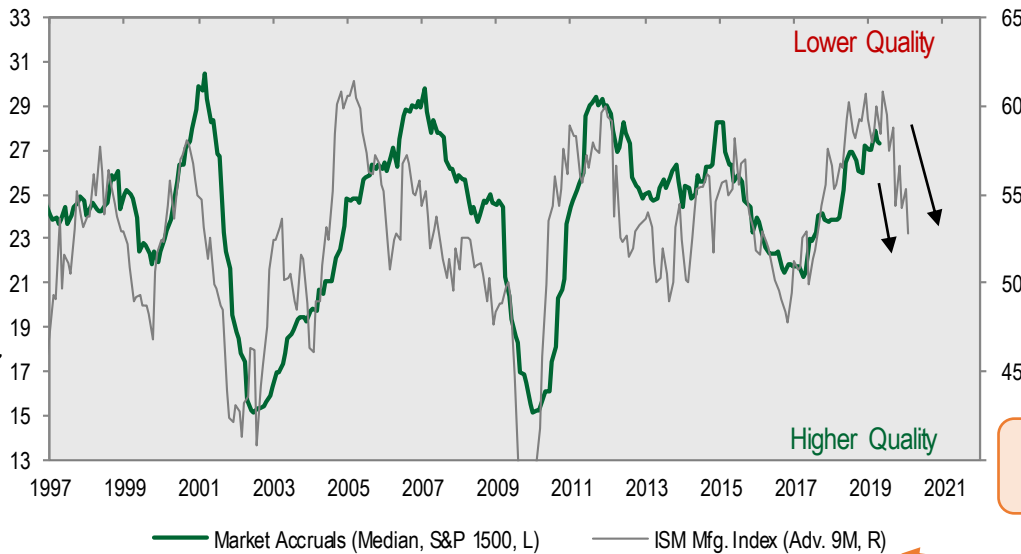
Portfolio Insights

NOW IS THE TIME EARNINGS QUALITY MATTERS MOST

Accounting quality is the most studied market anomaly hands-down. Why is it an anomaly? Most likely because it has got to be one of the least sexy subjects in finance. So while it may be a dry subject, this is the most important time in the market cycle for this type of work. Knowing where the potential risks lie in your portfolio could be the difference between boom or bust in '19.

Earnings Quality Ebbs And Flows With The Business Cycle

You Typically See Earnings Quality Deteriorate Near Peaks In The Cycle.

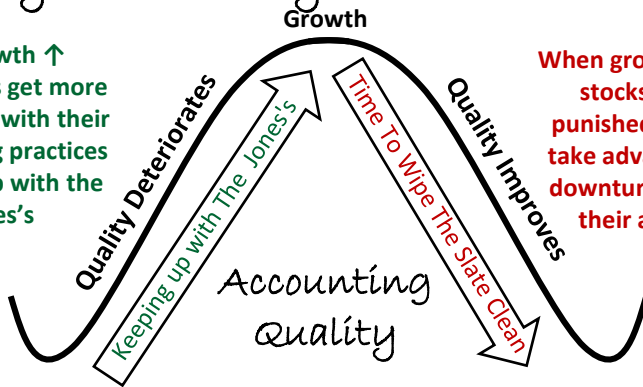


Earnings Quality Follows The Path Of Leading Indicators.

~3 Quarter Lead

Why Does Quality Move with The Cycle?

As growth ↑ companies get more aggressive with their accounting practices to keep up with the Jones's



When growth ↓ and all stocks are being punished, companies take advantage of the downturn to clean up their accounting

Why Does Quality Lag LEIs?

Leading
PMIs
Equity Prices
Etc.

Coincident
Earnings
GDP
Etc.

Quality Correlates Best With EPS Trends & Other Coincident Indicators

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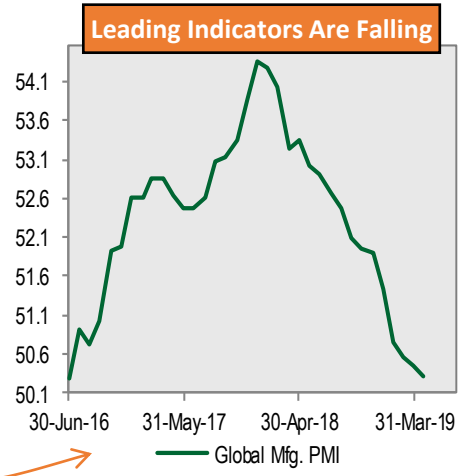
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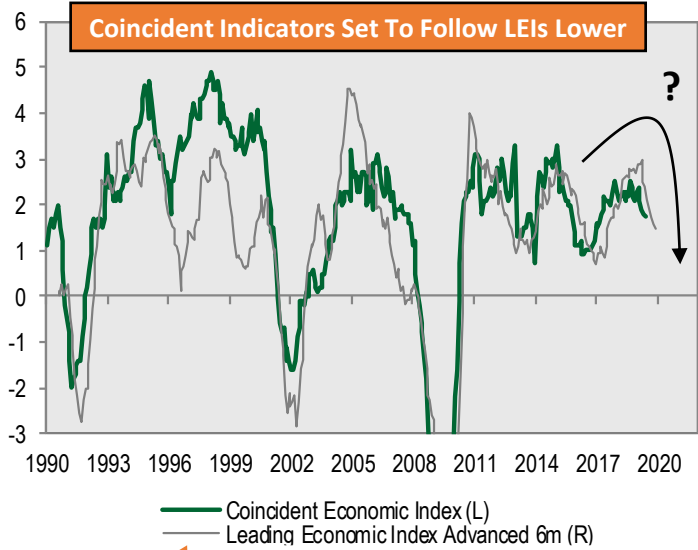
POOR EPS QUALITY FACING HEADWINDS FOR SEVERAL QTRS

When growth prospects are rising, earnings quality is not something that investors pay much attention to. When things are improving, investors are typically more focused on reward and less concerned about risks. When growth slows, investors shift their focus and start to dig in to where problems may be brewing. Today, PMIs around the world are falling and coincident indicators like earnings are set to see continued downward pressure for several qtrs. We expect recent underperformance of stocks with high accruals will continue.

The Global PMI Has Seen 13 Consecutive Downticks.

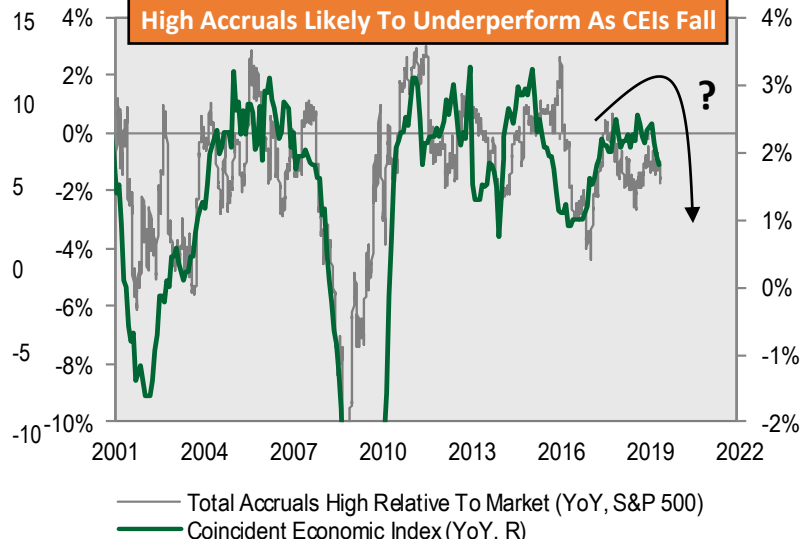


Coincident Economic Indices Likely Face At Least 6 More Months Of Downside ...

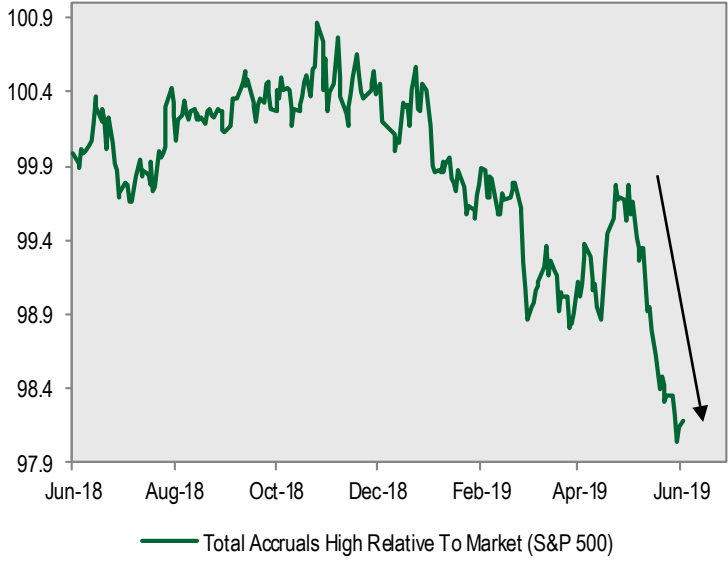


At Least Six More Months Of Downside For Coincident Indicators.

... High Accruals Typically Underperforms When Coincident Indicators Decline.



Recent Performance Of High Accruals



High accruals has been underperforming lately ... likely to continue for the next 6-12 months

Note:
 Leading Economic Indicator (LEI)
 Coincident Economic Indicator (CEI)

HOW WE MEASURE EARNINGS QUALITY ... THE AQ SCORE

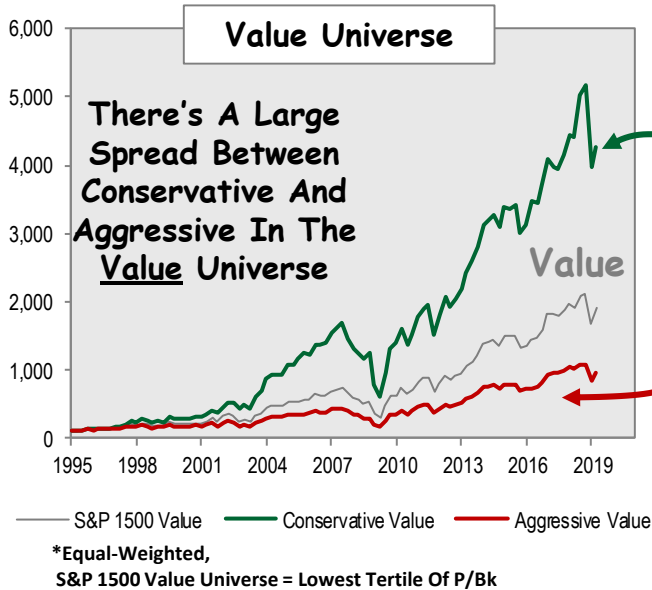
The Accounting Quality model measures the quality of a company by the amount of conservatism used when reporting its financial statements. This is achieved by combining point-in-time measures with historical metrics, as well as investor perception. As we show below, companies that rank as conservative have outperformed compared to their more aggressive peers.



The Stark Difference Between Conservative and Aggressive

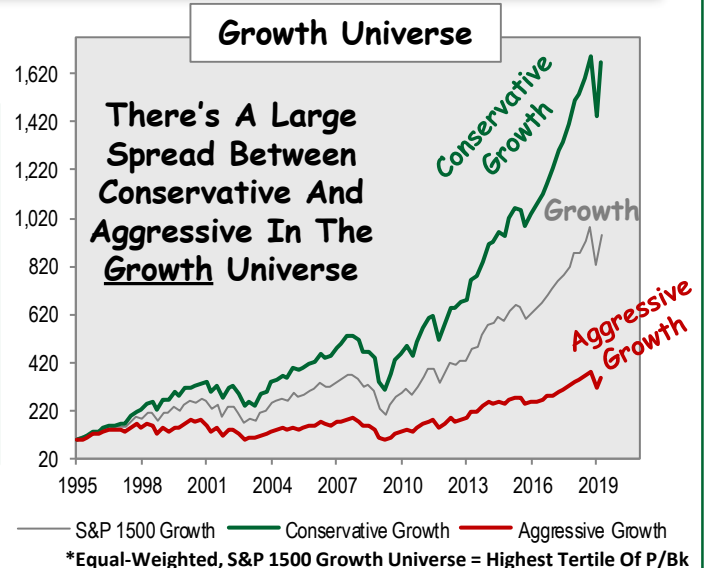
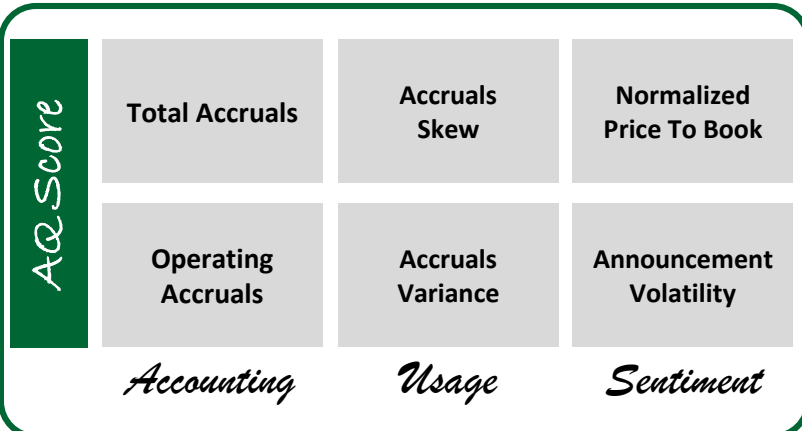
Firms Which Rank As Conservative Have Better Accounting Practices

Measures



Aggressive Firms Tend To Have Accounting Problems And Management Issues

Earnings Quality Needs To Be Tied To Other Metrics And Not Viewed Solely As A Catalyst. [Email us](#) If You Have Questions/Would Like More Details



WHO IS POTENTIALLY CONSERVATIVE AND AGGRESSIVE WITH THEIR ACCOUNTING

Given where we are in the business cycle, we are overweight defense (i.e. high profitability) and underweight cyclical (i.e. value). Below is an abridged list of attractive stocks (High Profitability with Conservative Accounting) and an abridged list of potential underperformers (Low P/E With Aggressive Accounting). We believe investors should pay close attention to accounting quality when growth is slowing as the risk of a potential restatement is amplified. How does your portfolio look? Where is your potential risk hiding? The lists below are from the S&P 500 but is available for U.S. and global indices. For a copy, please email quant@cormacteam.com.

Stocks With High Profitability (i.e. Defensive) & Conservative Accounting

| Ticker | Name | Accounting Quality (AQ)Score | Additional Stock Attributes | | | | Price (USD) | Industry |
|--------|-----------------------------|------------------------------|-----------------------------|------|----------------|-----|-------------|--|
| | | | Return On Asset | Beta | Sales Variance | P/E | | |
| AZO | Autozone Inc | 1 | 14.9% | 0.64 | 0.03 | 16 | \$ 1,036.27 | Specialty Retail |
| RHI | Robert Half Intl Inc | 1 | 23.0% | 1.32 | 0.21 | 14 | \$ 55.40 | Professional Services |
| COP | Conocophillips | 1 | 8.7% | 1.02 | 7.42 | 13 | \$ 59.10 | Oil Gas & Consumable Fuels |
| INTU | Intuit Inc | 1 | 28.8% | 1.09 | 0.72 | 33 | \$ 247.10 | Software |
| SBUX | Starbucks Corp | 1 | 15.7% | 0.50 | 0.13 | 26 | \$ 78.52 | Hotels Restaurants & Leisure |
| SYF | Synchrony Financial | 1 | 12.2% | 1.21 | 0.02 | 8 | \$ 33.9 | Consumer Finance |
| GOOG | Alphabet Inc | 1 | 14.4% | 1.01 | 1.16 | 21 | \$ 1,330.0 | Interactive Media & Services |
| ATO | Atmos Energy Corp | 1 | 3.7% | 0.25 | 4.22 | 23 | \$ 101.35 | Gas Utilities |
| FL | Foot Locker Inc | 1 | 13.9% | 0.98 | 0.04 | 8 | \$ 41.02 | Specialty Retail |
| AMG | Affiliated Managers Grp Inc | 1 | 2.9% | 0.99 | 0.01 | 10 | \$ 87.40 | Capital Markets |
| DFS | Discover Financial Svcs | 1 | 2.6% | 0.99 | 0.01 | 10 | \$ 77.23 | Consumer Finance |
| INTC | Intel Corp | 2 | 16.8% | 0.84 | 0.15 | 10 | \$ 44.79 | Semiconductors & Semiconductor Equipment |
| HSY | Hershey Co | 2 | 14.2% | 0.99 | 0.01 | 10 | \$ 133.13 | Food Products |
| CL | Colgate-Palmolive Co | 2 | 19.5% | 0.77 | 0.70 | 23 | \$ 70.82 | Household Products |
| MSCI | Msci Inc | 2 | 15.2% | 1.15 | 0.07 | 34 | \$ 224.83 | Capital Markets |
| BKNG | Booking Holdings Inc | 2 | 16.6% | 1.07 | 0.12 | 16 | \$ 1,747.03 | Internet & Direct Marketing Retail |
| ADBE | Adobe Inc | 2 | 15.6% | 1.12 | 0.30 | 31 | \$ 268.71 | Software |
| NDAQ | Nasdaq Inc | 2 | 2.9% | 0.64 | 0.17 | 18 | \$ 92.76 | Capital Markets |
| MAS | Masco Corp | 2 | 12.5% | 1.41 | 0.17 | 13 | \$ 37.19 | Building Products |
| OXY | Occidental Petroleum Corp | 2 | 9.6% | 0.89 | 8.40 | 13 | \$ 49.69 | Oil Gas & Consumable Fuels |

ABRIDGED LIST

please email for full list
quant@cormacteam.com

Attractive: High Profitability & Conservative Accounting

Stocks With Low PEs (i.e. Cyclical) & Aggressive Accounting

| Ticker | Name | Accounting Quality (AQ)Score | Additional Stock Attributes | | | | Price (USD) | Industry |
|--------|---------------------------|------------------------------|-----------------------------|------|----------------|-----|-------------|--|
| | | | Return On Asset | Beta | Sales Variance | P/E | | |
| REGN | Regeneron Pharmaceuticals | 10 | 23.8% | 1.13 | 1.49 | 14 | \$ 302.06 | Biotechnology |
| DE | Deere & Co | 10 | 5.0% | 1.03 | 3.21 | 13 | \$ 145.62 | Machinery |
| AIV | Apartment Invst & Mgmt Co | 10 | 10.9% | 0.57 | 0.02 | 36 | \$ 49.98 | Equity Real Estate Investment Trusts (REITs) |
| DHI | D R Horton Inc | 10 | 11.3% | 1.19 | 0.70 | 11 | \$ 44.41 | Household Durables |
| LEN | Lennar Corp | 10 | 6.3% | 1.27 | 2.56 | 9 | \$ 51.40 | Household Durables |
| DAL | Delta Air Lines Inc | 10 | 7.1% | 1.15 | 0.18 | 8 | \$ 54.31 | Airlines |
| WY | Weyerhaeuser Co | 10 | 4.2% | 1.65 | 2.87 | 32 | \$ 23.42 | Equity Real Estate Investment Trusts (REITs) |
| FANG | Diamondback Energy Inc | 10 | 5.9% | 0.84 | 27.22 | 10 | \$ 99.13 | Oil Gas & Consumable Fuels |
| CNC | Centene Corp | 10 | 3.7% | 0.99 | 4.84 | 19 | \$ 53.84 | Health Care Providers & Services |
| ADM | Archer-Daniels-Midland Co | 10 | 10.2% | 1.01 | 0.81 | 11 | \$ 65.65 | Food Products |
| RTN | Raytheon Co | 9 | 8.3% | 0.93 | 0.01 | 15 | \$ 179.0 | Aerospace & Defense |
| PHM | PulteGroup Inc | 9 | 10.2% | 0.61 | 0.67 | 13 | \$ 44.24 | Household Durables |
| PSA | Public Storage | 9 | 15.8% | 0.20 | 0.04 | 32 | \$ 237.70 | Equity Real Estate Investment Trusts (REITs) |
| ALB | Albemarle Corp | 9 | 9.0% | 0.99 | 0.01 | 17 | \$ 67.54 | Chemicals |
| BAC | Bank Of America Corp | 9 | 1.2% | 1.02 | 0.01 | 12 | \$ 27.92 | Banks |
| ANTM | Anthem Inc | 9 | 5.4% | 0.74 | 0.04 | 13 | \$ 279.81 | Health Care Providers & Services |
| SO | Southern Co | 9 | 2.0% | 0.99 | 0.01 | 12 | \$ 54.20 | Electric Utilities |
| AMP | Ameriprise Financial Inc | 9 | 1.5% | 0.99 | 0.01 | 12 | \$ 146.92 | Capital Markets |
| CAG | Conagra Brands Inc | 9 | 3.8% | 0.79 | 1.73 | 13 | \$ 28.62 | Food Products |
| D | Dominion Energy Inc | 9 | 3.2% | 0.26 | 0.64 | 18 | \$ 75.97 | Multi-Utilities |

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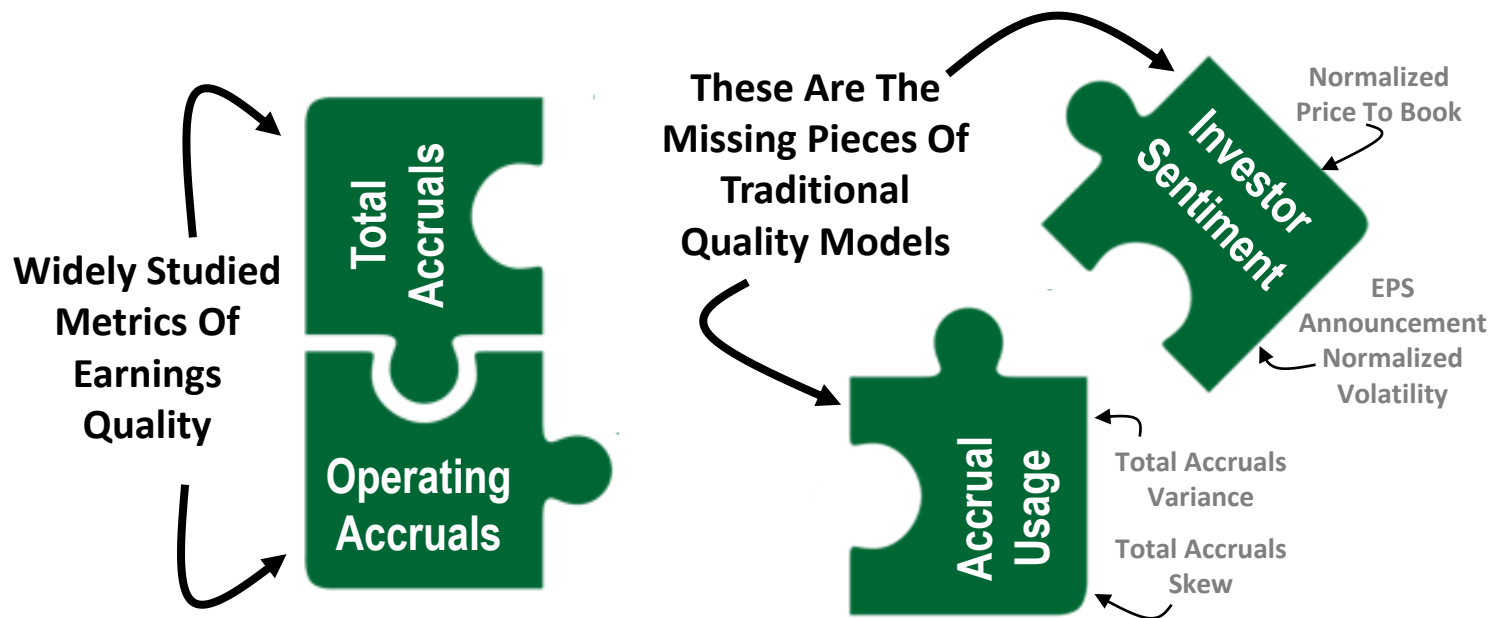
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Unattractive: Low PE & Aggressive Accounting

DIGGING INTO THE DETAILS ON THE QUALITY SCORE

The Accounting Quality model combines the most widely utilized measures of earnings quality with four additional metrics that are less commonly used in practice but are recognized and studied by experts in the field. Below we give details on how the various components are calculated. Please do not hesitate to reach out with any question at quant@cormacteam.com.

The Accounting Quality Model ... Putting The Pieces Together



Formulae And References

The Detection of Earnings Manipulation (Messod Beneish)

$$\text{Total Accruals} = \frac{\text{Net Income} - \text{Operating Cash Flow}}{\text{Assets}}$$

Predicting Material Accounting Misstatements (Dechow & Sloan)

$$\text{Operating Accruals} = \Delta \text{Working Capital Accruals} - \Delta \text{NonCash Operating Accruals} - \Delta \text{Finacial Accruals}$$

Rising Conservatism: Implications For Financial Analysis (Dan Givoly & Carla Hayn)

$$\text{Total Accruals Variance} = \sigma_{ROA} - \sigma_{CfROA} \text{ [5 Year]}$$

$$\text{Total Accruals Skew} = G_1(ROA) - G_1(CfROA) \text{ [5 Year]}$$

Estimation And Empirical Properties Of A Firm-Year Measure Of Accounting Conservatism (Mozaffar Khan, Ross Watts)

$$\text{Normalized Price To Book} = 1[\text{Theorized PBk}] - \text{Best Fit}(\text{PBk}, \text{Sales Growth})$$

$$\text{Earning Announcement Normalized Volatility} = \hat{y} = (15 \text{ Day Volatility Before Earnings}, \text{Earnings Surprise\%}) \text{ [5Year]}$$

The Conservatism Principle And The Asymmetric Timeliness Of Earnings (Sudipta Basu)