Del Vecchio, John & Jacobs, Tom – What's Behind the Numbers?

McGraw Hill, 2013, [Equity Investing] Grade ★★★★

If your portfolio looses 50 percent of its value it needs to recover 100 percent to reach the same spot. If you can avoid a fair number of the worst performers in the stock market you will have a good chance to outperform. One way to avoid some of the holdings that kill performance is to look to companies' earnings quality. The two hedge fund managers John Del Vecchio and Tom Jacobs have written *What's Behind the Numbers?* to show how this could be done.

In looking at the corporate accounting the authors choose to focus on the few warning flags they think most effective and they especially look to aggressive revenue recognition. I think this is wise. An exaggerated sales number will have ripple effects all over the financial statements and since sales is a large number in relation to the earnings, even a small boost to sales without the corresponding costs will have huge impacts on the perceived profitability. Most of the – still relatively numerous – warning flags the authors present try to detect if aggressive accrual accounting in an improper or unsustainable way has increased sales in the short term. Their favorite measure is Days Sales Outstanding. I quite liked the discussion on how to interpret changes in the measures they look to. In this genre I still prefer *Financial Shenanigans* by famed forensic accountant Howard Schilit (that John Del Vecchio previously worked for) but this book is a welcome addition.

Despite the above I hesitated a while to give the book a 4 star rating as it paradoxically left me with a feeling of false advertising. Apart from the title, the cover also reads *A Guide to Exposing Financial Chicanery and Avoiding Huge Losses in your Portfolio* and *Learn how to detect corporate sleight of hand – and gain the upper hand with smart investing*. In reality only about 130 – 140 pages are dedicated to how to analyze earnings quality. The rest discusses the authors' investment process in general and their short selling in some more detail. However, as long as you know this and don't expect any of the subjects to be covered in massive depths, what is being said is sound and often interesting.

To shortly summarize the investment strategy the long side consists of longer-term small-cap value holdings and the short side of companies where the accounting signals future trouble. The authors advice against simply shorting overvalued stocks in companies with bad business models. The reason is that nothing prevents the stock from getting even more expensive. Instead they wait for signs of aggressive accounting and declining earnings quality and use this as a trigger. If management has been forced to borrow an increasing amount of earnings from the future, their underlying operations has started to deteriorate and this will show up in the earnings in due time.

To work with a strategy like this you have to combine two very different mindsets and it's interesting to see the authors quote investors like Ben Graham and Warren Buffett when describing their long side but William O'Neil, Paul Tudor Jones and other traders when it comes to the limited time horizon of the short side.

A fair proportion of hedge fund managers display a self-assured and almost brash personality type with little patience for other investors that don't measure up to their standards. There are traces of these traits here as well. For a book on accounting and ways to detect if management is cooking the books the writing of this text is breezy and opinionated. The case studies repeatedly follow the formula "*in this company we saw this problem that no other realized was there and then the stock tanked*" - it becomes quite tiring after a while. Long only investors are seen with mild contempt, as they obviously cannot know what is best for them.

From what they write the authors know what they are doing professionally. However, my suggestion would be to split this book in two and write a more thorough text on the analysis of earnings quality plus one additional on long-short investing.

Mats Larsson, October 12, 2015

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