



*December 1, 2005*

# **Expectations Investing**

**Reading Stock Prices for Better Returns**

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# Agenda

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1. Groundwork
2. How the Market Values Stocks
3. Expectations Investing Process
4. Case Study

# Groundwork

# Groundwork

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## *Fundamentals versus expectations*

Perhaps the single greatest error in the investment business is a failure to distinguish between knowledge of a company's fundamentals and the expectations implied by the price

# Groundwork

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## ***Fundamentals versus expectations***

The issue is not which horse in the race is the most likely winner, but which horse or horses are offering odds that exceed their actual chances of victory . . . . This may sound elementary, and many players may think that they are following this principle, but few actually do. *Under this mindset, everything but the odds fades from view. There is no such thing as “liking” a horse to win a race, only an attractive discrepancy between his chances and his price.*

Steven Crist, “Crist on Value,” in Beyer, et al., *Bet with the Best* (New York: Daily Racing Form Press, 2001), 64.

# Groundwork

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## *Fundamentals versus expectations*

I defined variant perception as holding a well-founded view that was meaningfully different from the market consensus . . . *Understanding market expectation was at least as important as, and often different from, the fundamental knowledge.*

Michael Steinhardt, *No Bull: My Life in and Out of Markets*  
(New York: John Wiley & Sons, 2001), 129.

# Groundwork

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## *Introduction*

- ◆ Investing, like many things in life, relies on expectations
- ◆ Changes in expectations trigger stock price changes
- ◆ The investor's key task is to *anticipate* expectations revisions

# Expectations Investing

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## *Introduction*

- ◆ What expectations?
- ◆ Are all expectation revisions the same?
- ◆ What's the best way to anticipate expectations revision?

# Expectations Investing

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## *Introduction*

- ◆ Expectations are based on long term cash flow
- ◆ Expectation revisions are *not* all the same
- ◆ Investors need to wed competitive strategy and finance to best anticipate important revisions

## *Three myths*

<i>Myth</i>	The market is short-term oriented	EPS dictate value	P/E multiples determine value
<i>Reality</i>	The market takes a long-term view	EPS tell us little about value	P/E's are a function of value

## *ROIC and P/E multiples—theory*

		Return on Invested Capital			
		4%	8%	16%	24%
Earnings Growth	4%	6.1x	12.5x	15.7x	16.7x
	6%	1.3	12.5	18.1	20.0
	8%	NM	12.5	21.3	24.2
	10%	NM	12.5	25.5	29.9

Assumes all equity financed; 8% WACC; 20-year forecast period.

# How the Market Values Stocks

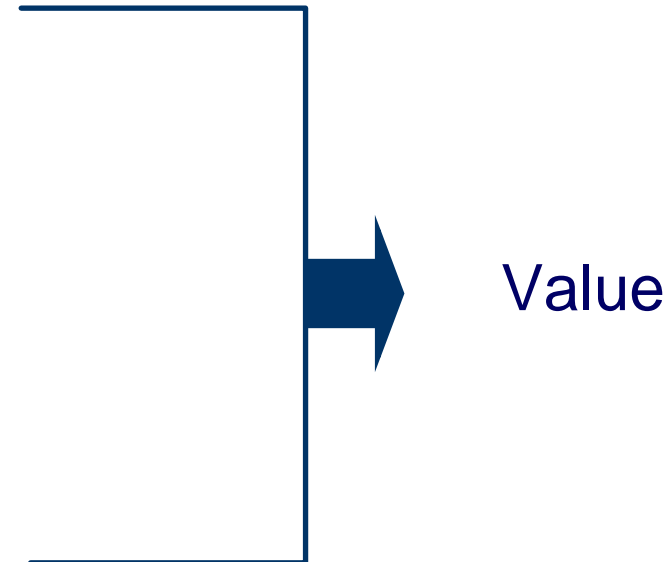
# Basics of Valuation

## *First principles*

(1) Cash flow

(2) Risk

(3) Forecast horizon

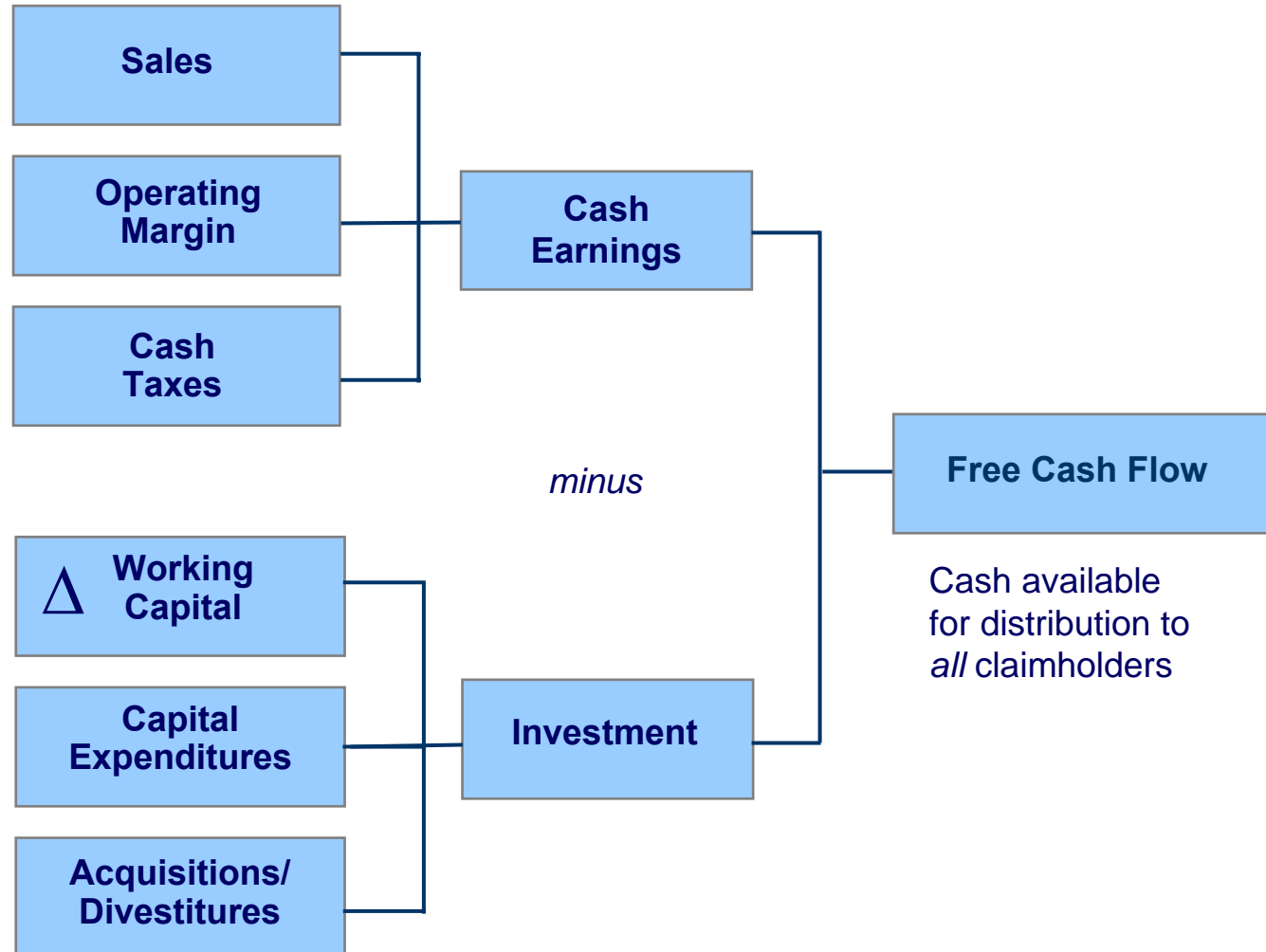


These drivers are *expectational* in the stock market

# Basics of Valuation

## Cash flow

- Volume
- Pricing
- Expenses
- Leases
- Tax Provision
- Deferred Taxes
- Tax Shield



Cash available for distribution to *all* claimholders

# Basics of Valuation

## Microsoft (2005)

In \$ millions	Earnings	Adjustment	Cash Flow	Cash flow as a % of income stmt item
Sales	39,788.0			
+ Increase in unearned revenue		13,831.0		
- Recognition of unearned revenue from prior periods		(12,919.0)		
- Increase in accounts receivable		(1,243.0)	<u>39,457.0</u>	99%
Cost of revenue	(6,200.0)			
+ Increase in other assets		172.0		
- Increase in other liabilities		1,245.0	<u>(4,783.0)</u>	77%
Depreciation and amortization expense				
+ Depreciation expense		855.0		
- Capital expenditures		(1,019.0)	<u>(164.0)</u>	
Research and development	(6,184.0)			
Compensation				
- Stock-based compensation		2,448.0		
Sales and marketing	(8,677.0)			
General and administrative	(4,166.0)		<u>(16,579.0)</u>	
Operating income	<u>14,561.0</u>			
Losses on equity investees and other	0.0			
Investment Income	2,067.0			
+ Investment income		(527.0)	<u>1,540.0</u>	
Income before income taxes	<u>16,628.0</u>			
Income tax expense	(4,374.0)			
- Deferred taxes		(179.0)		
- Stock option tax benefits		668.0	<u>(3,885.0)</u>	89%
<i>Reported Net Income</i>	<u>12,254.0</u>			
<i>Operating Net Income</i>	<u>12,254.0</u>			
<i>Cash Flow</i>			<u>15,586.0</u>	127.2%

# Basics of Valuation

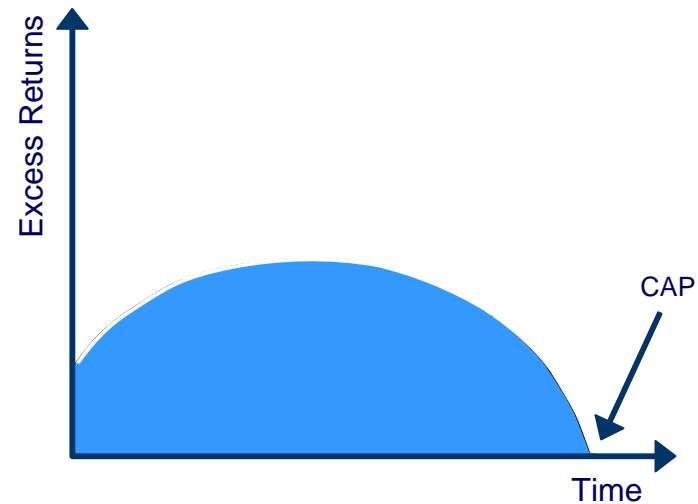
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## *Cost of capital*

- ◆ Opportunity cost of capital providers
- ◆ Cost of equity is greater than the cost of debt
- ◆ Cost of capital can be tricky to estimate

# Basics of Valuation

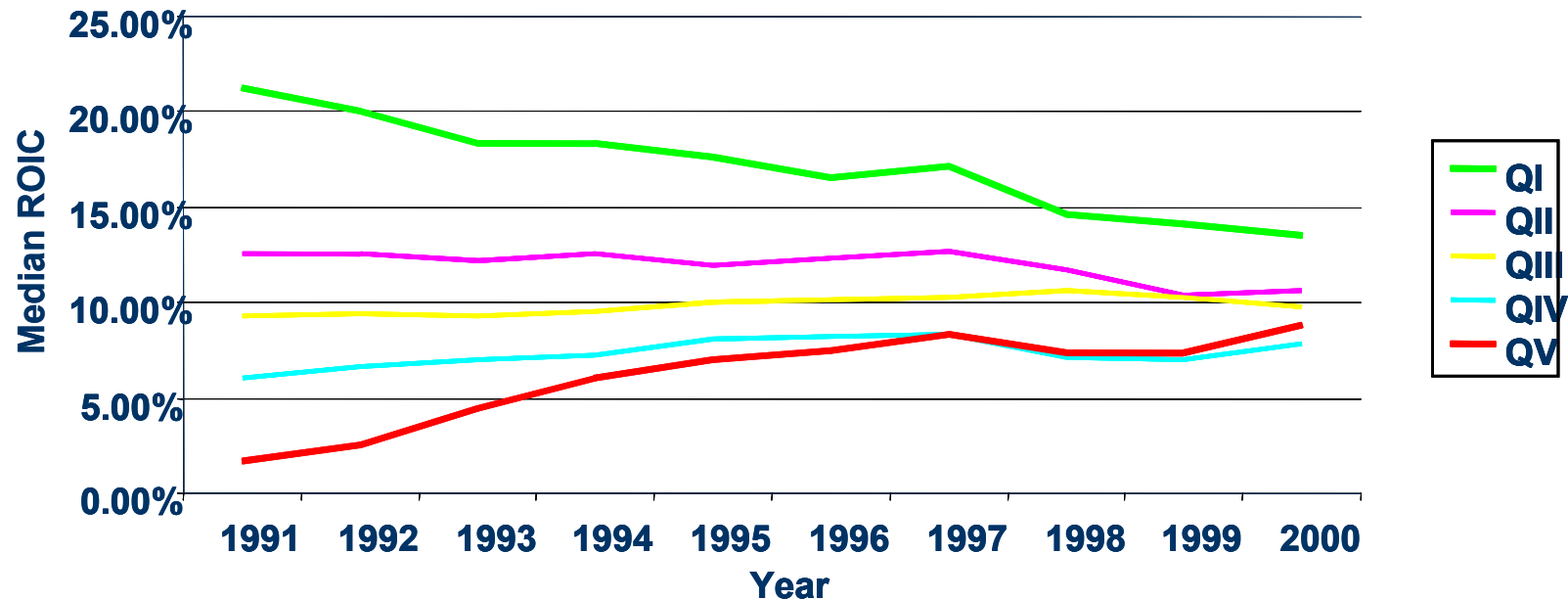
## *Competitive advantage period (CAP)*



- ◆ Period of time a company can generate excess returns on new investments

# Basics of Valuation

## *Competitive advantage period (CAP)*



Source: CSFBEdge database.

# Basics of Valuation

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## ***Competitive advantage period (CAP)***

- ◆ Reversion to the mean fastest in fast-changing industries
- ◆ Some companies and industries demonstrate persistence
- ◆ CAPs cluster by investment neighborhood

# Expectations Investing Process

# Expectations Investing

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## *A fundamental shift in stock selection*

### The Expectations Investing Steps

1. Estimate price-implied expectations
2. Identify expectations opportunities
3. Make buy and sell decisions

# Expectations Investing

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## ***Step 1: Estimate price implied expectations***

- ◆ Uses the sound DCF model
- ◆ Bypasses need to forecast
- ◆ Overcomes the shortcomings of traditional analysis (i.e., price/earnings ratio)

# Expectations Investing

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## ***Step 2: Identify expectations opportunities***

- ◆ Apply appropriate competitive strategy framework
- ◆ Determine which expectations revisions matter most
  - Value neutral      —————> incremental returns
  - Value creating    —————> incremental growth

# Expectations Investing

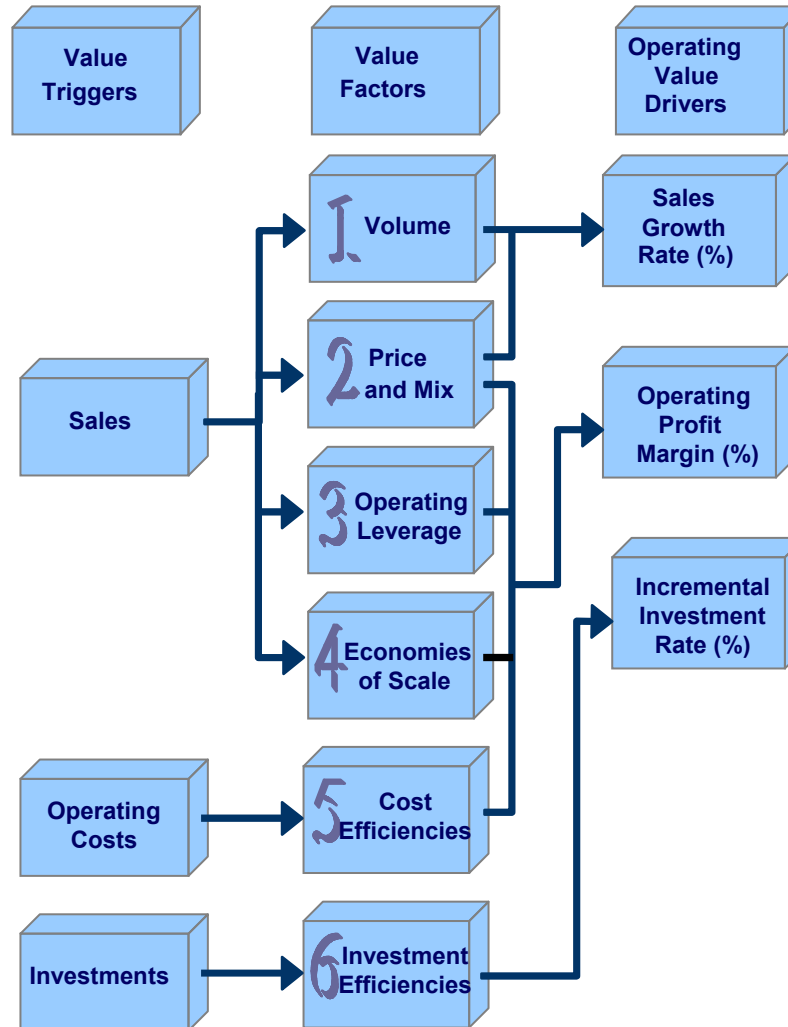
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## ***Competitive strategy analysis***

- ◆ *Five forces* – assessing industry structure
- ◆ *Value chain* – assessing activities and where companies create value
- ◆ *Innovator's dilemma* – why great companies fail
- ◆ *Information rules* – contrast between physical and knowledge businesses
- ◆ *Game theory* – capacity additions and pricing

# Expectations Investing

## *Expectations infrastructure*



# Expectations Investing

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## ***Step 3: Make buy and sell decisions***

- ◆ Expected value analysis
  - Frequency of correctness is not the key
  - Magnitude of correctness matters
- ◆ Incorporate margin of safety
  - Turnover
  - Transaction costs
  - Taxes
- ◆ Consider decision making pitfalls

# Case study

# Case Study

## Coca-Cola

Cash flow

6.0% EBITA growth

45% Incremental investment rate

Cost of capital

7.5%

CAP

12 years

\$42

Source: *Value Line Investment Survey*, November 4, 2005 and LMCM estimates.

# Case Study

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## ***Options-derived distribution***

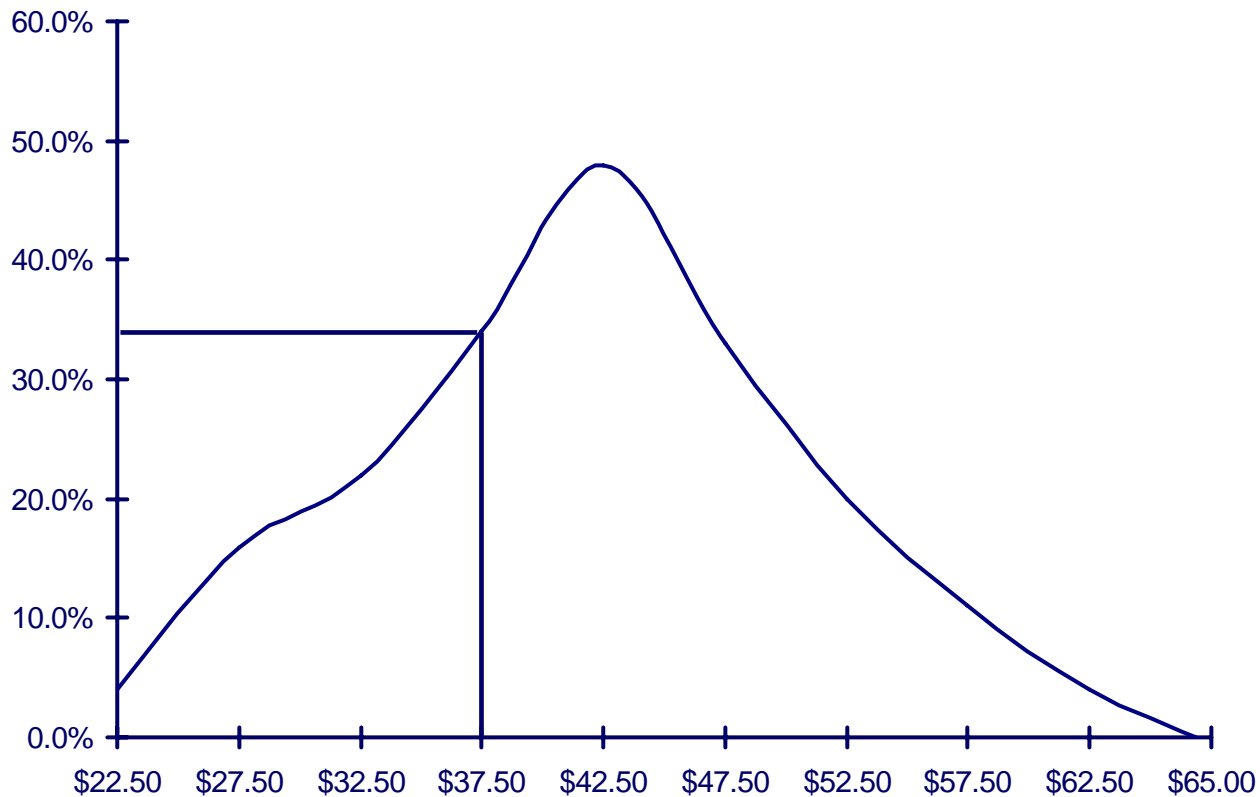
L Jan 08 35 call @ \$9.40

S Jan 08 40 call @ \$6.20

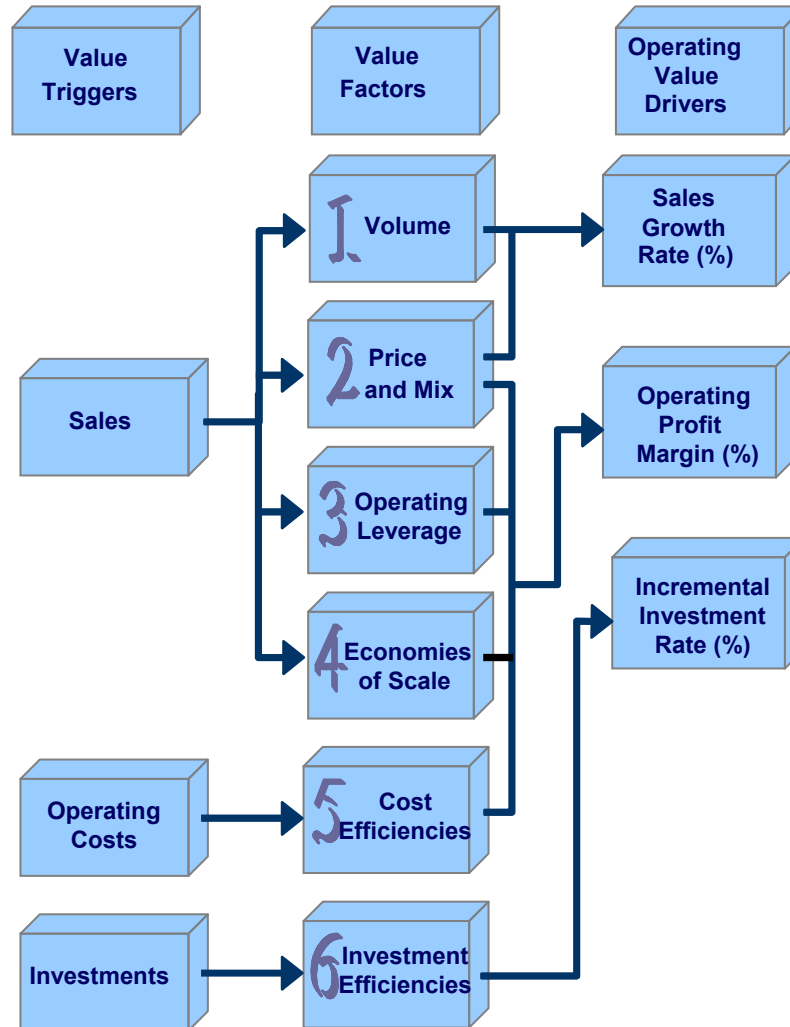
- ◆ Pay \$3.20 net (\$9.40 minus \$6.20) for the possibility of receiving a maximum of \$5 (\$40 minus \$35)
- ◆ \$3.20 divided by \$5 equals a 64% probability the stock will exceed \$37.50 (mid point of the strikes) and 36% probability the stock will be at or below \$37.50

Source: *Bloomberg*, November 17, 2005.

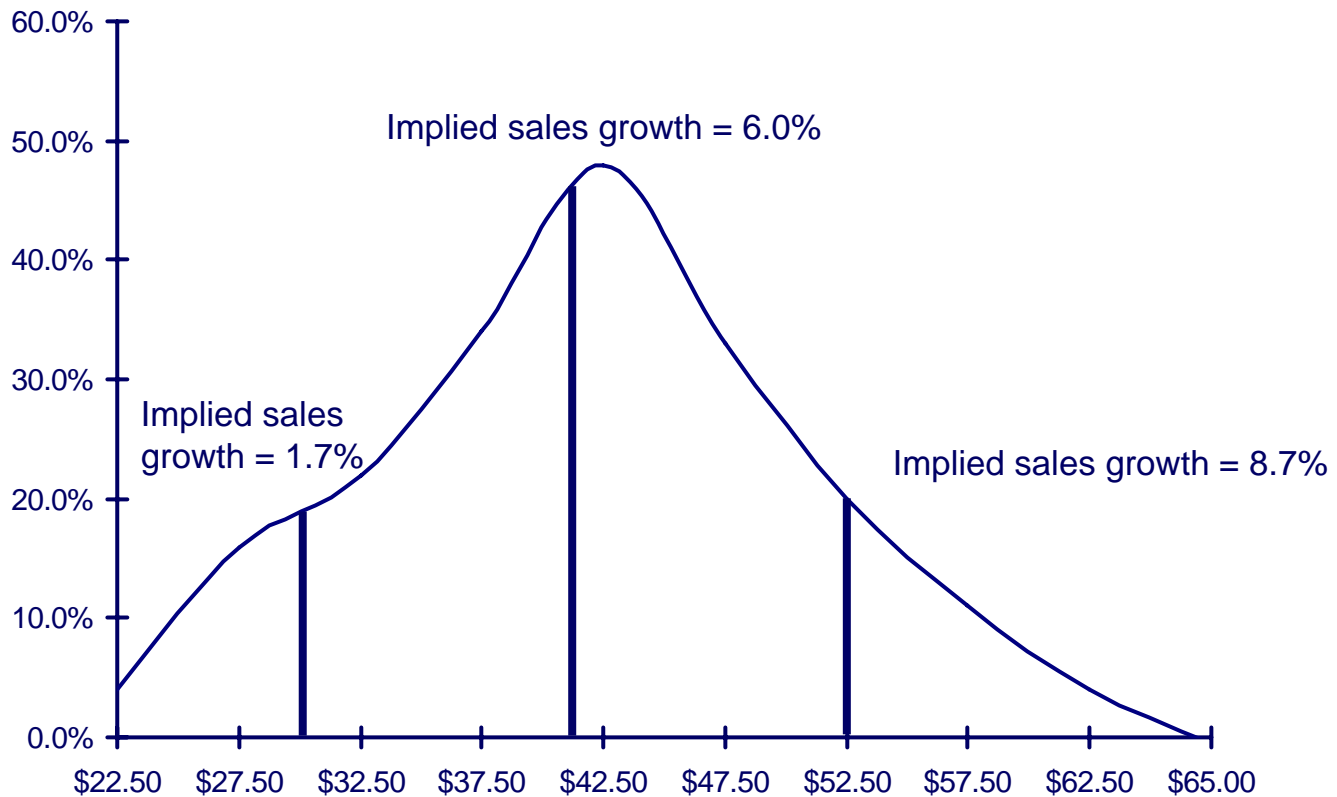
## KO options-implied distribution Based on January 2008 options



## *Sales growth is the key trigger for KO*



## KO options-implied distribution Based on January 2008 options



## EXPECTATIONS INVESTING

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— Clayton Christensen  
Professor, Harvard Business School  
Author, *The Innovator's Dilemma*

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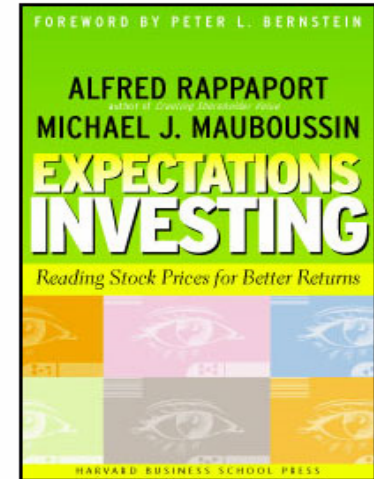
1. A revolutionary yet common-sense investment approach that reads the market's current expectations and provides the tools to anticipate future expectations.
2. A clearly written book on expectations investing written by valuation experts Alfred Rappaport—author of *Creating Shareholder Value*—and Michael J. Mauboussin—Chief Investment Strategist at Legg Mason Capital Management—and published by Harvard Business School Press.
3. A web site that serves as a resource for those wishing to learn more about Expectations Investing—and how to apply its powerful analytical tools.

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