Review: What's Behind The Numbers?

February 10, 2013

In the opening lines of ***What's Behind the Numbers?***, co-authors John Del Vecchio and Tom Jacobs offer to ***"help you find where the investing bodies are buried so you don't join them."*** These are appropriate words to begin a book on the detective work of finding financial chicanery. *Numbers* covers the art of short selling—a lonely endeavor that requires thick skin. By definition, you aim to win when others lose. This means that when you're right, you're hated; and when you're wrong, you are shown no sympathy. In Del Vecchio and Jacobs' words, short selling is considered "un-American at best and criminally manipulative at worst."

Moreover, shorting stocks requires taking an unsentimental approach to investing and—perhaps most importantly—keeping the ego in check. Very few investors have the disposition to be successful short sellers; John Del Vecchio is one of them.

Del Vecchio is the co-manager of the **Active Bear ETF (HDGE)** and the creator of the Del Vecchio Earnings Quality Index that drives the **Forensic Accounting ETF (FLAG)**. Tom Jacobs is the portfolio manager of Motley Fool Special Ops and a specialist in small-cap value opportunities. In *Numbers*, Del Vecchio and Jacobs reveal some of the tricks of their trade and expose some of the myths that tend to get novice short sellers in trouble.

To start, overvaluation is *not* a sufficient reason to initiate a short position. A stock that is irrationally expensive can always get more expensive. Likewise, while it is tempting to short a fad stock—think of **Crocs (CROX)**, the maker of colorful rubber clog shoes—fad stocks can stay trendy for longer than you think. The same is true of questionable business models—think **Netflix (NFLX)**.

And what about the stocks of companies engaging in fraud? Well, maybe. But good luck finding them ahead of time. Remember, if management is engaged in something illegal, they're not likely to mention it in the footnotes of their financial statements.

What is missing in each of these cases is the catalyst. What is the sign that the jig is up—and that the stock is due for a tumble?

Some traders rely on contrarian indicators, gauges of investor sentiment towards a stock, or simply the feeling in their gut. But Del Vecchio and Jacobs take a more rigorous approach.

The key is aggressive accounting and specifically aggressive revenue recognition and inventory management: *"The time to sell or short is not when you think a* *business model can’t survive. The time is when the numbers suggest that management is covering up poor performance.”*

And how might you know when this is the case? Del Vecchio and Jacobs spend most of the book telling you, but I’ll give two examples that I found to be particularly insightful.

The first is a metric called **Days Sales Outstanding (DSO),** which measures accounts receivable in proportion to sales. An unusual increase in DSO can mean that future sales and being pulled forward by looser payment terms or special financing.

This hurts future profitability in two ways. The most obvious is that sales that might have happened in the following quarter have now already happened. But worse, those sales might have come with more favorable pricing had the company not been in such a hurry to book revenues. In order to keep Wall Street happy for another quarter, management makes the eventual day of reckoning worse.

A second, similar metric is **Days Sales in Inventory (DSI),** which measures inventory build-up. You don’t need to be a CPA to see why this metric is important. Inventory build-up suggests that the company’s products are not selling as briskly as forecast. It also means that discounts will probably be needed move the merchandise, which will lower profit margins.

All inventory is not equal, of course. A build-up of raw materials inventory may mean that demand is stronger than ever. It is the build-up of finished goods that should be a major red flag.

What’s Behind the Numbers? is full of little tricks like these, explained in simple terms that non-CPAs can understand. Before you attempt to short another stock, read and re-read this book, particularly the chapters on aggressive revenue recognition and aggressive inventory management.

I’ll leave you with two final nuggets of wisdom from Del Vecchio and Jacobs.

First, don’t be too eager to jump into a short position. As the authors point out, *“You make as much money shorting a stock that falls from $70 to $5 (93 percent) as one that falls from $100 to $5 (95 percent).”* Getting into a trade too early will turn a would-be profitable short into a frustrating loss.

Second, watch out for crowded trades. Don’t short a stock if the short interest is too high as a percentage of the float. This puts you at risk of being short-squeezed as your fellow sellers all scramble to buy at the same time and send the share price to the moon.

If you are a serious investor, pick up a copy of *What’s Behind the Numbers?* and keep it close at hand. More than anything else, it will help you to win by not losing.

Discuss this story

More Articles by Charles Sizemore:

- **Betting on Japan's Legalization of Gambling**
- **Is Sears the Next Berkshire Hathaway and Eddie Lampert the Next Warren Buffett?: SHLD, BRK.A, BRK.B**
- **Turkcell - Top Pick For 2012**
- **Emerging Markets Will Shine in 2012**