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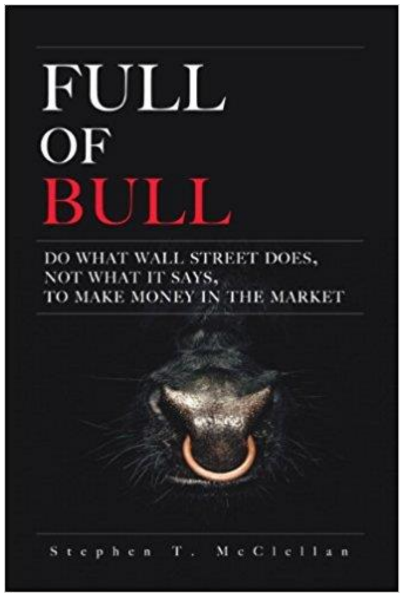
How Full of Bull is Wall Street Right Now?

Talking Points Presentation on Current Valuations of the Major Stock Indexes & the Use of non-GAAP accounting

"Misleading pro forma, adjusted smoothing of earnings results, is the key manner in which corporate executives alter reality"

-S. McClellan



Over the last few years we have been continuously informed that our public corporations are doing great and earnings are roaring ahead as the economy picks up steam. However, this is not true. In fact, from 2014 through 2017 the only earnings growth in the major indexes has been from non-recognized accounting methods that have flourished. The actual true accounting earnings have declined slightly on average. Although there are healthy growing companies, the average S&P 500 stock component or company, and the market in general, has struggled to maintain profit margins and revenues. The companies are increasingly turning to misleading "non-GAAP" accounting presentations and other forms of deception to pass the critical earnings reporting period and create the illusion of economic vitality. Wall Street and the media are happy to play along usually reporting every non-GAAP earnings number as a true accounting that "beat" the estimate. Although the market has been happy to move higher it seems that there is no one in any financial, regulatory and media capacity that even begins to question the misbehavior. We decided to highlight Steve McClellan's' book "Full of Bull" which reveals the different deceptive methodologies that company managements will use to try to promote their own stock. Steve was a Wall St Analyst for 32 years.

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Note: GAAP means: generally accepted accounting principles) is a collection of commonly-followed accounting rules and standards for financial reporting. Non-GAAP means: Financial information about companies calculated through alternative methods from the generally accepted accounting principles, or as we say, **whatever you want it to be.**

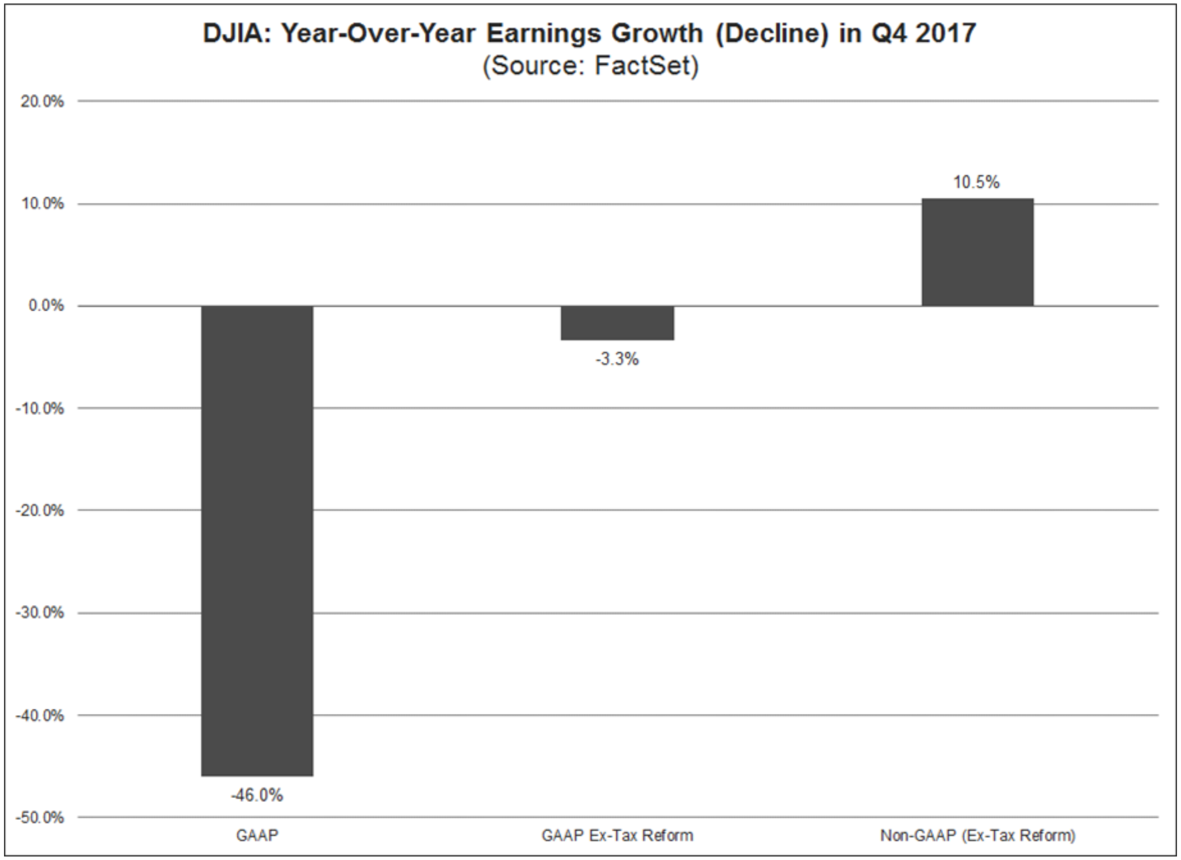
Since 2014 there has been no Growth in GAAP net income for the S&P 500

As we see the real GAAP accounting (trailing 12 month) earnings of the S&P 500 (yellow line) is currently 1% above the 12 month period ending September 30 2014.

As of 4th quarter 2017 the number has weakened slightly, not including the effect of the tax changes. The tax changes had a negative effect.

S&P 500 QUARTERLY DATA	
QUARTER END	AS REPORTED EARNINGS PER SHR
12/29/2017	
9/30/2017	$28.45
6/30/2017	$27.01
3/31/2017	$27.46
12/30/2016	$24.16
	$107.08
9/30/2016	$25.39
6/30/2016	$23.28
3/31/2016	$21.72
12/31/2015	$18.70
	$89.09
9/30/2015	$23.22
6/30/2015	$22.80
3/31/2015	$21.81
12/31/2014	$22.83
	$90.66
9/30/2014	$27.47
6/30/2014	$27.14
3/31/2014	$24.87
12/31/2013	$26.48
	$105.96

For the Dow the 4th quarter 2017 GAAP earnings adjusted for the tax charges was slightly negative.



Non- GAAP abuse takes many forms.

Here is one of the hilarious examples-

One detailed example On February 16th Coke reported its 4th quarter numbers

CNBC

Coca-Cola earnings Q4 2017 beat expectations

Coke has been betting on innovation and pricing to counter

Visited

So far so good!! They beat expectations.

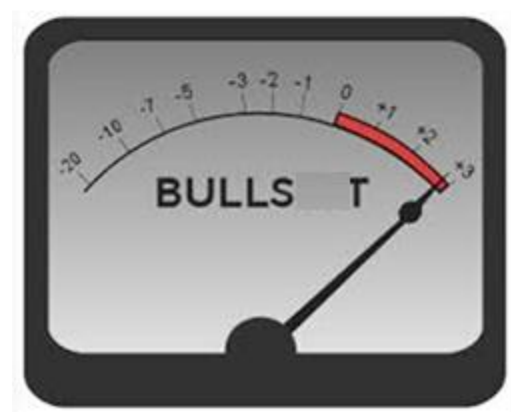
Coke stated: *The Coca-Cola Company delivered strong fourth quarter operating results…"I am pleased with our accomplishments and results in 2017,"* said James Quincey, President and CEO of The Coca-Cola Company.

However, we also found this??: *Net revenues declined 20% to $7.5 billion for the quarter and declined 15% to $35.4 billion for the year, impacted by headwinds of 26% and 17%, respectively, from the ongoing refranchising of bottling territories.* And *Cash from operations for the full year was $7.0 billion, down 20%.* Upon our own inspection we found that case volume was down slightly for 2017 and that operating income declined 14% from 2015 through 2017. However, Coke had a great answer for this: *Organic revenues (non-GAAP) grew 6% for the quarter!!!!* **Continued-**

Coke has no definition for organic revenues that we can locate, but we don't think there is any growth if revenues are down and case volume is down. There were no GAAP income tables or balance sheets presented with this announcement, but Coke did invite us to follow them on Instagram.

We decided to break down the numbers. Coke said they made 39 cents per share on a non-GAAP basis. This was critical because the estimate (need to beat) was 39 cents. What was the real number?

We used the S.E.C. guidelines for non-GAAP and our discretion on some of the reversals and came up with 17 cents. If we allowed all of the reversals we would have come up with 30 cents. So a far cry from real. As far as non-GAAP reporting goes there is no oversight from accountants or regulators. When a company reports real GAAP numbers it must be signed off on by their accountants. However, what we would like to impart is this is a super high stakes game. For every dollar of reduction in shares there is a $ 4.2 billion dollar loss. Management owns shares. We wouldn't want to sugar coat it but basically this is a form of fraud. This is what we think of Coke:



Coke is not the only company, our estimate is that 40-50% of the companies are reporting false non-GAAP numbers. It is statistically impossible for so many companies to miss the estimate but meet it or beat it with non-GAAP. Hundreds of companies are doing this.

Here are a few other examples:

Many companies are abusing the non-GAAP

We noted a new world record for non-GAAP earnings when Stamps.com posted $4.68 of non-GAAP income per share for the fourth quarter. This was based on roughly $7 per share of revenue and equals a 67% net income margin. The actual non-GAAP number would have been around $2.48 and the actual GAAP number was $2.15. Fortunately for Stamps the number was better than the need to beat $2.68 analysts estimate because <u>if they had of used the correct computations the company would have "missed" earnings</u>! Also, we noted that we were not surprised when Caterpillar posted $2.16 in NON GAAP net income per share when the need to beat estimate was $1.79 and again we were not surprised when we calculated the NON GAAP using SEC Guidelines and arrived at $1.42. Posting the honest number could have resulted in a "bummer" on the stock price.

Broxton observation: Usually if there are abuses that you can readily see, there are more that you cannot see.

We have been doing deep fundamental analysis for over 20 years including work on Enron and many other complicated situations. Historically we have owned index shares and believe that they offer good investment opportunities from time to time.

However, we would like to point out that from 2014 through 2017 there has been no growth in net income for the S&P 500 index despite large share buybacks and reduced tax rates. At this time, We do not believe that the indexes offer the probability of short or medium time frame positive returns. (5-7 years). We believe that investors are incorrectly valuing shares based on the non-GAAP earnings. If we valued the indexes at 17 X trailing GAAP net income the S&P 500 would be 33% lower.

Market dislocation

In 2017 Broxton holdings saw performance in excess of the indexes as far as fundamental improvements for many of its holdings but the shares did not rise because investors are chasing the high flyers. We experienced the same problem in 1999 and 2000. We believe that there are many similarities. What is different are the extremely low interest rates and the complete lack of concern for the accounting frauds or the beginning of the rising interest rates. There are shares that are extremely overpriced and shares that are extremely underpriced. We are seeing the cheapest shares we have ever owned at this point. We believe that these trends will reverse, possibly sooner rather than later and investors will value shares on their financial merits.

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About Broxton Capital

Broxton Capital is an investment manager located in Los Angeles, and employs The Primary Broxton Strategy or “PBS.” The Primary Broxton Strategy or “PBS” for managed accounts. The PBS is a bottom up, fundamental strategy that seeks higher total returns with lower risk. The focus is on low risk investments with attractive return (LRAR Securities) with an average holding period of 18 to 36 months. The strategy invests in high yield, fixed income, and equities but does not have any allocation mandates.