



Expectations Investing

Taking Advantage of a Short-Term World

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Barriers to Long-Term Thinking

	<u>Phenomenon</u>	<u>Effect</u>
<u>Psychology</u>	Availability bias Recency bias Stress	Accounting versus economic focus Betting on what <i>has</i> worked Creates a short-term focus
<u>Incentives</u>	Agency costs	Agent/principal shift
<u>Expectations</u>	Diversity breakdowns	Expectations gaps

Groundwork

Groundwork

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

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

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

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

Introduction

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

Expectations Investing

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

Groundwork

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

Groundwork

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

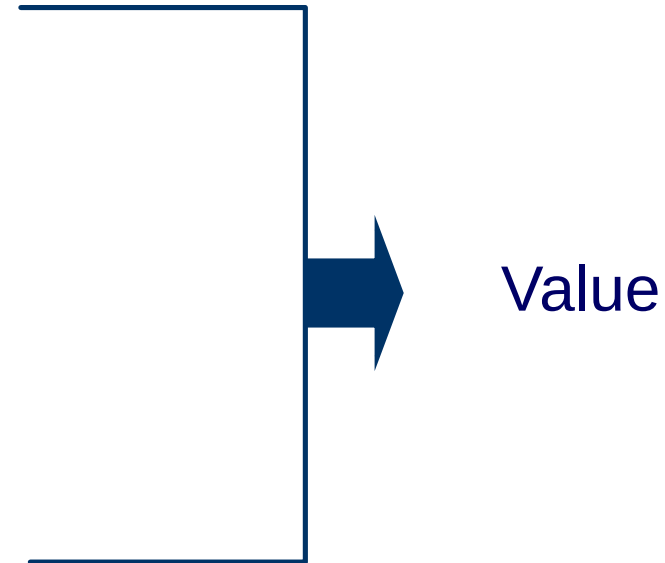
Basics of Valuation

First principles

(1) Cash flow

(2) Risk

(3) Forecast horizon

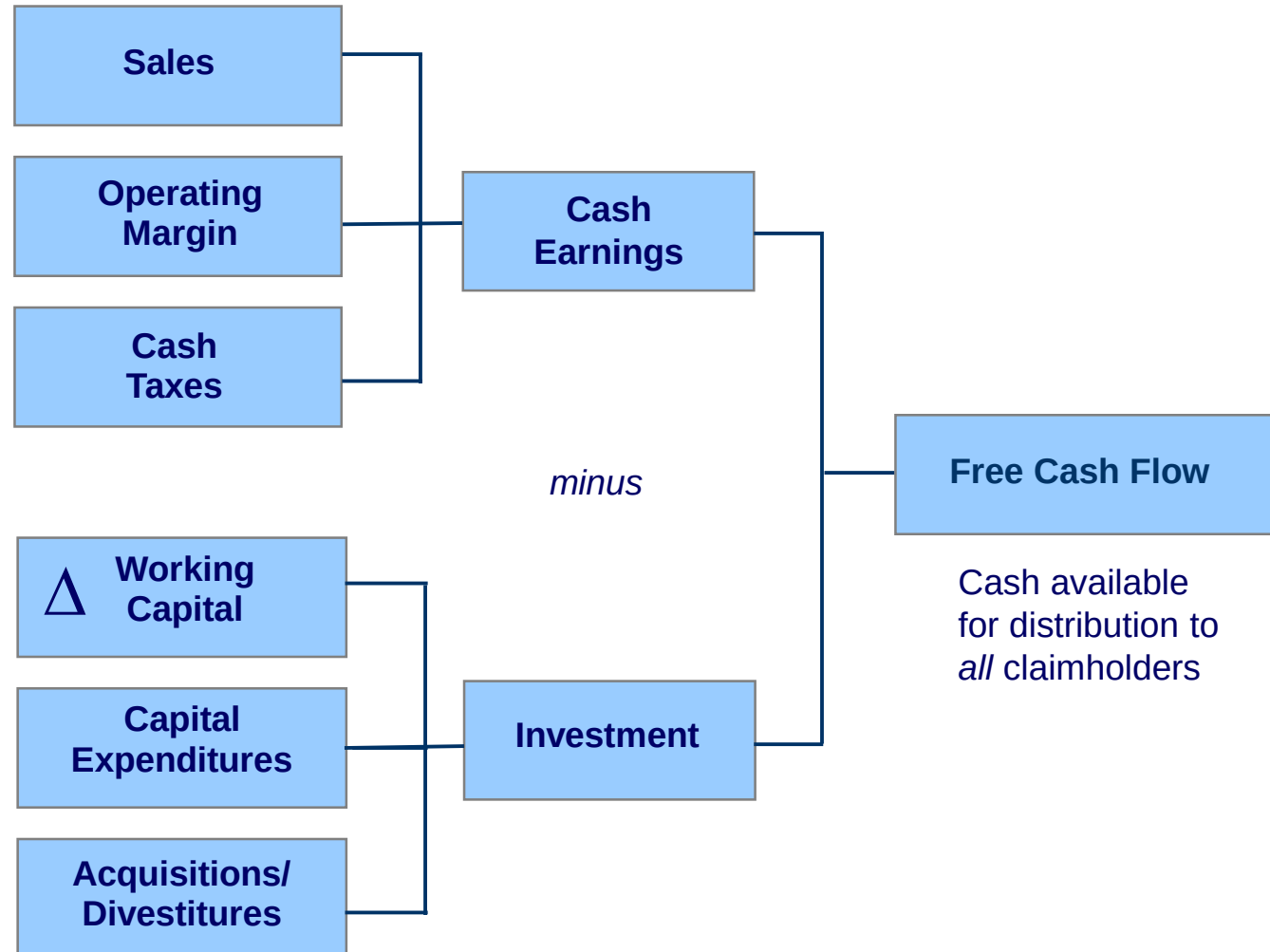


These drivers are *expectational* in the stock market

Basics of Valuation

Cash flow

- Volume
- Pricing
- Expenses
- Leases
- Tax Provision
- Deferred Taxes
- Tax Shield
- A/R
- Inventories
- A/P
- Net PP&E
- Operating Leases



Basics of Valuation

Amazon (2005)

In \$ millions	Earnings	Adjustment	Cash Flow	Cash flow as a % of income stmt item
Revenues				
Net Sales	8490.0			
Accounts receivable, net and other current assets		(84.0)	8,406.0	99.0%
Cost of Sales	(6,451.0)			
Inventories		(104.0)		
Accounts payable		274.0		
Accrued expenses and other current liabilities		60.0		
Additions to unearned revenue		156.0		
Interest payable			(6,065.0)	94.0%
Depreciation and amortization				
Depreciation of fixed assets, including internal-use software and website development, and other amortization		121.0		
Capital Expenditures: purchases of fixed assets, including internal-use software and website development		(204.0)	(83.0)	
Operating Expenses				
Fulfillment	(745.0)			
Marketing	(198.0)			
Technology and content	(451.0)			
General and administrative	(166.0)			
Stock-based compensation		87.0		
Amortization of previously unearned revenue		(149.0)		
Other operating (income) expense	(47.0)	7.0		
Gains on sales of marketable securities		(1.0)	(1,663.0)	103.5%
Interest income	44.0			
Interest expense	(92.0)			
Non-cash interest expense and other		5.0		
Other (expense) income, net	2.0			
Remeasurements and other	42.0	(42.0)	(41.0)	
Provision (benefit) for income taxes	(95.0)			
Deferred income taxes		70.0		
Cumulative effect of change in accounting principle	26.0	(26.0)	(25.0)	
Reported Net Income	359.0			
Operating Net Income	454.0			
Cash Flow			529.0	116.5%

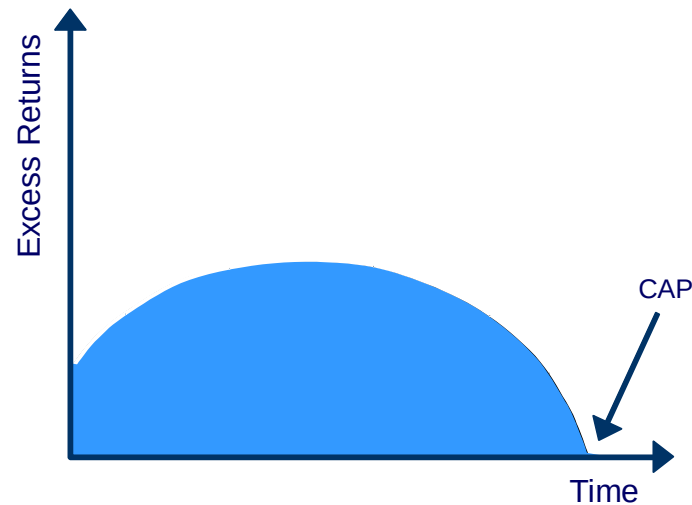
Basics of Valuation

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

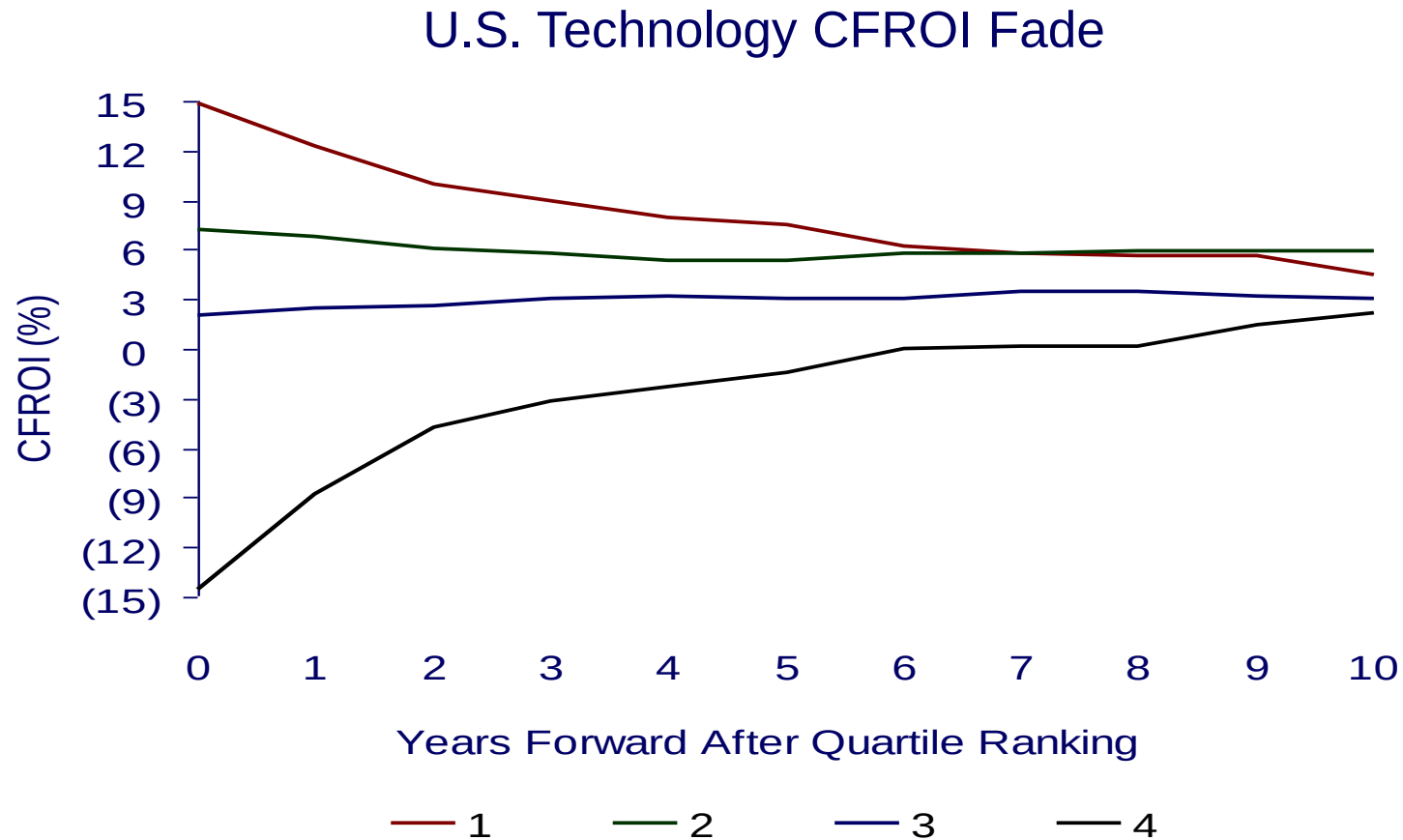
Competitive advantage period (CAP)



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

Basics of Valuation

Competitive advantage period (CAP)



Source: HOLT.

Basics of Valuation

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

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

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

Step 2: Identify expectations opportunities

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

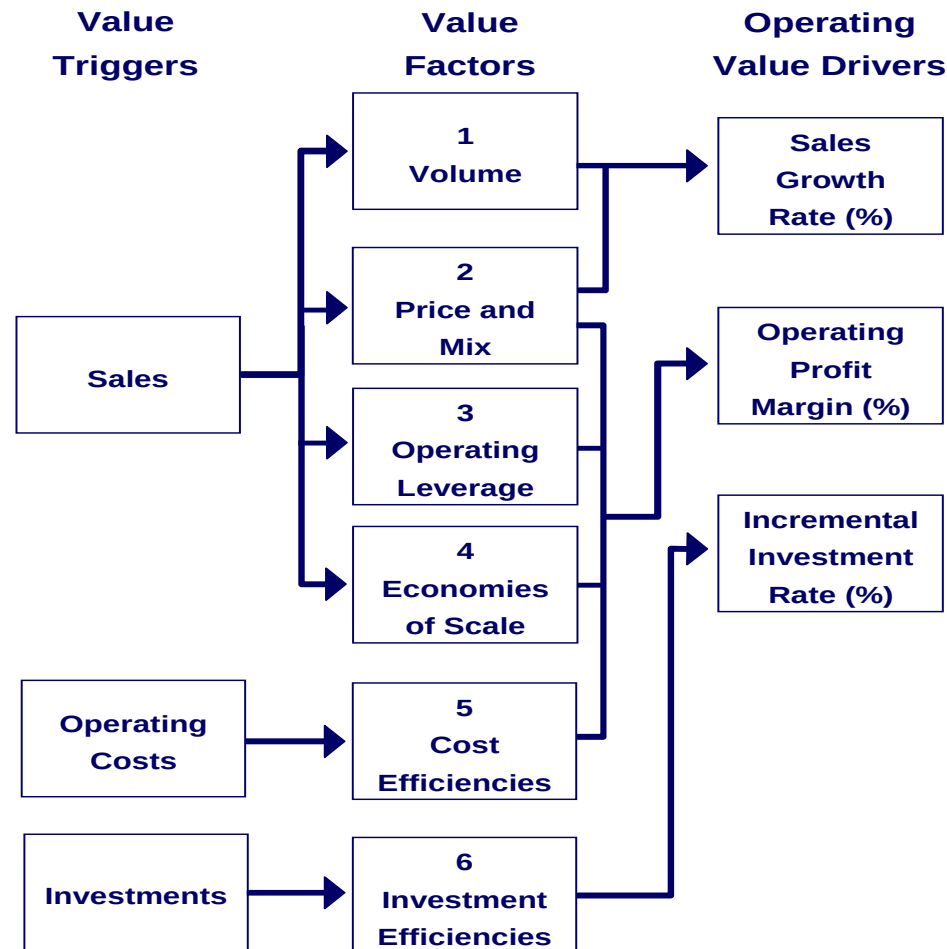
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Competitive strategy analysis

- ◆ *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

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

Coca-Cola



Source: *Value Line Investment Survey*, May 5, 2006, and LMCM estimates.

Barriers to Long Term Thinking

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

WELCOME TO EXPECTATIONS INVESTING

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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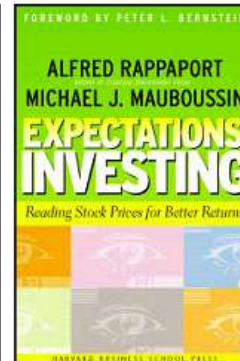
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