Special Report:
PROFIT FROM SHORT SELLING WITH ICARUS STOCKS

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A high-flying growth stock can be the best thing in the world – until suddenly it isn't.

A high-flying growth stock can be the best thing in the world – until suddenly it isn't.

A truly compelling growth stock can deliver triple-digit returns, or even quadruple-digit returns. A growth stock held through the strong part of its cycle can become a "ten-bagger," returning 1,000 percent or more.

And so it's possible to make a fortune in growth stocks. The trouble is that it's possible to LOSE a fortune also.

Virtually all growth stocks go through a life cycle – a series of chapters as the underlying business expands.

In the bullish portion of a growth stock life cycle, multiple factors work together.

> The business is typically expanding, adding to revenue and sales growth.
>
> Earnings per share estimates are typically rising, as the increasing scope and scale of the business improves operating margins.
>
> Wall Street analysts are projecting optimistic numbers into the future, forecasting more blue skies ahead.
>
> And the multiple assigned to the business (e.g. price to earnings ratio) is typically expanding too, as enthusiastic buyers push the valuation higher.

Notably, all of the above can apply to a business that is still losing money… as long as the quarterly metrics are pointed in the right direction, giving investors confidence that the business is on its way to being a profitable enterprise in the future.

But here is the thing: No growth cycle lasts forever.

Eventually the growth starts to slow. Or profit projections start to look overly optimistic. Or new competition reduces the attractiveness of the market. Or the business starts to mature.

For whatever reason, a point comes at which original investor expectations are due for a rethink.

For whatever reason, a point comes at which original investor expectations for the company – and the extreme enthusiasm built into valuations – are due for a rethink.

It's at this point when the price multiple on a stock begins to contract, reverting towards the mean (for stocks on the whole) from its originally inflated state.

If this happens when earnings and revenue estimates are also being revised downward, or when growth projections are being cut back, the result can be a precipitous drop in the share price.

A one-time "hot growth stock," upon facing inevitable maturity issues and downward revisions to growth estimates, can easily lose one-third to one-half its value as the original inflated multiple, and profit estimates, return earth. And if the business model turns out to be problematic, the stock can lose eighty percent or more.

There is an old saying, "In a windstorm even turkeys can fly."

High flying stocks can be caught up in a "windstorm" of temporary optimism surrounding a particular industry, concept or trend.

You can also find stocks that are caught up in a "windstorm" of temporary investor optimism surrounding a particular industry, concept or trend.

These are companies with shaky or questionable prospects that are suddenly high flyers, having been given an aggressive benefit of the doubt by virtue of rampant bullishness on the industry or sector (or concept, technology or trend) as a whole.

Eventually, enthusiasm for the industry or sector fades. (When it comes to investing, the romance is never permanent.) At this point, the turkeys are suddenly viewed with a more skeptical eye – and the wind beneath their wings disappears.

Or, alternatively, a stock that has been bid up to extreme valuations, while shouldering the burden of high expectations, can be at risk for a misstep or a stumble.

The more the stock is "priced for perfection," the greater the pain of even a modest disappointment.

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Growth stocks can sometimes react sharply to a seemingly small piece of data because the elevated share price reflects a bullish outlook extrapolated far into the future. If something is wrong in the here and now – if new customers aren't signing up at a fast enough rate for example – that could have a substantially negative impact on the entire long-run forecast.

Given the above, there is a class of shares we call "Icarus Stocks."

> **ICARUS STOCK:** A high-flying stock that has flown too close to the sun (in terms of profit expectations and extreme valuation) and – like Icarus of the Greek legend – has the potential to become an ex-high-flyer that plummets back to earth in dramatic fashion.

Value investors have a saying: "Good things happen to cheap stocks."

The logic behind this rule of thumb is that, if a company's assets are undervalued, or if expectations are bargain-basement low, then any surprise that occurs is likely to have a favorable impact on the share price.

The pessimism is already priced in – which suggests there is room for optimism to revalue things to the upside.

With Icarus Stocks, traditional value investor logic – the idea that "good things happen to cheap stocks" – gets turned on its head.

With Icarus stocks, that gets turned on its head: "Bad things happen to Icarus stocks."

The greater the degree to which a stock is priced for perfection – or better yet, priced for world domination and shareholder nirvana – the greater the risk that a misstep or a stumble will lead to something bad happening (e.g. a sharp fall).

As such, Icarus stocks have the potential to be attractive shorting vehicles, particularly if caught in transition to a new downtrend phase with the potential to last for months, quarters or even years.

For investors, knowing how to identify Icarus Stock candidates is a useful skill – even if there is little desire to go short.

That's because every high-flying growth stock – no matter how great the company or how profitable the business model – has the potential to turn into an Icarus Stock at some point.

In fact it's almost an implied guarantee in that, the more enthusiastic investors become regarding a great growth stock and its prospects, the more likely they become to push the multiple and profit expectations to a point where a reckoning – and a return to earth – is inevitable.

It's useful to have an eye for shorting opportunities in situations like these.

Aside from shorting, it can be equally useful to know when to sell out of profitable long-side holdings in a portfolio.

But it can be equally useful (if not more so) to know when to sell out of profitable long side holdings in a portfolio (as the wax on the wings starts to melt).

Following are ten warning signs that can be thought of as flashing red lights – or signs of opportunity if one is inclined to short. "Warning! This may be an Icarus Stock!"

ICARUS SIGNAL #1: SLOWING EARNINGS GROWTH

Growth companies live and die based on their ability to grow earnings.

The rate of change is as important as the number itself.

In this calculation, the **rate of change** is as important as the earnings number itself.

It's not just a requirement that earnings continue to go up, or that sales or total subscriber numbers (or whatever metric the stock is judged on) continue to go up.

It's the rate or pace of acceleration that needs to stay impressive, or at least steady.

If a growth stock reports higher earnings per share year-on-year, or higher subscriber growth year-on-year, but the rate of change is slowing down, the stock may get punished.

It's not just the need to move forward, but the need to maintain an impressive forward pace that is key.

If you think of the company as a marathon runner, it can be a concern if the marathon runner slows their pace too much, even if they are still moving forward. That is because a slowdown in the pace can mean issues later.

An Icarus Stock can continue to report improved earnings numbers well after the stock has peaked and the share price has started to fall.

This happens when a decline in the rate of growth has turned investors cautious or even turned them away, causing the earnings multiple to contract.

If a stock goes from a 40X multiple to 20X, it can lose 50% of its value while earning the same amount.

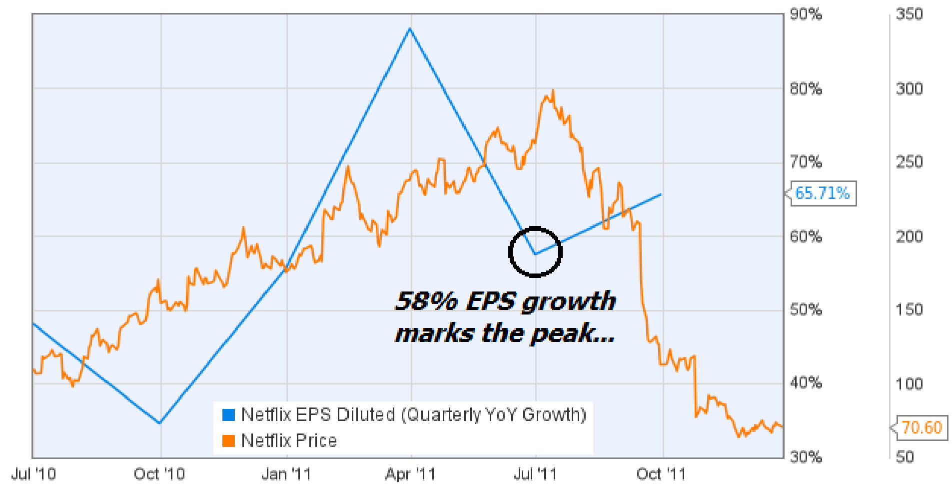
If a stock goes from a price multiple of 40X earnings to 20X earnings, it can lose 50% of its value, even while earning the same amount per share. (And if the earnings per share amount declines too in absolute terms – yikes.)

As a historical example, Netflix (NFLX) saw its share price reach a peak near $300 midway through 2011.

Growth investors were pleased with the company's first quarter earnings growth, which had increased by nearly 90% year-over-year.

Three quarters later, Netflix announced that earnings increased by 58% over the previous year. A 58% increase is great, but it ain't 90%, and it represented a slowdown that made investors worry about future growth.

Because Netflix shares had such an extreme valuation at that point, the 58% growth announcement coincided with a major peak in share price - and by the end of the year, NFLX had lost more than 75% of its market value.



For most companies, a 58% increase in earnings year-on-year would be a fantastic quarter. But because that represented a deceleration – a slowing of growth momentum –investors took it as a warning sign.

Any time a high-profile growth company reports a deceleration in earnings growth, there is a danger investors will revalue expectations.

Any time a high-profile growth company with a premium price/earnings ratio reports a deceleration in earnings growth, there is a danger that investors will revalue their expectations to a painful degree.

In this case, even though Netflix continued to grow nominal earnings, the stock price dropped significantly. Netflix fell because investors were no longer willing to pay a premium price for every dollar of earnings produced by the company.

Growth expectations were essentially reduced to a more reasonable level, and the stock dropped until the valuation had readjusted to a more reasonable level as well.

When a stock does something surprising or unexpected, it is usually a result of investors gaming future prospects.

When a stock does something surprising or unexpected relative to reported numbers, the mystery is usually solved by understanding how investors are thinking about the business model and its future prospects.

If investors look into their crystal ball and see trouble in the future, they may react bearishly even if current numbers seem bullish on the surface. It also works in reverse, as demonstrated when a stock has a bullish reaction to a bearish report. And of course the starting point of valuation, high or low, can have a significant impact.

ICARUS SIGNAL #2: SLOWING REVENUE GROWTH

Growth stocks typically show impressive revenue growth as the business expands.

Revenue growth should be going up and to the right, even if profits are not there yet.

If the company is opening more stores, signing up more customers, selling more units or what have you, revenue should be going up and to the right, even if profits don't yet exist because capital is being reinvested.

The rate of change for revenue growth is tied directly to a company's life cycle and total size relative to its market space.

During the early stages of growth, a company will typically experience rocket-like levels of revenue growth. It is not unusual to see triple-digit percentage increases (year-over-year) in reported revenue as a company expands.

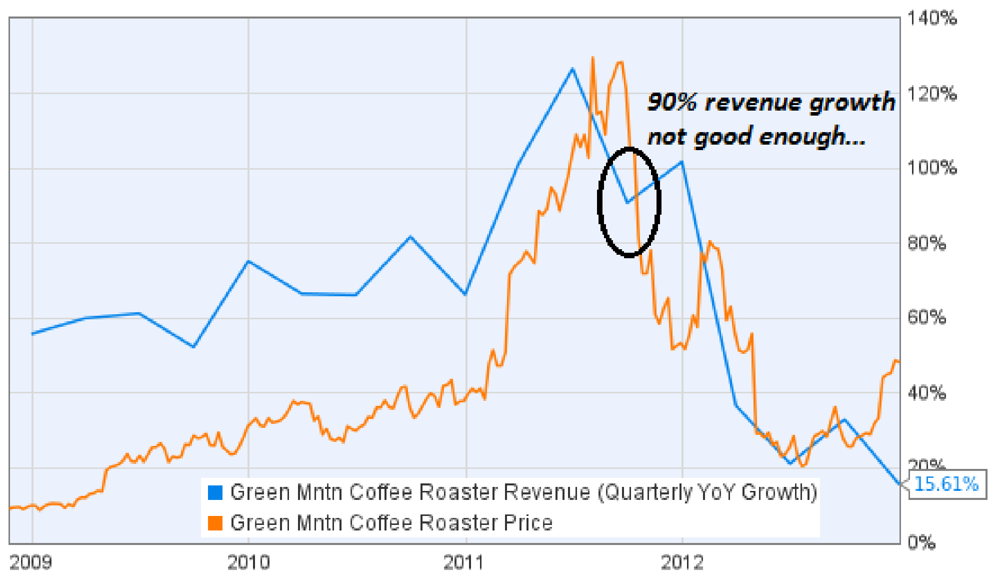
In certain cases, like when a company is not yet profitable, other metrics can act as a proxy for revenue growth, like total number of users.

A small social media business with a hefty stock valuation, for example – where the valuation assumes it will become a LARGE social media business – will need hockey stick levels of growth in the total number of users in order to reach expected goals.

In such a case, investors might focus intensely on user growth rather than revenue growth, but the basic logic is the same. It's the rate of change, and not just the absolute numbers, that needs to stay strong.

If a stock's valuation is priced for stellar numbers, and the numbers are not-quite-stellar, the share price can take a massive hit.

And once again, if a stock's valuation is priced for stellar growth numbers, and the numbers come in strong but not-quite-stellar, the share price can take a massive hit.



To give another historical example (as shown above):

In the Fall of 2011, Green Mountain Coffee Roasters (GMCR) had already booked a 200% share price run-up. In its quarterly earnings report, GMCR then announced revenue had increased more than 90% year-on-year.

A 90% revenue increase year-on-year is almost a double in size. For most mature companies, a revenue boost of that nature – if profitable – would be a home run.

But Green Mountain had previously shown growth of 120% year-on-year, which meant 90% was a significant drop from the previous rate of change… which meant that overall growth was slowing down… and thus the share price got hammered.

Once again, the problem here was not an absolute revenue decline. GMCR continued to report nominal increases in revenue after the peak.

It was the level of enthusiasm among investors – and long run investor expectations – that had been revised downward, causing the share price to decline dramatically.

ICARUS SIGNAL #3: CONTRACTING PROFIT MARGINS

Profit is ultimately what it's all about. Many investors don't quite understand this…

When an investor buys a stock, they are really buying a long-term stream of future cash flows.

When an investor buys a stock, they are really buying a long-term stream of future cash flows – the cash thrown off by successful operation of the business, in the form of directly distributed profits or the accumulation of profitable assets on the books.

> Even if a company is losing money every quarter at the time of purchase…
>
> Even if a company never pays a dividend…
>
> Even if a company retains all its earnings to build a cash hoard (Google)…
>
> Even if a company shows little to no profit for almost two decades (Amazon)…

Even given all those possibilities, buying a stock is still best seen as buying a long-term stream of future cash flows, i.e. profits created by the business in the future.

The valuation of a company, at least in theory, should reflect all the profit that a company is someday likely to make – with plans to either return that profit to shareholders, or to reinvest and expand, or to accumulate profitable assets.

A company can also use profits to invest in tangible assets.

A company can also use profits to invest in tangible assets, sheltering gains from the tax man. This picture looks different, but it's the same concept. For example:

> A thriving landscaping business takes out a mortgage on its shiny new headquarters, a building in a modern office park worth $10 million.
>
> Over the course of many years, the owner of the landscaping business uses accumulated profits to aggressively pay off the mortgage note.
>
> At the end of X years of successful operations, the landscaping business does not have a cash hoard on hand – but the business 100% owns a building whose value has appreciated to $15 million.

Whatever a company does with its cash specifically, investing in the business means gauging long-term profit potential, in terms of cash flows and asset values.

Every publicly traded company is either a profitable enterprise at moment, or is expected to become one in the future.

Every publicly traded company – unless it's a front or a fraud – is either currently a profitable enterprise at the moment, or is estimated by investors to be on its way to becoming a profitable enterprise at some point in the future.

When a company that loses money has a high valuation, that reflects the optimistic expectations of how much money the company will make when all of its investment in growth, or fixing of problems and so forth, finally pays off.

For investors there is a kind of psychological divide between loss-making companies and companies that have crossed over into the generation of actual profits.

For a silicon valley company in its early years, for example, it is often considered fine and good – desirable even – for the company to be losing money, because it is taking all of its available resources and plowing them into growth in order to be a strong competitor in its particular market space.

But if that same company becomes profitable, and develops an expectation of delivering profits, and THEN later stumbles, there can be hell to pay.

Or if the company spends too long in loss-making land, or starts showing signs of faltering on its journey to the land of profits, the stock can tank. Once again, it is all about gauging what is likely to happen in the future, possibly the distant future.

When a company has crossed over into the realm of profitability, there are two basic ways to look at profit margins – giving a sense of how profitable the company is:

- **Gross Profit Margin** is a simplified calculation that is especially important to companies that sell tangible, physical products. It looks at revenues minus cost of goods sold (COGS). For example, if a company sells $50 million worth of windshield wipers, and its cost of goods sold is $35 million, the gross profit would be $15 million and the gross profit margin would be 30% (because 15 divided into 50 is 30%).

- **Net Profit Margin** compares revenue to ultimate net income. It includes all expenses and costs like overhead, rent, debt service payments, marketing, compensation, and so on. Start with the revenue, take out everything that was spent to get the profit that was left over, and that is net profit margin. So if the windshield wiper company, which sold $50 million in windshield wipers, had $12 million in marketing and distribution and plant and equipment and office and administrative costs on top of its $35 million in cost of goods sold, the net profit margin would be $3 million out of $50 million and the net profit margin would be 3/50 or 6%.

Profit margins can expand or contract for all kinds of reasons.

Profit margins can expand or contract for all kinds of reasons. Some of those reasons are "one-off," like a special charge taken against earnings, while other reasons can be permanent or structural, like a change in the windshield wiper market.

A healthy growth stock, which has crossed over into the land of profitability, should see its profit margins expanding, or at least remaining steady.

In the growth phase of the business, an enterprise should be getting steadily more profitable on balance – causing profit margins to expand – through the impact of scaled-up operations, return on investment for marketing and branding efforts, repeat business from a growing customer base, and so on.

If profit margins start to contract, that can be a warning sign that hammers the stock.

If profit margins start to contract, then – if the gross or net profit margins begin to shrink – that can be a warning sign that hammers the stock, and the possible start of a major decline if investors are forced to revise their lofty expectations downward.

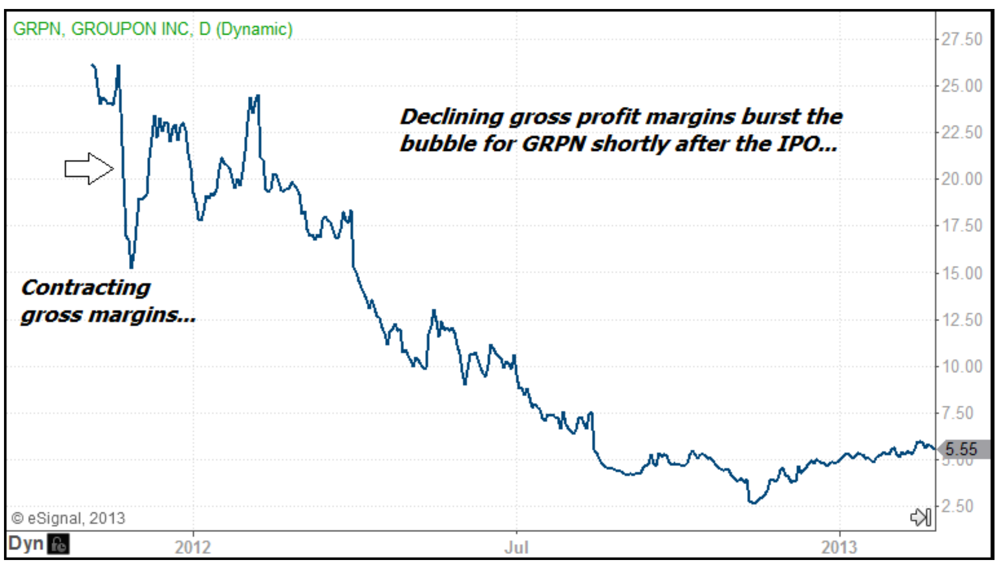
Groupon Inc. (GRPN) offers a good example of what can happen to high-flying growth stocks when profit margins contract.

In late 2011, the company raised $700 million in the biggest internet IPO since Google. Shares were priced at $20 (above the expected range of $16 to $18) and closed more than 25% higher on the first day of trading.

But when the company reported earnings shortly after the IPO, gross profit margins raised concern.

While Groupon reported a 32% increase in revenue (year-over-year), gross margins declined from 86% to 84%.

A slip from 86% to 84% may seem trivial, but this was the first time the company had experienced a decline in gross margins – the numbers going the wrong way.



The stock was then range-bound for a few months before declining in earnest, but the contraction in gross margins was one of the early warning signs preceding a 90% decline in the stock. This is the point where overly attached investors start rationalizing, while more savvy investors think hard about getting out (or going short).

As we have hopefully communicated, growth stocks by definition have high future expectations built in – and as such are especially sensitive to changes that suggest a less-than-stellar future outlook. Any time a high flyer sees a contraction in profit margins, it warrants investigation… and might be an Icarus Stock candidate.

ICARUS SIGNAL #4: DESTRUCTIVE COMPETITION

Capitalism works because of competition.

Companies compete for customer dollars, and they do so by offering products that are faster, or better, or lower cost, or more tailored to a customer's wants and needs.

Companies can also find growth by exploiting a fad, a fashion trend, or a market niche. This is the same basic idea of doing a great job in meeting customer demand, with the caveat that customer demand in terms of fads and fashion trends can be extremely fickle.

High-flying growth stocks often live or die on competition factors.

High-flying growth stocks often live or die on competition factors.

The story behind a hot growth stock may be one of meeting new demand in the marketplace, in a way that established players can't.

Growth stocks can also benefit from exotic new categories, like smartphone accessories or 3D printers or a new type of restaurant concept. When this happens, multiple companies in the hot space can benefit from lofty expectations.

If the market space is big enough, competition can actually be seen as helpful. If existing competitors try to muscle in on a new trend or product category, for instance, that may give extra validation to the space, and give more credibility to the growth stock players at the forefront.

But competition is a two-edged sword, and the impact of competition can also be seen as negative or even fatal to a growth stock's prospects.

What matters is the market's collective judgement as to the impact of competition on future prospects.

What matters, once again, is the market's collective judgement as to the impact of competition on future prospects.

If established players are willing to start a price war, or throw billions in capital at a market space in order to dominate it, or to cannibalize profit margins in order to swallow up the space, the high flyers may be seen as too small or weak to survive.

There is also the question of "moat" surrounding a company's product offering. If a company's product or business model is too easily copied, it can be vulnerable to "me too" copycats or to larger players creating their own version of the product.

This is why it's possible to think about competition as "constructive" or "destructive" for a company's prospects.

In the beginning, a high-flying growth stock is likely to have a constructive competition outlook. It is either the new competitor benefiting from disruption, or it is in a market space where added competition validates the space without detracting from the company's long-term profitable growth estimates.

That competition becomes destructive, however, if growth or profit estimates start to become negatively impacted, causing investors to sour on long-term expectations.

For example: The once white-hot Crocs Inc. (CROX) struggled with competition once it gained popularity with consumers.

The company's unique shoes with holes were imitated by discount apparel companies in a way that was seen as destructive, rather than helpful, to the CROX bottom line. While Crocs filed suit against copycat manufacturers, it was unsuccessful in blocking these competitor shoes from remaining on store shelves.

As a result, Crocs was unable to charge as much of a premium for its merchandise, giving up market share to competitors willing to charge lower prices for their Crocs knock-off offerings, which were enough like the original for customers to choose the substitute on the basis of price.

A company can lack the "moat" to protect the market share or profit margins inherent in its product.

Crocs had a great idea that tapped into a trend, but ultimately lacked the "moat" to protect the profit margins that optimistic investors had priced into the shares.

Increasingly destructive competition, compounded by some untimely supply-chain issues – which might have been forgiven had the business been more robust – ultimately resulted in a sharply lower stock price for CROX.

Another more recent example of destructive competition is Snap Inc (SNAP), the parent company of the social media Snapchat app.

There were a whole host of reasons to avoid the Snap Inc IPO like the plague. The optimism embedded in the valuation was ridiculous – often the case with IPOs – and the governance and control issues were appalling.

But the major reason to avoid SNAP was the ruthlessly competitive giant looming in the background: Facebook. As a social media competitor, Facebook had already proven its willingness to either acquire or kill off every serious competitor with ruthless efficiency.

Having purchased Instagram and WhatsApp but turned down in its effort to acquire Snapchat, Facebook proceeded to turn Instagram into a "Snapchat clone" in many respects, shamelessly lifting the best innovations of the Snapchat application.

SNAP has been underwater from the day of its IPO – the shares at one point tanking by more than 50% from the opening IPO price – and as of this writing, management is making alarmingly large changes to its flagship product (the Snapchat app) in order to grasp at lofty expectations in a brutal social media landscape. This is not surprising.

The broader lesson here is the importance of being aware of the competitive landscape for a growth stock. One can ask:

One can ask, Is the competition "constructive?"

> **Is the competition "constructive?"** Meaning, is the company perceived as having a dominant edge in its competitive landscape? Is the company a new competitor to be feared, rather than one who is fearful? Does the company benefit from a fast-growing market space where new entrants validate bullish enthusiasm, rather than detract from it?

> Does the company have "moat" in the sense that its product offering or competitive advantage is protected from knock-offs or substitutes?

…Or is the competition "destructive?"

> **Or is the competition "destructive?"** Is the company's product or service vulnerable to lower-cost substitutes that take away market share and erode profit margins? Are large players a threat to dominate the market space or drive out competition through aggressive spending and economies of scale? Is the company a potential victim of price wars or copycat products?

As such, any material change in the competitive landscape should be noted – particularly if it comes with negative movement in the share price.

If competition is increasingly viewed by investors as destructive rather than constructive, and if this change of view is a significant transition, you could be looking at an Icarus Stock.

ICARUS SIGNAL #5: DECLINING FREE CASH FLOW

In the early stages of growth, a young company may burn cash – operate at a loss, or at very low profit margins which swing back and forth between quarterly profits and losses – as it builds out the foundation of its business.

This typically occurs when the company is making hefty investments in future growth, depleting cash reserves through the process of expanding operations, acquiring customers, building out technology infrastructure, and so on.

At some point in the cycle, revenue and profit margins should grow to the point of overtaking these upfront investment costs. (That is the whole point of making the upfront investments in the first place – to see a return on investment down the road.)

Once the business has established itself, and started booking profits as a matter of habit, free cash flow levels should stabilize and start to improve.

> **FREE CASH FLOW:** The amount of actual cash a company generates from regular operations, after capital expenditures are accounted for.

Cash flow and earnings are not the same thing. For example:

Cash flow and earnings are not the same thing (and can differ by large amounts).

> **Reported earnings can be far bigger than cash flow.** Software company ABC reports $100 million worth of earnings via new customer contracts. But only a tiny portion of this is actually collected upfront as cash, with all the rest in the form of accounts receivable. As such ABC's earnings per share for the quarter might be X, but the actual cash generated is only a small fraction of X.

> **Cash flow can be far bigger than reported earnings.** Fertilizer company XYZ reports $10 million worth of quarterly earnings. But free cash flow for the quarter – the cash generated – was actually $100 million. The earnings number was reduced by equipment depreciation and an investment charge-off for some acquisition assets whose value was written down.

Cash matters because cash is the lifeblood of a business. In times of stress or strain, a shortage of cash means a business can die.

Cash is the lifeblood of a business, and free cash flow can be a more stable metric than earnings.

Cash can also be a more stable metric in terms of how a business is doing, as opposed to earnings, because reported earnings can be wildly out of synch with actual cash generated (as a result of accounting adjustments).

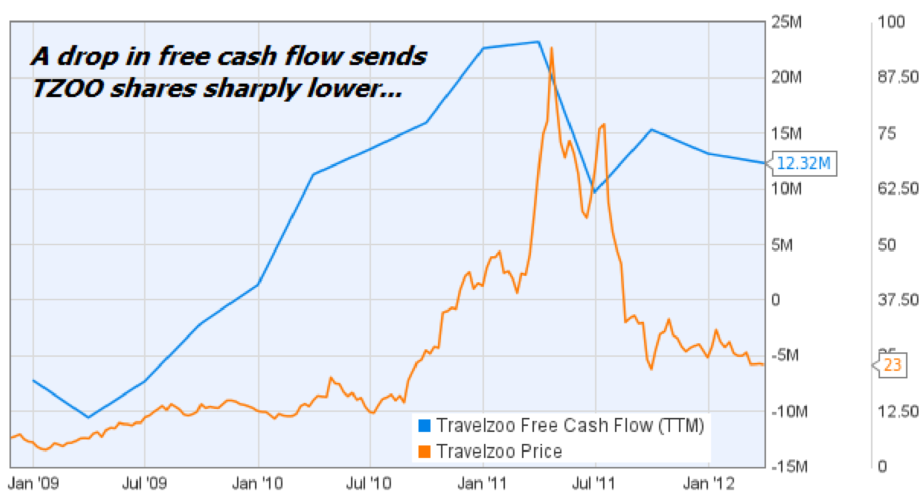
That is why some investors prefer to pay more attention to free cash flow – the amount of cash a business routinely generates – than the reported earnings, which can be impacted by accounting maneuvers.

And so, once a business graduates from the "cash burn" phase into the "generating cash" phase, the free cash flow metric becomes something investors pay attention to, as any sudden drop in free cash flow can indicate a problem.

A sudden drop in free cash flow can potentially point to all manner of business issues.

A sudden drop in free cash flow can be a major warning sign, as it potentially points to all manner of possible business issues:

- Rising upfront costs relative to longer-term revenue projections
- Declining ability to collect on accounts receivable (customers not paying bills)
- Increasing reliance on verbal customer commitments (versus actual payment)
- An increasing presence of expenses written off via accounting gimmicks
- And so on...



Shares of Travelzoo (TZOO) hit their high point early in the second quarter of 2011, along with a peak in free cash flow for the company.

When TZOO announced a 50% decrease in free cash flow for the second quarter, investors went from hyper-optimistic to newly pessimistic in a heartbeat. The share price fell from $75 to $25 in a matter of weeks.

There are justifiable reasons for a sudden drop in cash flow. But they have to be reasons that make sense, ideally with implications that are positive for the business. A drop in free cash flow caused by investment in a new manufacturing plant, for example, might be fine, whereas a drop in cash flow due to a spike in unpaid customer invoices is a possible sign of alarm. Investors are sensitive to free cash flow changes because such can speak directly to the long-term outlook of the business.

ICARUS SIGNAL #6: GUIDANCE REVISIONS

When a high-flying growth company reports earnings, investors typically pay close attention to management's comments and predictions regarding the upcoming quarter and annual forecast. This is generally known as earnings guidance, or sometimes just “guidance.”

> **EARNINGS GUIDANCE (OR JUST “GUIDANCE”):** Predictions and forecasts from management as to near-term performance expectation on future earnings, revenues, expenditures and so on.

It is, of course, in the management team's natural best interest to paint as rosy a picture as possible. But beyond the general expressions of optimism and fluff, there are typically a number of key data points for which investors are given a range of expectations (a high end and low end).

Guidance, like so many other factors, is scrutinized for clues to the long-term outlook.

Guidance, like so many other factors, is scrutinized by investors for clues to the long-term outlook. As with most everything else associated with an inflated valuation growth stock, guidance expressions should feel “up and to the right.”

As with other metrics, small adjustments to guidance matter – particularly in the negative direction – when a company’s share price and valuation reflect a great deal of optimism baked into the long-term outlook.

If guidance from management gets worse instead of better – if the stated guidance reflects a less positive outlook – that can be taken as seriously by investors as a decline in profit margin or free cash flow or other critical growth metrics.

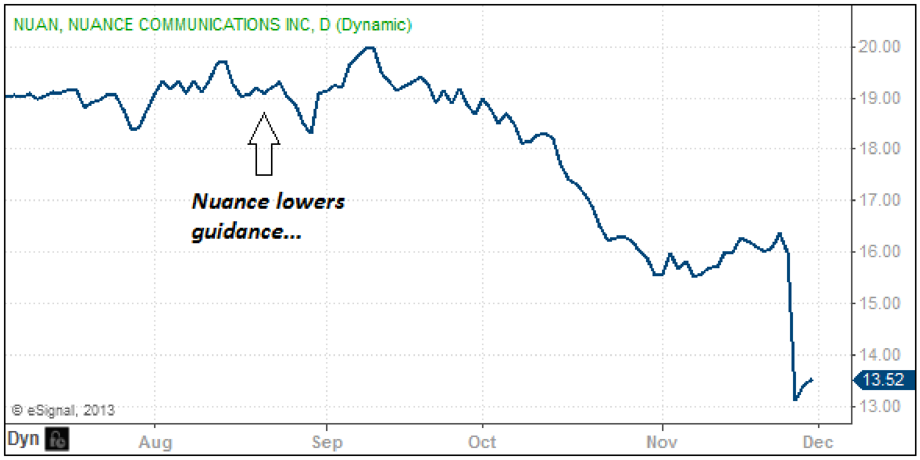
Poor guidance can overshadow strong results from the recent quarter, for reasons that make intuitive sense.

Poor guidance can also overshadow strong results from the recent quarter, for reasons that make intuitive sense. If management says the last few quarter was wonderful, but the next few will be not-so-wonderful or even lousy, investors will respond more to what’s expected for the future, versus what happened in the past.

> Management of company XYZ gives full year earnings guidance of $1.00 to $1.30 per share, reflecting midpoint guidance of $1.15.
>
> In the following quarter, full year earnings guidance is revised to a tighter range of $1.05 to $1.15, representing midpoint guidance of $1.10.
>
> Investors notice that the midpoint for full year earnings guidance has dropped from $1.15 to $1.10. Because the stock is very optimistically priced, this negative shift in the forecast causes a large sell-off in the shares.

Guidance can also reference key metrics other than earnings per share.

The metrics that matter will depend on the business, and the particular factors that shape the long-term outlook for that business. For social media and online gaming companies, for example, MAU (monthly active users) is a key metric. If guidance on MAU is higher or lower in future quarters, that might impact expectations more than the near-term earnings number. Once again, the core idea is the same: Investors are always trying to game out the long-term profit and growth outlook for the business.



In August of 2013, Nuance Communications (NUAN) announced quarterly earnings of 34 cents per share, which beat analyst expectations by 2 cents.

An "earnings beat" is generally a good thing, which most everyone knows. It means that the official expectations hurdle set by analysts was exceeded.

But on that same earnings call, management lowered its earnings guidance for the fiscal year, citing a delay in customer contract renewals.

That lowered guidance revision turned out to be a harbinger. While NUAN climbed after an initial drop, the stock then proceeded to lose a third of its value over the course of the next few months.

Lowered guidance is also an important warning sign because of the gamesmanship that goes on.

There is another reason why lowered guidance is an important warning sign. It has to do with the inevitable gamesmanship that goes on.

Company management is typically quite aware of the games that Wall Street likes to play. Wall Street analysts, in their desire for access, also have incentive to keep company managements happy. As a result of this, an unspoken agreement develops.

> Company management tries to issue guidance just a little bit below their actual views, so they can get the benefit of "beating" expectations.
>
> And Wall Street analysts quietly participate by setting their earnings forecast hurdle a tiny bit lower, so the company has a chance to "beat" that hurdle.
>
> As a result of this, the earnings "beat" happens more often than one would expect by chance. This is a psychological pat on the back and makes everyone happy (including the shareholders).

Lowered guidance, which is out of the norm, magnifies concern from investors when a target is missed.

The problem with this gamesmanship, though, is that it also **magnifies the concern when guidance is lowered or missed.** If the system is designed to produce beats on a frequent basis, what does that mean when a company botches things badly enough to have to lower guidance, or miss?

And as with all things growth stock related, the stakes are magnified by the high flyer valuations and optimistic expectations already baked into the stock price.

ICARUS SIGNAL #7: ACCOUNTING ISSUES

Mark Twain popularized the phrase "*lies, damned lies, and statistics*." The concept can be directly applied to accounting practices, which can be manipulated to help a company meet or exceed investor expectations.

Any time a key accounting figure is revised or accounting practices are questioned, investors should cautiously take note.

Any time a growth company makes a change to the way it reports or recognizes a key accounting figure, or the company's accounting practices are called into question, investors should cautiously take note. Some examples of changes include:

- **LIFO / FIFO Inventory** - A growth company may change inventory measurements from LIFO (Last In, First Out) to FIFO (First In, First Out) - or vice versa - to adjust inventory valuations. This transition could be used to draw attention away from rising inventory levels, or to mask pricing issues for inventory on hand.

- **Allowance for Doubtful Accounts** - When merchandise is sold to customers on credit, companies typically maintain an "allowance for doubtful accounts" which is the estimated amount that will not be repaid. This category has potential for earnings manipulation, as accountants can increase or decrease this "allowance" which then directly affects earnings figures.

- **"One Time" Activities** - One of the most commonly used accounting tricks is to record a specific expense as a "one time cost." A company may then report adjusted earnings which exclude this one-time charge - which are typically more favorable. Of course there are instances where recording an expense as "one time" may be wholly justified. But once again, this change in accounting metrics should be investigated as "one time" charges can become a routine occurrence or used to mask growing problems in the business.

Investors in Apollo Group (APOL) could have considered themselves warned in October of 2009, when the company announced that the SEC was looking into its revenue accounting practices.

While the stock dropped 15% on the day the announcement was made, this was just the beginning. APOL investors ultimately saw the stock drop another 45% within a 12 month period, and more than 75% in the following two years.

Professional short sellers, who are often vocal in what they find, can be a resource in this area.

Accounting issues can be very public events (such as with Apollo Group), or they can be changes or red flags that fly under the radar of most investors. Professional short sellers, who are often vocal in what they find, can thus be a resource in this area.

> Jim Chanos, one of the most well-known short sellers on Wall Street, rose to prominence after raising red flags on Enron.
>
> Andrew Left, another well-known short seller, highlighted discrepancies and accounting questions that led to the implosion of Valeant Pharmaceuticals.
>
> And Carson Block, another high profile short seller, uncovered massive fraud in the Canadian-listed Sino-Forest.

In regard to Enron, Valeant and Sino-Forest, there were sophisticated investors on the long side of each of these companies who wound up losing billions.

It's further interesting that the investors who lost billions in these companies took the bulk of their heavy losses AFTER the accounting warnings were publicized, and AFTER the share prices of these companies had gone into significant decline.

If a short seller highlights irregularities in a company you are long, sit up and take notice.

Perhaps the biggest lesson with accounting issues – for those who don't wish to become forensic detectives hunting through 10K footnotes – is to pay close attention to any accounting-related revisions or disciplinary actions that come up… and to sit up and take notice if a high profile short seller warns on one of your favorite names.

If the price action warrants, such could be sign of a profitable Icarus short.

ICARUS SIGNAL #8: INDUSTRY DETERIORATION

Growth stocks often draw strength from excitement surrounding their niche or market space.

Growth stocks typically don't operate in a vacuum. They often draw strength from excitement surrounding their niche or market space.

If the story behind a growth stock is cyclically driven, or powered by optimism for an entire industry or sector, this is even more true.

Sometimes a high-flying growth stock will find a turbo kicker in the optimism regarding its industry, which then adds to the premium valuation and inflated profit outlook.

As with so many other things, this industry or sector affiliation can be a two-edged sword. If prospects for a particular sector or industry start to turn, that can lead to a souring of expectations for the most inflated stocks in that group in terms of valuation multiples or forward earnings projections.

When an industry starts to cool, it is common for the laggards to go south early on.

This is a useful dynamic because, when an industry starts to cool, it is common for the laggards to go south early on – the names that investors were less enthusiastic about in the first place.

Price action and data suggesting a shifting tide for an entire industry, then, may first result in price action warnings showing up in laggard names and ETFs representing the industry on the whole – before finally hitting the high flying leaders, who then become Icarus Stocks.

For example: In May of 2009, the Market Vectors Steel ETF (SLX) saw a peak, followed by a sharp selloff a few weeks later.

In contrast, the hot growth stock Steel Dynamics (STLD) continued to climb all the way through June of that year. The steel industry on the whole was showing sign of being "done" – but STLD was temporarily resisting the trend due to embedded optimism.

The industry dynamics prevailed. Once it reversed and turned lower, STLD lost nearly 90% of its market value in the second half of the year. The huge drop in STLD shares caught many investors by surprise… but deterioration in other steel names, and the drop in SLX, flashed bright red warning lights ahead of STLD's major decline.

When an industry or sector shifts gears from bullish to bearish, or even bullish to neutral, the greatest negative impact can often be felt in Icarus Stocks – because these are the names that had the most inflated valuations and optimistic expectations built into the share price in the first place, and thus have the most to potentially lose.

The higher they fly, the greater the altitude from which they can descend…

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ICARUS SIGNAL #9: MULTIPLE CONTRACTION

This report highlights multiple factors that, when changed in a negative direction, can lead to a downshift of investor expectations.

That downshift of expectations, applied to a stock with an inflated multiple, can then cause the valuation multiple to contract, which in turn causes the stock price to drop.

It is this double whammy of contracting multiples and declining earnings estimates that is so painful. A stock that drops from a 40X earnings multiple to a 20X earnings multiple can see its price cut in half – even as earnings stay the same.

If the earnings estimate also falls, the drop can be even worse – and all of that for a stock that still finishes at 20X earnings when the drop is done!

The ability of the valuation multiple to expand and contract is part of what makes valuing stocks such a challenge.

The ability of the valuation multiple to expand and contract – the premium that investors are willing to pay for a stream of future cash flows – is part of what makes valuing stocks such a challenge.

It's not just the general range of what a company could be earning in five or ten years, but also how investors feel about that potential future cash flow stream, relative to other competing opportunities, and supply and demand factors for capital in general.

No wonder it's tricky. That is why a few basic guideposts are key. Certainty is illusion, but by paying attention to a suite of factors, you can get a handle on probabilities.

In the case of valuation multiples, we are talking about the resulting outcome from a cause-and-effect relationship. If negative change X or rate-of-change slowdown Y is the cause, then multiple contraction Z is one of the effects that makes the stock drop.

It's possible to view multiple contraction as a warning sign itself, before price starts to turn.

But it's also possible to observe multiple contraction as a visible warning sign in and of itself, not unlike the breaking of a long-term price trend. And you can potentially see a multiple contraction take hold BEFORE price action begins to turn south.

> Consider the Forward P/E ratio (FP/E) for example – the estimated price-to-earnings multiple for the upcoming twelve months.
>
> Sometimes it is possible for a stock to continue making new highs, or sustain a consolidation-type sideways direction, even as the Forward P/E multiple starts to contract.
>
> This contraction can represent a deterioration of sentiment or waning faith in the optimistic future outlook – and thus be the early harbinger of a decline.

First Solar (FSLR) offers a good example of this concept, as the stock went through a topping process in late 2007 and the first part of 2008.

The stock initially peaked in December of '07, selling off sharply after hitting a high near $275. In the first quarter of 2008, the stock found support and overtook its previous high, briefly breaking through $300 per share.

However, while the stock was making a new high, the company's forward PE ratio (price to 1-year forward earnings estimates) failed to make a new high. This was an indication that investors were no longer willing to pay as much of a growth premium for the stock.

The contracting growth premium was a sign that all was not well in other areas.

Essentially, the company's growth premium began to contract. This contraction in the Forward P/E was not a cause, per se, but a sign that all was not well in other areas. It was a means of gauging the fact that investor optimism was waning. FSLR would ultimately lose more than 95% of its market value from the prior peak.

ICARUS SIGNAL #10: ANALYST REVISIONS

It's little secret that Wall Street analyst recommendations are mostly worthless…

It's little secret that Wall Street analyst recommendations are mostly worthless.

Historically there has been an extreme bias to the buy side, due to the favorable relationships investment banks try to cultivate with clients.

If the analysts of a Wall Street bank are too negative on the company's prospects, that reduces the odds of doing business with that company on the mergers and acquisitions side, or the odds of assignment for other lucrative corporate needs.

This isn't supposed to matter but it does. Analysts also prefer optimism in their reports in order to maintain access to the corporate executive suite. (CEOs don't like analysts who write negative reports, and managements tend to shut them out.)

At the same time, consensus analyst expectations are often intended to quietly help the company game the earnings call process, by making it easier to produce the "beat" that keeps management looking good (and shareholders feeling positive).

Since virtually everyone involved in this process has bullish incentives – and because investors apply little or no penalty to Pollyanna tendencies – this unspoken conspiracy of forced optimism is seen as a good thing (even if it produces problems later on).

…Yet revisions from Wall Street analysts can be impactful in certain circumstances.

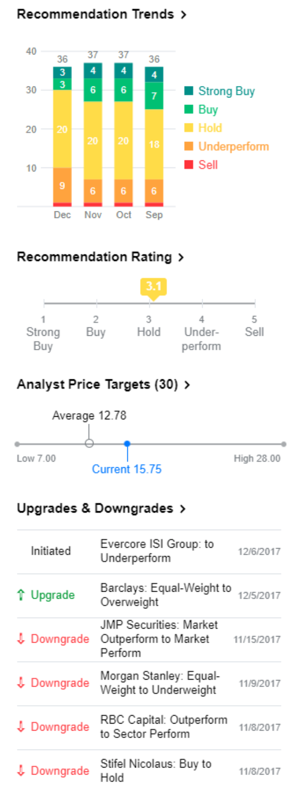
With the above said, revisions from Wall Street analysts can be impactful in certain circumstances. Once again it is the rate of change or the direction of the change that generally matters here, rather than the specific revision content.

During the honeymoon period for top-performing growth stocks, analysts typically scramble to keep their projections up to speed versus booming revenue and earnings growth. Consensus expectations and outlooks are commonly revised higher quarter after quarter, as the company reports strong growth and issues positive guidance.

When this cycle of rising bullish consensus is broken, however, it can be a glaring danger sign. The breaking of the cycle can indicate trouble in paradise.

Though Wall Street analysts and corporate managements have incentive to be as optimistic as the day is long, they are also duty-bound to maintain fidelity to the truth – or at least to a plausibly defensible version of the truth that could hold up in court.

What this means is that, if a company's metrics start to turn south or otherwise look wobbly, management is obligated to report on that, and Wall Street analysts are required to pick up on it as a matter of due diligence.



When this shows up in analyst revisions, it is a little bit like having a friend who is super-optimistic and sunny all the time suddenly sounding a tad gloomy.

If your super-optimistic friend ever says "I am a little bit bummed out today," that is a potentially major signal that something is wrong (because it is so far from the norm).

Analyst revisions can't be taken at face value, but the direction of change can be a signal in itself.

Comparably, analyst revisions can't really be taken at face value – moving something from "buy" to "hold" might actually mean "SELL THIS DOG," though they can't say that – but the direction of change can be a signal in itself, particularly for a company in which the valuation is very high (and thus high stakes in terms of ongoing optimism).

There are a number of free online tools for tracking analyst revisions. The Yahoo Finance toolbar at right shows the picture for SNAP, which a number of analysts have downgraded as of this writing.

Analyst revisions are typically not an "early" warning sign. Wall Street can be notoriously slow to change a bullish view.

But for that reason, the notable presence of analyst revisions (in a negative direction) can be that much more serious when it shows up.

Institutional money managers, in thrall to consensus analyst views, can reinforce existing trends.

Institutional money managers, furthermore, are somewhat in thrall to consensus analyst views, due to the "safety of the herd" factor. It's safer to be wrong on something if the analysts were wrong too; if the money manager was wrong and the analysts' consensus was negative, woe betide him. As such, negative analyst revisions in the early or mid-stages of a downtrend can reinforce the institutional selling that fuels that downtrend, in something of a self-fulfilling prophecy.

Eventually, all high-flying growth stocks become Icarus Stocks – unless the company is acquired and the ticker disappears. If this were not true, companies would grow to the sky and sport multi-trillion market caps. (Amazon to be the first perhaps?)

When that transition happens – from growth stock darling to darling no more – the share price reckoning can be painful. But there are numerous warning signals to take heed of in identifying these "Icarus Stocks" – for the purpose of preserving capital on the long side, or generating new potential profits on the short side. We hope you've gained insights from the signals listed in this report.