



# INTEGRITY RESEARCH INSIGHT

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**Economic Profit**  
*Research.com*

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## McLean Capital Management's New Research Tool

This issue of **ResearchInsight**<sup>SM</sup> will explore a number of investment ideas which boutique research provider, Economic Profit Research's (EPR) proprietary valuation system prices differently than their research counterparts on Wall Street. This issue will give examples of firms which EPR values highly that the Street does not, as well as instances where the Street is bullish on a firm and EPR does not see much cause for enthusiasm.

EPR is the research arm of McLean Capital Management, a Registered Investment Advisory firm that provides research and asset management services. McLean Capital develops investment ideas based on its own proprietary valuation methodology which is explained in the next section.

EPR is headed by Richard McLean, who has 30 years of experience on Wall Street with firms like Merrill Lynch, Legg Mason and Morgan Keegan. Mr. McLean was also Chairman and President of the Lancaster Growth Fund. The main drivers of McLean's proprietary methodology are the amount of free cash flow generated by a company's business operations and the firm's adjusted cost of capital.

Economic Profit Research tries to come up with conservative investment ideas that Graham and Dodd would appreciate. EPR's research database regularly turns up intriguing recommendations – in particular, it does a good job of highlighting smaller companies with favorable cash-flow characteristics and valuations that might otherwise have slipped under the radar screen of most sell-side analysts.

## Methodology

Ultimately, the goal of all companies is to create value for their shareholders but just how that value is measured often differs. The way that EPR measures it is by evaluating **Economic Profit**. Economic Profit is based on classic financial theory and is not entirely different from traditional free cash flow measures.

*Integrity Research Associates is an information and solutions provider specializing in the investment research industry. Our primary clients are institutional investors that use Integrity's services to find new research providers and monitor existing ones. Integrity's analysts cover over 2,500 research firms in the U.S., Europe and Asia.*

The conceptual pillar to support economic profit is the fact that access to equity capital is not free. The company does not create value until a threshold level of return is generated for shareholders after the cost of equity capital is deducted. A company can earn an **accounting profit (net income) but not necessarily an economic profit.**

Companies with strong and steady free cash flow are rated as “BUYS” by EPR while those with poor cash flow profiles are rated as “SELLS”. A low cost of capital classifies a company as a “CONSERVATIVE” risk while those with high cost of capital are rated as “SPECULATIVE” bets.

Mr. McLean feels that the examination of economic profit across their entire database is the main way that EPR differentiates itself from its competitors. EPR is particularly suited to identify companies with a difference between their accounting profit and their economic profit because of the rigor and detail of the algorithms it uses. EPR’s database keeps track of cash flow anomalies at all of the approximately 8,400 non-financial companies that report their financials to the SEC. The firm’s algorithms adjust a company’s accounting metrics to reflect its underlying economic reality and to accurately measure how the core operations of the business are performing. McLean says that out of the 8,400 companies it tracks in its database, only about 1,000 are creating an economic profit.

EPR makes a number of adjustments to accrual based earnings to determine a firm’s cash based earnings. They scrub financial statements reported by the SEC and calculate the cost of capital for each firm. Another benefit of their complex algorithms is that EPR significantly reduces the amount of time it takes to go from filing to actionable recommendation. The firm typically issues an “upside filing alert” to clients within hours of a relevant change to a company’s reported cash flow.

EPR recognizes that companies with a competitive edge can cover higher costs of capital, but those without a competitive edge or in highly competitive industries will struggle to do so. To take this into account EPR applies proprietary weights to its cost of capital calculation depending on how the core operations of a company are doing. The point of this analysis is to determine if a company can make an economic profit or if better opportunities exist elsewhere.

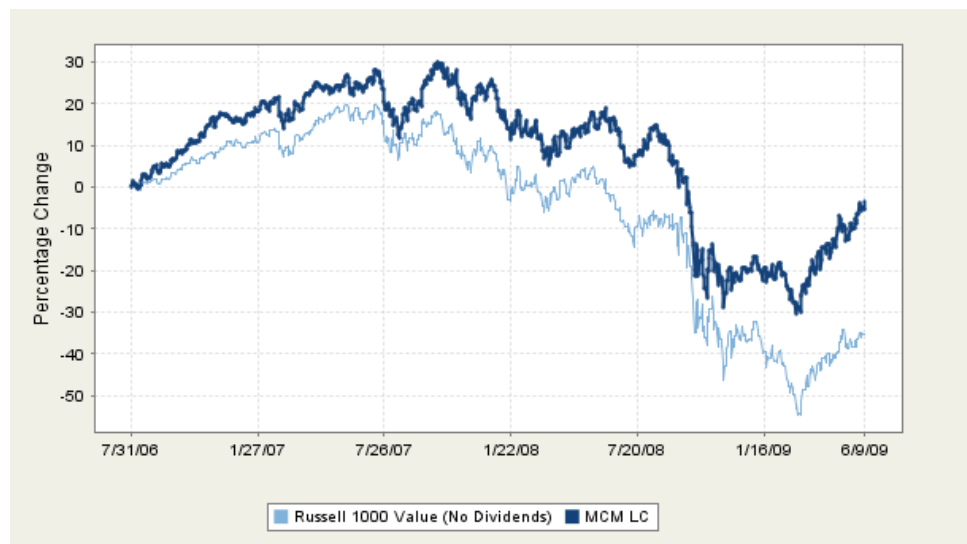
McLean says that at one time, accrual based earnings were considered a meaningful picture of the financial health of the company. This just isn’t the case anymore, as there are just too many executives who manage their accruals to produce the “accounting earnings” necessary to keep investors

happy. Essentially, McLean and EPR are trying to sell the idea that asset managers can invest in companies with great fundamentals and still do well by taking less risk. They don't have to keep buying stocks which will do well in the next quarter but are suspect overall.

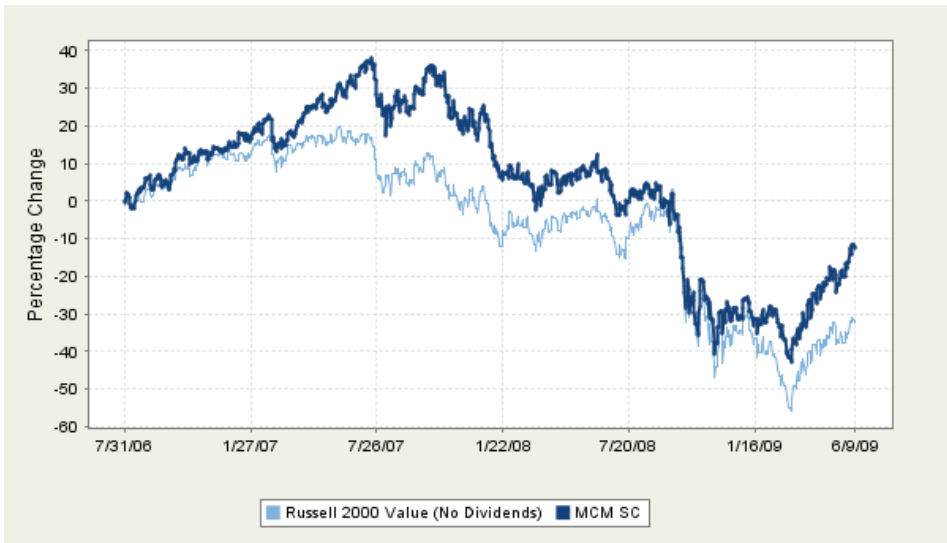
McLean sees his research as a good way to diversify the inputs asset managers are looking at in making investment decisions. If all the research they read is from people watching net income, McLean can offer a different viewpoint. No one is insinuating that evaluating income statements is a waste of time, but asset managers also need information on whether or not a company is making an economic profit.

## Performance Data

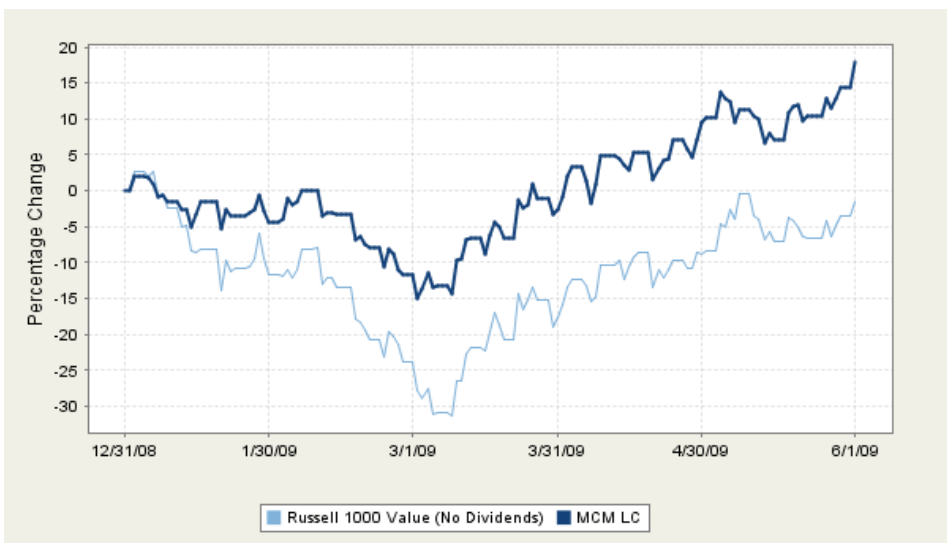
McLean Capital Management and EPR are relatively new firms, founded in 2006. McLean has some back-tested data available portraying how the firm's research methodology would have fared in the years leading up to 2006. However, we have seen numerous examples where back-tested performance of quantitative models can be manipulated. As a result, we think the more interesting performance data for EPR is from the actual performance of McLean's portfolios. It is worth noting that McLean's performance is measured over a time frame of just less than three years.



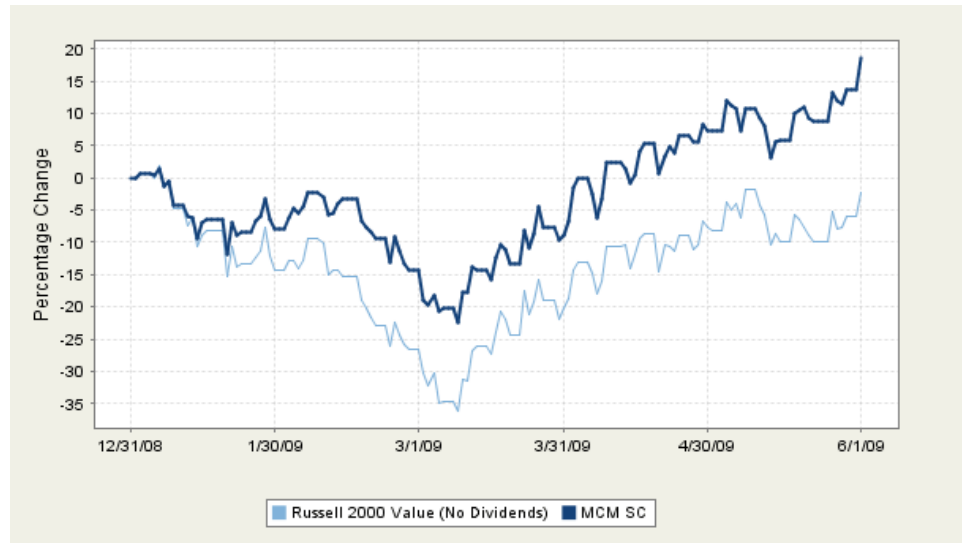
Since inception McLean's large cap portfolio has outperformed the Russell 1000 Value index by more than 30%, returning -3.65% since the beginning of August 2006 to June 9<sup>th</sup>, 2009 compared to the return on the Russell 1000 over this same time frame of -35.25%.



Since inception, clients can see that McLean's small cap portfolio has also outperformed the Russell 2000 Value index by almost 20%, generating a return of a -12.11% since the beginning of August 2006 to June 9<sup>th</sup>, 2009. This compares to the Russell 2000's performance of -32.01% over this time frame.



The chart above shows the year-to-date returns of McLean's large cap portfolio (from 12/31/08 through the beginning of June). McLean's portfolio posts an impressive return of 17.74% compared to the Russell 1000's -1.46% return over this period.



Similarly, the chart above shows the year-to-date returns of McLean's small cap portfolio (from 12/31/08 through the beginning of June). Comparably to the large cap stocks, this portfolio returns an impressive 18.46% compared to the Russell 2000's -2.15% return over this period.

## Introduction to Specific Stock Recommendations

As we have seen, the actual performance of McLean's portfolios is somewhat intriguing. This has led us to use his research methodology to identify a number of ideas which EPR is bullish on that the Street might have either a neutral or somewhat negative outlook on. EPR provides full research reports on each of these stocks on its website which includes a number of charts detailing information on the companies' debt, sales, shareholder value and many other factors. EPR takes each of these factors into account and also makes it easy to compare the individual companies to their industry peers. In one section of the website each company in an industry is ranked by EPR's methodology and given a risk analysis rating of either conservative or speculative, as well as a recommendation on how to proceed with the stock. The information reproduced below is only a portion of the full analysis available on EPR's website.

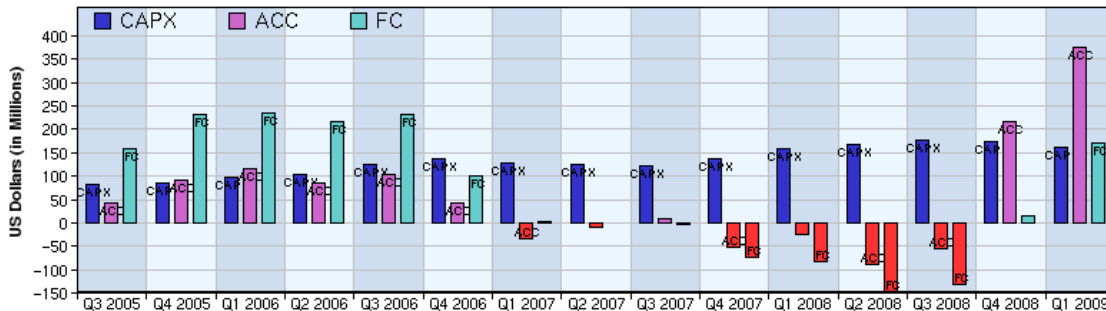
## Positive Recommendations

### WLK

The first company that EPR is bullish on is the Westlake Chemical Corporation (WLK), a member of the Specialty Chemicals industry. WLK has been found to

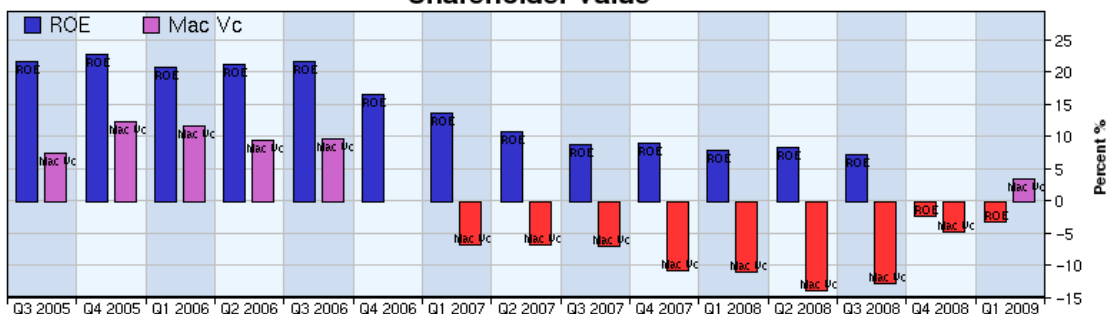
be a conservative stock in terms of its risk rating and is recommended as a Strong Buy. WLK is a mid cap stock and has positive cash flow in both the last three months as well as the past year. The Street meanwhile is somewhat bearish on WLK as in the current month 4 sell-side analysts have an Underperform rating on the stock, 1 has a Sell rating, 2 have Hold ratings. No sell-side analysts have positive ratings of any sort on the stock.

### Free Cash Flow



- In this chart, capital expenditures and accruals are compared to free cash flow.
- EPR has shown that companies with high levels of accruals and high levels of free cash tend to outperform in the future.
- Accruals increased 1,657.6% year over year to \$375.7M in Q1 2009.
- Capital expenditures have increased by 1.6% over the last year while free cash flow has increased by 306.3%.
- Free cash increased 306.3% year over year to \$172.3M in Q1 2009.
- This company is generating significant amounts of free cash flow and is clearly self-funding.

### Shareholder Value

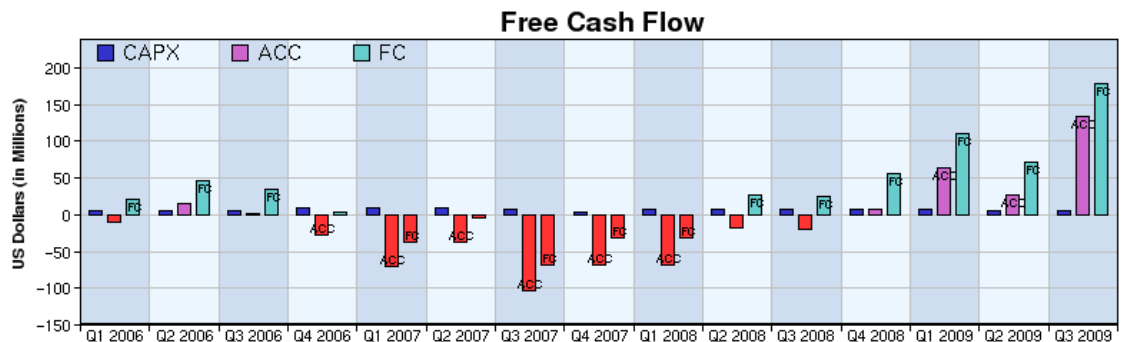


- This chart shows if a company is earning both an accounting profit (ROE) and an economic profit (MAC Vc).
- Mac Vc is EPR's proprietary metric used to determine if a company is currently adding to shareholder value.

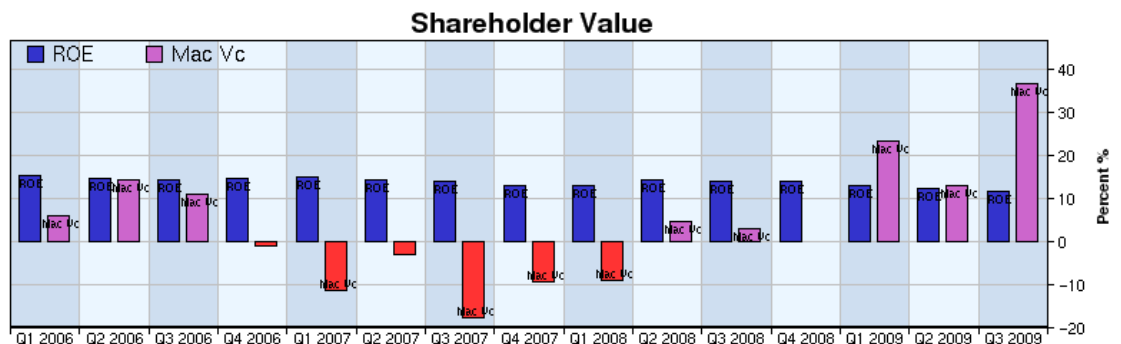
- Mac Vc is Economic Profit Research's measure of Economic Return on Invested Capital.
- EPR believes the distinction between making an investment versus speculation is whether or not a company is creating shareholder value.
- The chart shows a positive trend to creating shareholder value.

**SCSC**

Another company which EPR thinks is a good long recommendation is Scansource, Incorporated (SCSC). SCSC is in the Computers Wholesale industry and is the only small cap stock in its peer group. EPR thinks that SCSC's fundamentals warrant a conservative risk ranking and it also has generated a positive cash flow in the past year. The street is decidedly neutral on SCSC as all five analysts who have a recommendation on the stock have it as a hold.



- Accruals increased 875.4% year over year to \$134.4M in Q3 2009.
- Capital expenditures have decreased by -37.6% over the last year while free cash flow has increased by 604.0%.
- Free cash increased 604.0% year over year to \$179.3M in Q3 2009.
- This company is generating significant amounts of free cash flow and is clearly self-funding.



- Mac Vc is Economic Profit Research's measure of Economic Return on Invested Capital.
- The chart shows a positive trend to creating shareholder value.

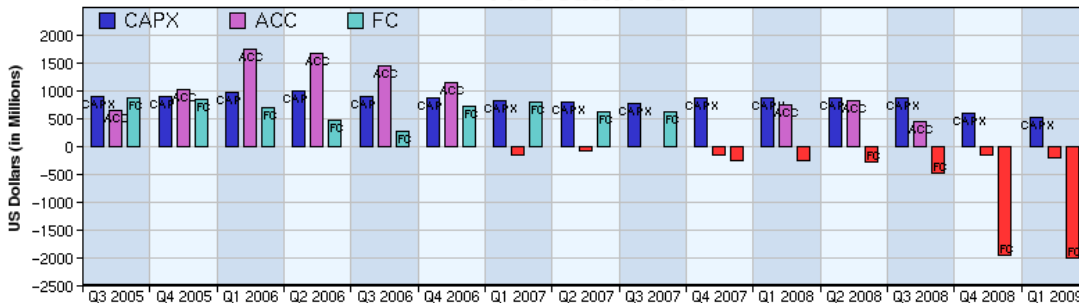
## Short Recommendations

Alternatively to the last two ideas mentioned in this section, we now present a couple of stock selections which EPR views as short options. These stocks may also in some instances be viewed positively by the street.

### WY

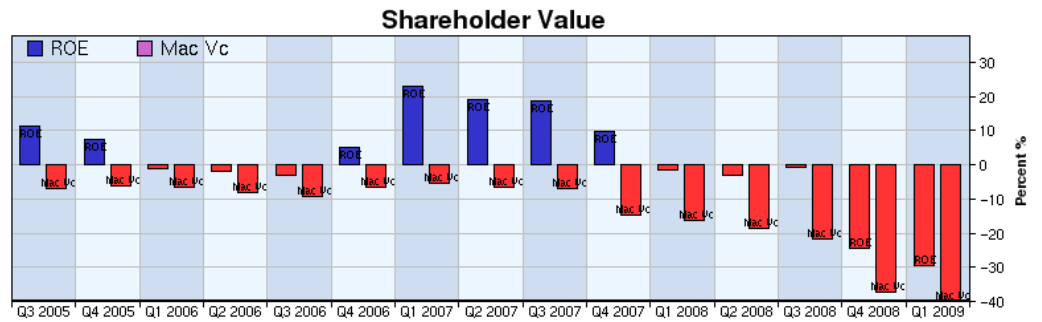
The first short idea that EPR has identified for this report is Weyerhaeuser Company (WY). WY is in Lumber, Wood production and has earned a speculative risk ranking from EPR. WY has negative free cash flow in the past year and is ranked second to last in its peer group by EPR. The Street meanwhile is somewhat bullish on WY with 2 analysts currently ranking it a Strong Buy, 4 analysts currently considering it a Buy, 8 giving it a Hold rating and only one giving it an Underperform recommendation.

Free Cash Flow



- Accruals decreased -125.6% year over year to \$-191.0M in Q1 2009.
- Capital expenditures have decreased by -41.2% over the last year while free cash flow has decreased by -710.5%.
- Free cash decreased -710.5% year over year to \$-2,002.0M in Q1 2009.
- This company is not generating significant amounts of free cash flow and is clearly not self-funding.

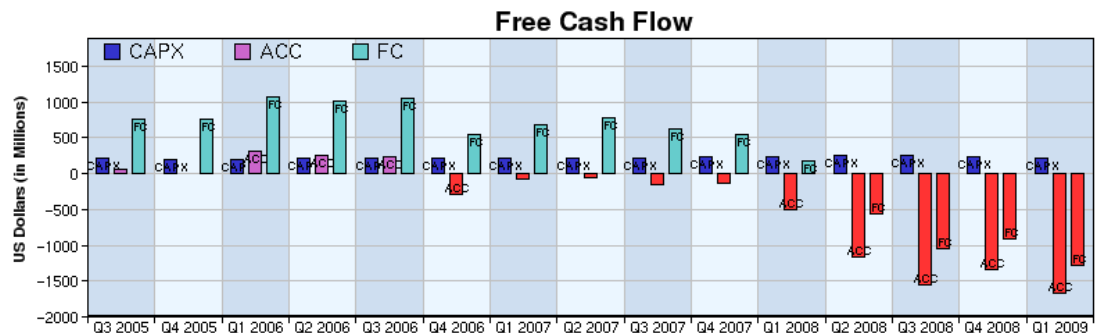




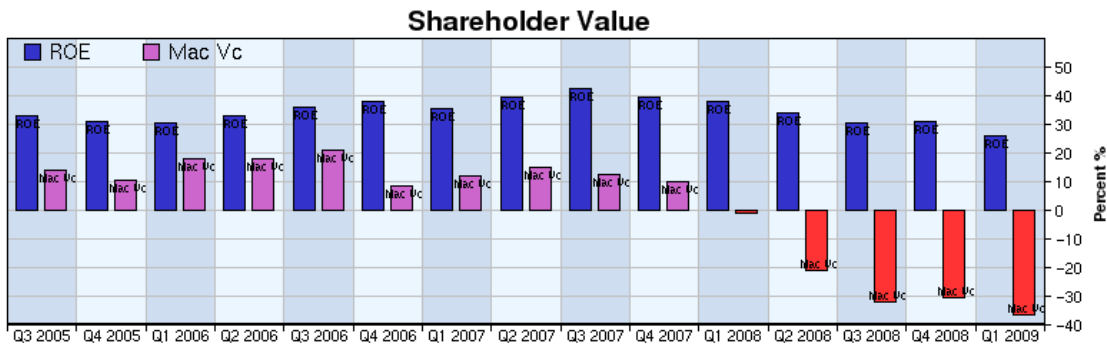
- Mac Vc is EPR’s measure of Economic Return on Invested Capital.
- The chart shows a negative trend to creating shareholder value.

**HOG**

The final company which EPR is bearish on is Harley-Davidson, Incorporated (HOG). HOG is in the Recreational Vehicles industry and has been rated as speculative according to EPR’s risk analysis metric. They have negative cash flow over the past twelve months. The street meanwhile is somewhat neutral on HOG with ratings spanning the board in terms of Buy and Sell recommendations.



- Accruals decreased -229.6% year over year to \$-1,660.5M in Q1 2009.
- Capital expenditures have decreased by -13.4% over the last year while free cash flow has decreased by -812.6%.
- Free cash decreased -812.6% year over year to \$-1,287.9M in Q1 2009.
- This company is not generating significant amounts of free cash flow and is clearly not self-funding.



- EPR believes the distinction between making an investment versus a speculation is whether or not a company is creating shareholder value.
- The chart shows a negative trend to creating shareholder value.

## Summary

Economic Profit Research has not been around for very long time but since its inception just under three years ago, its performance has been admirable. EPR's past performance is particularly impressive given the state of the economy and the stock market during this same time frame. The firm's comprehensive coverage across 8,400 firms, as well as its ability to apply its methodology consistently to each of these firms makes it a particularly helpful tool in analyzing small or mid cap companies which Wall Street does not follow closely. EPR is also helpful as a risk analysis tool for large cap stocks, particularly given the abundant supply of traditional fundamental company research that is available on most of these stocks.

## About Economic Profit Research

Economic Profit Research is the research arm of McLean Capital Management. MCM is a Registered Investment Advisory firm that provides expertise and services in asset management. McLean Capital develops investment recommendations based on its own proprietary valuation methodology. McLean strives to earn the highest possible risk-adjusted return for its clients on a long-term basis using a valuation driven quantitative methodology. The fundamental premise of the valuation model is that each company has a true intrinsic value, and that shareholder prices will correct and gravitate toward that value price over time. McLean Capital is a bottom-up fundamentally driven firm. It invests in companies that have superior cash flow characteristics, and focuses on the Cash Flow Statement as it validates the quality of earnings as measured by Generally Accepted Accounting Principles (GAAP). McLean's methodology evaluates the relative quality of a company's cash flow stream, which comes closer than any other measurement for analysis and valuation in revealing how successfully a company allocates, manages and redeploys resources to maximize the net present value of the enterprise.

McLean Capital Management manages assets on behalf of high net worth clients and institutions, and also provides sub-advisory and research services to institutional investors. One particularly unique service offered by McLean is a portfolio review of existing client holdings using its proprietary cash flow valuation methodology. McLean is also able to provide M&A advisory services focusing on the smaller firms in its database.

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