

How Counterpoint Equity Funds Look At Stocks

A quantitative system that ranks stocks according to factors that have historically explained investment returns is not always easy to grasp in the abstract. To give investors a better sense of what constitutes the market neutral portion of Counterpoint Tactical Equity and Counterpoint Long-Short Equity's strategies, we evaluated a few recent individual model results. The stocks discussed may have been fund holdings in the past, but neither fund currently has any position in any specific investment discussed in this piece.

Here we attempt to formulate our model's rankings of recent top long and short investments in terms of a more standard "investment pitch" that illustrates the interplay among the variables our model considers.

Long Position: YRC Worldwide

Our quantitative model recently ranked YRC Worldwide (NASDAQ:YRCW) as one of the most attractive long opportunities in our investment universe.

Founded in 1924, YRC Worldwide is a holding company consisting mainly of trucking service providers. It has two main business lines – YRC Freight, which focuses on long haul transportation; and Regional Transportation, which focuses on next-day delivery. The stock dropped almost 20% at the beginning of February as the company announced earnings. To sum up the model's assessment of the stock, this decline in share price created a value opportunity in a profitable company that appears to be making increasingly efficient use of its capital.

After the price drop, our model viewed YRC Worldwide as cheap – in fact, the cheapest stock available based on a sales to price ratio. YRC earned about \$4.89 billion in revenue in 2017, about 14 times its market value in early February.

Despite the bargain basement price, YRC did very well on our model's profitability measures. The company's gross margin in 2017 stood at 7.0%, having improved from 4.9% in 2013.

Meanwhile, YRC ranks highly on our model's asset growth measures. The asset growth anomaly says that companies with expanding balance sheets tend to underperform. According to YRC's financial statements, the company has shrunk its total assets by 23% in the past few years, from \$2.06 billion at the end of 2013 to \$1.58 billion at the end of 2017. While our model assesses asset growth and profitability separately, it's worth noting that strong profitability and a shrinking balance sheet combine in many analysts' eyes to indicate favorable capital efficiency, which can signal strong returns on investment.

Not surprisingly in light of the recent price plunge, YRC did less well on momentum rankings, ranking in the top third of stocks in terms of recent short term momentum, and falling into the bottom quarter of stocks in terms of Counterpoint's longer term momentum measure. Despite a poor showing on these metrics, the model still rated YRC as an overall attractive investment. Keep in mind that momentum and valuation will often tend in opposing directions – it is hard for a stock to become cheap relative to its fundamentals if its price has been rising quickly.

Interestingly, YRC did not perform well on our model's measure of earnings announcement returns – the tendency for stocks to continue to rise in the periods following positive earnings announcements and fall after poor earnings announcements. Nor did it do well on our seasonality measure, which evaluates whether the current time of year is historically a profitable time to hold a stock.

Short Position: 22nd Century Group

One of our model's top short positions, 22nd Century Group (NYSE:XXII), is a "plant biotechnology company" that works to customize the level of nicotine in tobacco and the level of cannabinoids in marijuana plants. The company went public in 2012. In some ways it is the inverse of YRC Worldwide. It is an unusually unprofitable company with a growing asset base and an unattractive valuation, according to our model. Also unlike YRC, whose share price crash on earnings created poor momentum ratings, 22nd Century ranks very high on short- and longer-term momentum measurements.

Shares have been volatile in the past year, rising from under one dollar to a 52 week high above \$4 in late January. They've pulled back in recent weeks to the low \$3 range. That overall gain of more than 230% explains our model's favorable momentum ratings. The model registers little of interest in terms of seasonal stock price effects or earnings surprises, perhaps due to the steep upward trajectory the stock has shown in the past year.

The fundamentals, in contrast, rate poorly. XXII ranked in the bottom 10% for asset growth, profitability, and sales to price. In the past four years, total assets have more than doubled to \$27 million. A bottom-up stock analyst might put that asset growth in context by explaining that relatively young companies, especially startups like XXII, are likely to experience asset growth simply because they start with so little. Regardless, our model rates XXII poorly on this metric, playing the overall statistical odds that growth in total assets is a negative signal.

Other fundamental metrics register as more clearly "bad business." The company has earned a negative gross profit margin in each of the last three reporting years to 2016. This indicates that the company has been selling its products at a discount to what it paid for them. You don't need a quantitative model to know that marking down inventory below cost is not a good strategy. Many business managers would call that a "liquidation sale."

In light of those business economics, 22nd Century's valuation doesn't help matters. The company was in the bottom 6 of all companies with respect to sales to price. Every dollar invested in the company (as measured by market cap) corresponded to about 3.6 cents in annual sales – and remember, those sales translate into losses for investors due to negative gross margins. It's also worth mentioning that the sales to price ratio calculation is complicated by the company's capital structure, which includes preferred stock and outstanding warrants.

Conclusion

We have supplemented our model's outputs with some basic qualitative elements to sketch out how our investment method captures elements of a more conventional, human-driven security analysis. The model's top and bottom ranked stocks respectively show characteristics that analysts tend to associate with attractive and unattractive investments. YRC Worldwide is a long-tenured operator with decent profitability that has become cheap due to recent share price declines – a classic value pitch. 22nd Century, meanwhile, is a young and unproven company whose stock has risen out of proportion with its unattractive fundamentals – a classic short idea.

One benefit of Counterpoint's equity quantitative model is that it makes these assessments without muddying the waters with the qualitative narrative we have created here. Such "pitches" can lead human analysts and portfolio managers to make mistakes – succumbing to confirmation bias on companies they have been fond of in the past or selling winners too early due to loss aversion. Counterpoint's equity funds unsentimental, mechanical approach seeks to mitigate those risk while attempting to capture many of the benefits that have traditionally been associated with bottom-up fundamental security analysis.

Disclosures

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Investors should carefully consider the investment objectives, risks, charges and expenses of the Counterpoint Tactical Equity Fund and the Long-Short Equity Fund. This and other important information about the Fund is contained in the prospectus, which can be obtained at www.counterpointmutualfunds.com or by calling 844-273-8637. The prospectus should be read carefully before investing. The Counterpoint Tactical Equity Fund and the Long-Short Equity Fund are distributed by Northern Lights Distributors, LLC member FINRA/SIPC.

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