

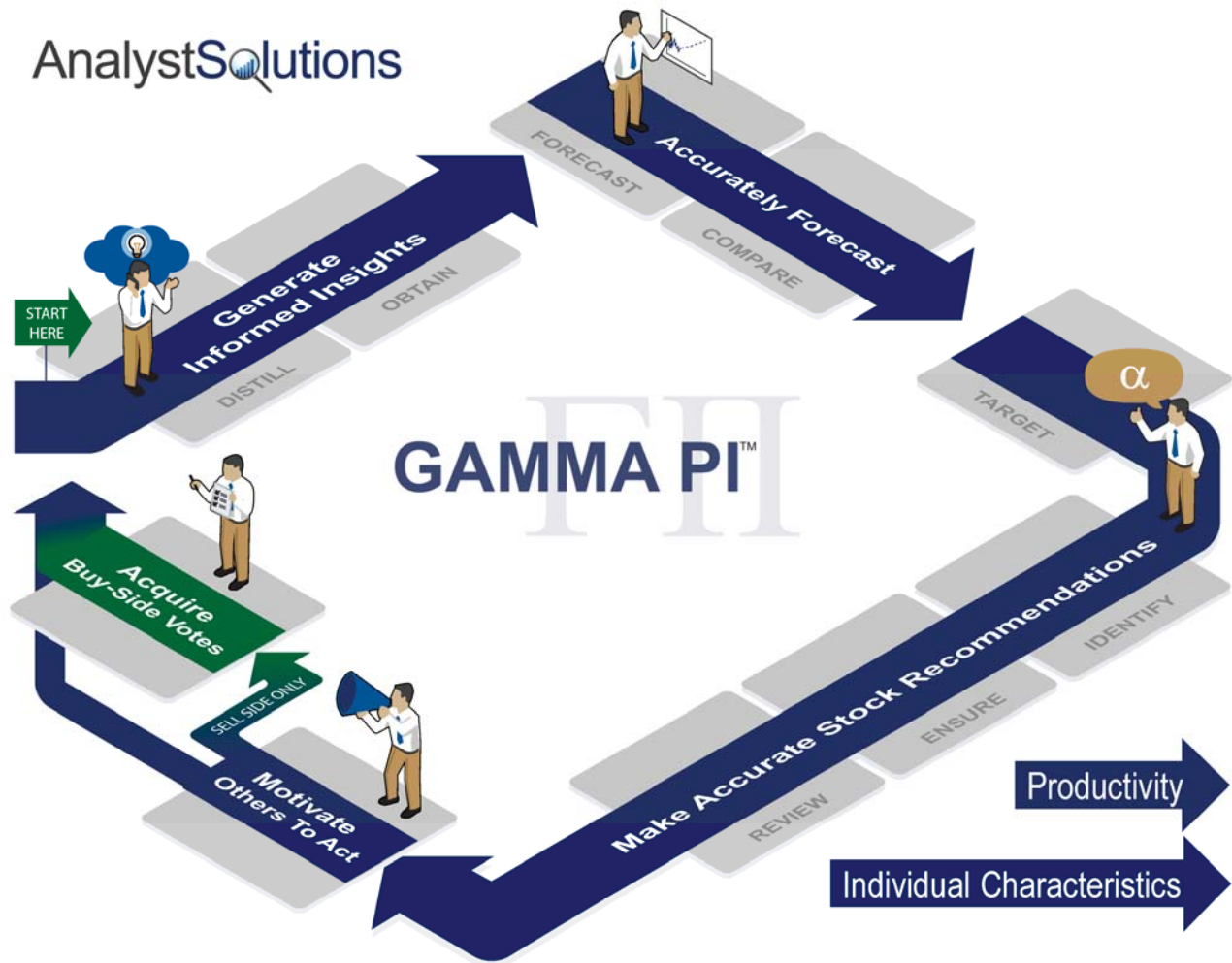
# MATERIALS

[www.analystsolutions.com/EICmaterials](http://www.analystsolutions.com/EICmaterials)

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# EXERCISE: LIST EVERYTHING

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# Part 1: Identify & Monitor Your Stock's Critical Factors

## Part 2: Get Noticed With Differentiated Stock Calls

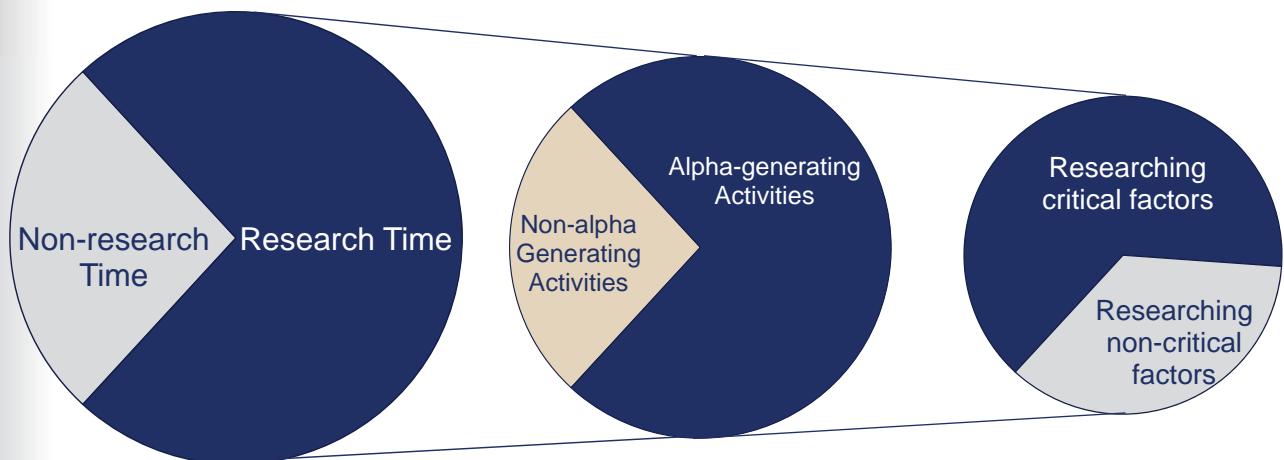


# Make the Alpha-Generating Time Matter

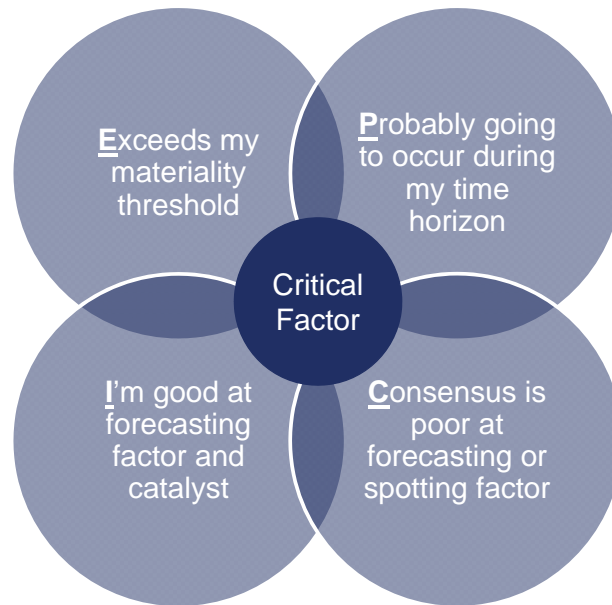
Total Work Time

Research Time

Alpha-Generating  
Time



## EPIC™ Stock Calls Require Critical Factors Meet All Four Criteria



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## Exceeds Materiality Threshold?

- Material changes in earnings or cash flow growth
- Material changes in returns
- Material changes in the probability:
  - The company makes an acquisition
  - The company is purchased by another entity
  - There is a change in senior management
- Material change in the volatility profile of the stock



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# Exceeds Materiality Threshold?

“Materiality” can mean different things to different people:

- A hedge fund that turns over its portfolio every month may need only a 5% relative move in a stock to make a trade
- A large long-only fund that builds large positions may need at least a 15% relative move to invest in a stock



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## What’s “Material” To You?

Ticker	Revenue from volume	Revenue from pricing	Expenses
1. ABC	\$24 million	\$3.6 million (or 0.5% change in overall pricing)	\$3.6 million
2.			
3.			

# Create Tool to Compute Materiality

Create a template to help conceptualize “materiality” for the companies in your sector. It generally comes from 3 places:



- Change in revenue from volume (simplistically assuming margins remain constant)
- Change in revenue from pricing
- Change in expenses (without a corresponding change in revenues)

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# Your “Materiality” Threshold



To illustrate the concept, we use 5% as a starting point

- Earnings per share (EPS) or cash flow per share (CFPS) need to change by more than 5 percent

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# Example: Computing Materiality

Example Company	
Revenues	\$698
Expenses	\$593
EBIT margin	15%
EBIT	\$105
Int Exp, net (MM)	\$33
Pre-tax income	\$72
Tax rate	34%
Tax expense	\$24
Net Income	\$48
EPS	\$0.88
Share count	53.9

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**To cause EPS to move by 5%, what will need to occur on each of these line items (in isolation):**

- Change in revenue from:
  - Volume
  - Pricing
- Change in expenses

Start by computing how much EBIT will need to change to cause a 5% change to EPS

# Example: Computing Materiality

Example Company	
Revenues	\$698
Expenses	\$593
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Share count	53.9

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1. Compute backwards, starting with 5% change to EPS:

$$\$0.88 \times 5\% = \$0.04$$

2. Compute net income impact:

$$\$0.04 \times 53.9 = \$2.4 \text{ million}$$

3. Convert after-tax to pre-tax:

$$\$2.4 \div (1 - 0.34) = \$3.6 \text{ million}$$

**\$3.6 million is our threshold EBIT value that equates to a 5% change to EPS**

# Example: Computing Materiality

Example Company	
Revenues	\$698
Expenses	\$593
EBIT margin	15%
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Int Exp, net (MM)	\$33
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Net Income	\$48
EPS	\$0.88
Share count	53.9

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1. Compute required change in revenue from volume (assumes no change in margins):

$$\$3.6\text{MM} \div 0.15 = \$24\text{MM}$$

2. Compute required change in revenue from pricing:

$$\$3.6\text{MM} \div \$698\text{MM} = 0.5\%$$

3. Compute required change in expenses:

$$\$3.6\text{MM}$$

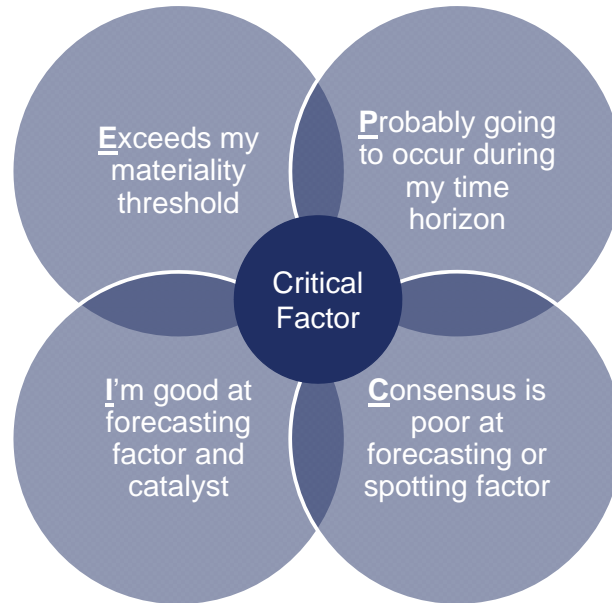
## Is It Worth Your Time?



Compute level of materiality to determine if it's worth spending any more research time on this factor



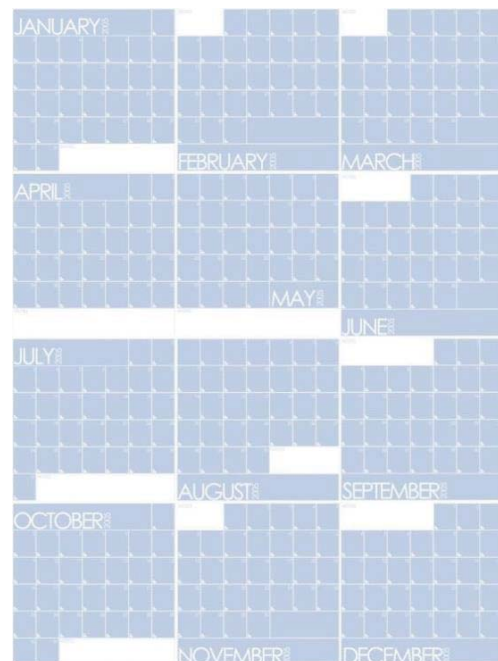
# EPIC™ Stock Calls Require Critical Factors Meet All Four Criteria



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## Probably Going to Occur?

- Will likely occur during your investment time horizon
- What is your investment time horizon?



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# I'm Good at Forecasting?



- It's not just "guesstimating"
- Can we forecast most alpha-generating events?
  - Systematic vs.
  - Unsystematic
- What other element needs to be forecast, beyond financial estimates?

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## High Quality Catalyst(s)

- Why does a great stock call need a catalyst?
- Some of the more common places to expect catalysts include:
  - Company-sponsored analyst meetings and calls
  - Earnings releases
  - The company's annual pricing, volume, or earnings guidance or projection
  - Deadlines for new legislation, regulations, or court case outcomes
  - Prescheduled announcements by the company's customers, competitors, or suppliers
  - New product releases or significant product extensions
  - Interim sales data, for the company or the sector
  - Non-deal investor roadshows



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# An Analyst's Goal...

## Identify where consensus is wrong

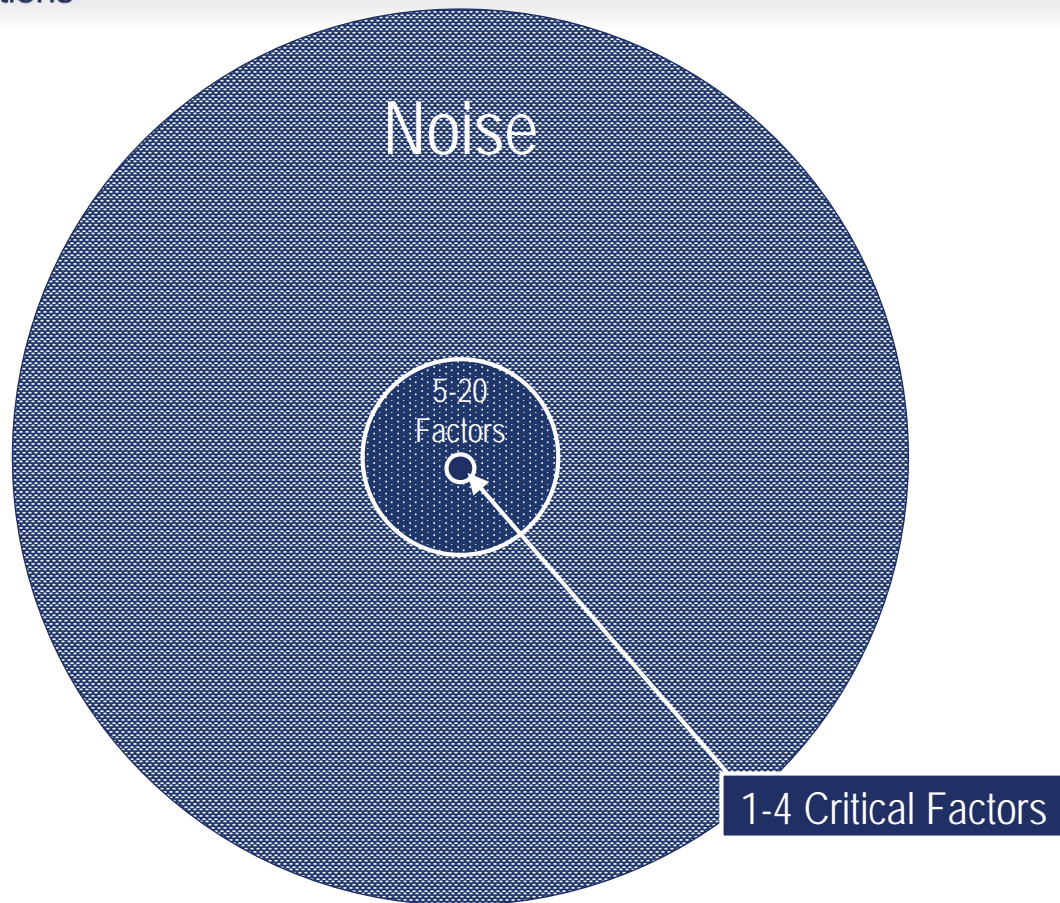
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## Consensus is Poor at Forecasting?

- Tough to generate alpha when others have done work in the same area
- Does consensus have the answer already...
- If not, why not?



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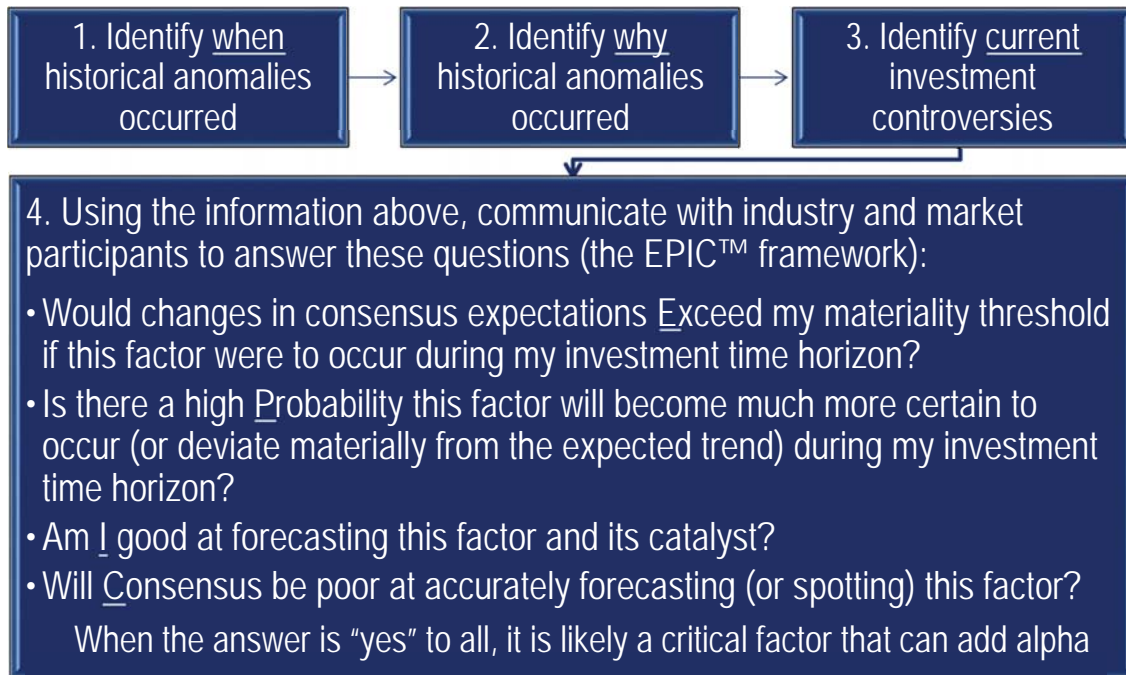


## Agree or Disagree?

“Most of the factors that drive stock prices in the current market place are similar to factors in the past”



# Follow the 4 Steps to Identify Critical Factors



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# Examples of Potential Critical Factors

Sector or Stock	Potential Critical Factor
Amazon.com	Market share shift from traditional retailers
Ford Motor Company	New car pricing in North America
Time Warner Cable	Growth of competing content providers such as Netflix, Amazon and HBO
Interpublic Group (advertising)	Changes in ad spending for traditional channels (e.g. TV, print)
Nike	Top line growth rate keeping up with historical trends
Union Pacific	Freight railroad customer pricing
SolarCity	Growth of renewable energy revenue
The Gap	Apparel pricing deflation
VMware (software)	Growth of Open Source software vs. traditional vendors
T-Mobile	Competitive pricing among the wireless carriers
Walgreens	Generic drug price inflation

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# EXERCISE: EVALUATE YOUR LIST

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Factor to Potentially Be Researched	Total	Total: With Half Weight for "I" and "C"	Total: "E"x"P" added to "I" and "C"
Cost management/productivity/Improved network efficiency	18	13.5	29
Level of fuel surcharge collected	17	13.0	28
Acquisition(s)	15	11.5	22
Ground package volume growth	15	11.0	20
Domestic Express package pricing/yield	14	10.5	19
Ground package pricing/yield	14	10.5	19
International Priority package pricing/yield	14	10.5	19
International Priority package volume growth	14	10.0	16
Service levels other than during the holiday season	14	9.5	15
Change in senior management	13	10.0	16
Electronic documents reducing need for overnight envelopes	13	9.5	15
GDP growth	13	10.5	20
Labor cost trends	13	9.5	16
Domestic Express package volume growth	12	8.5	13
Service levels at holiday season	12	8.0	12
Asia-Pacific volume growth	11	8.0	12
Change in level of tech shippers vs. non-tech shippers	11	8.5	13
Purchase of new aircraft	11	7.5	10
Level of major weather disruptions	10	7.0	9
Depreciation rate	9	6.0	8

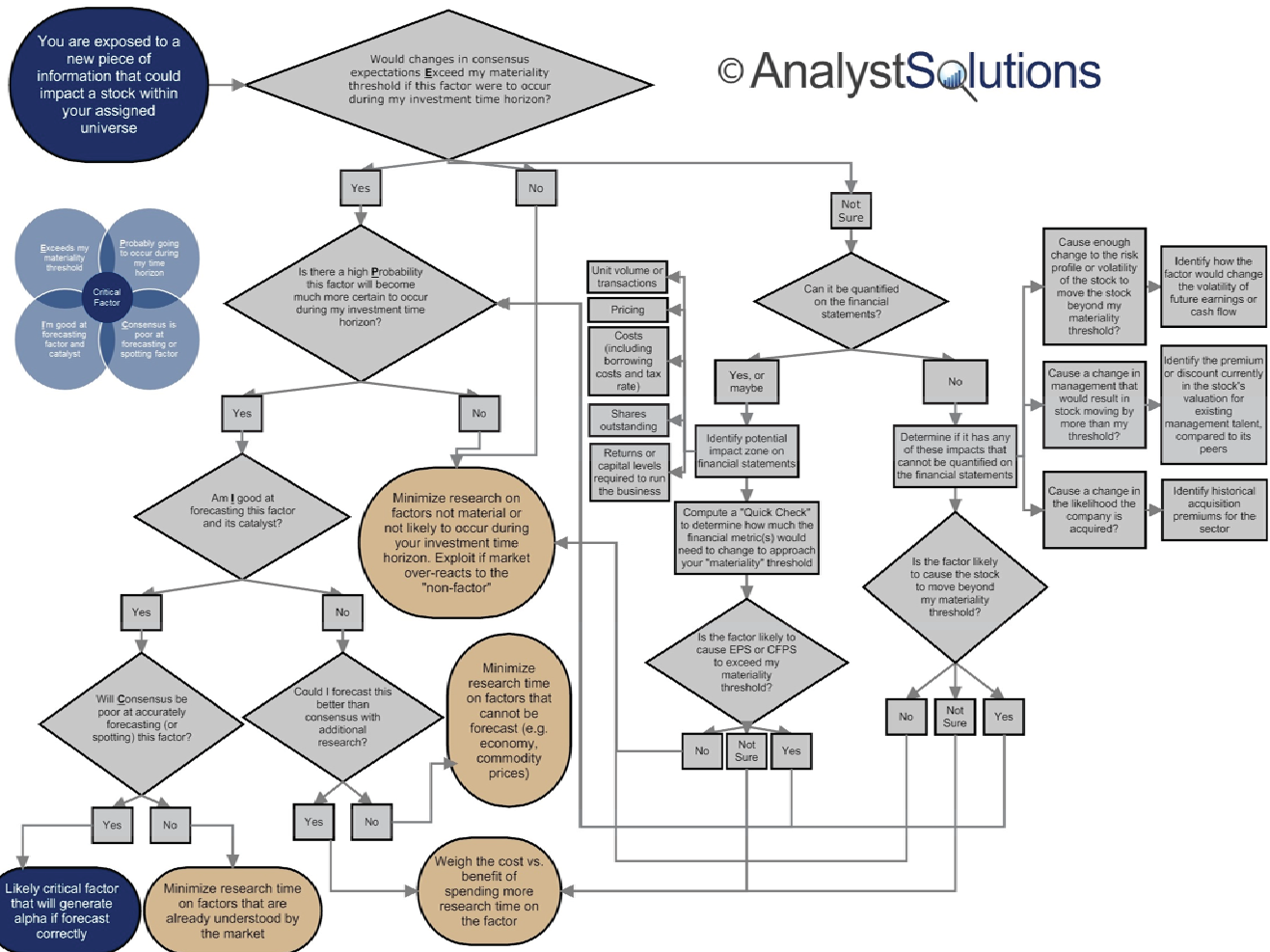


# Review DRC: Identify a Stock's Critical Factors

## Detailed Reference Card (DRC)

### Identify a Stock's Critical Factors

Seek Factors That Meet All Four Criteria Below



# OPTIONAL EXERCISE

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## Seeking Insights Before Defining Critical Factors...

Is akin to setting  
off on a journey  
without a  
destination

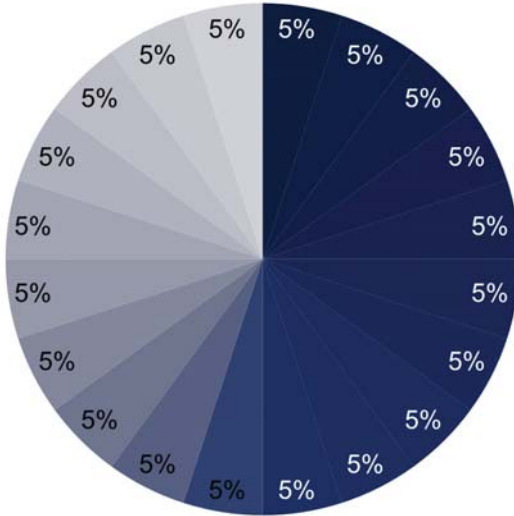


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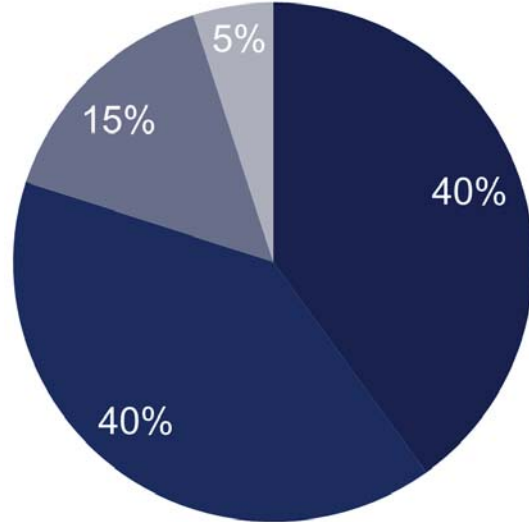


# What Will Your Day Look Like?

**Critical Factors  
Not Defined**



**Critical Factors  
Defined**



# Our Tools



Workshops



One-on-one  
coaching



Assessments



Consulting



Keynote/offsite  
presentations

# Workshops that Address Universal Analyst Needs

- 

Identify & Monitor a Stock's Critical Factors
- 

Generate Differentiated Insights Through Better Discovery, Questioning and Influencing
- 

Apply Practical Valuation Techniques For More Accurate Price Targets
- 

Master the Stock Call Techniques of Highly Experienced Analysts
- 

Communicate Unique Stock Calls Successfully So Others Take Action
- 

Maximize Your Time for Alpha Generation

# Best Practices Bulletins

## 10 Steps for Equity Research Analysts to Perform Better



According to Reuters, one of its sister companies, Lipper, finds that roughly 85% of active large-cap stock funds are lagging their benchmarks year-to-date through late November. Investors are voting with their feet as shown by the \$206 billion of inflows into ETFs through the first 10 months of 2014 vs. only \$36 billion for the...

## Portfolio Managers' #1 Frustration With Equity Research Analysts



While I was studying the Japanese language during college, I initially didn't take notice that the word "chigau" (ちがう) is used to convey both "different" and "wrong." But after moving to Tokyo and learning the importance of conforming to the group, I developed a newfound appreciation for why these two English words require only one...

[Read the Entire Bulletin >](#)

# Questions and Feedback



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Activity  CFA Institute

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## MATERIALS

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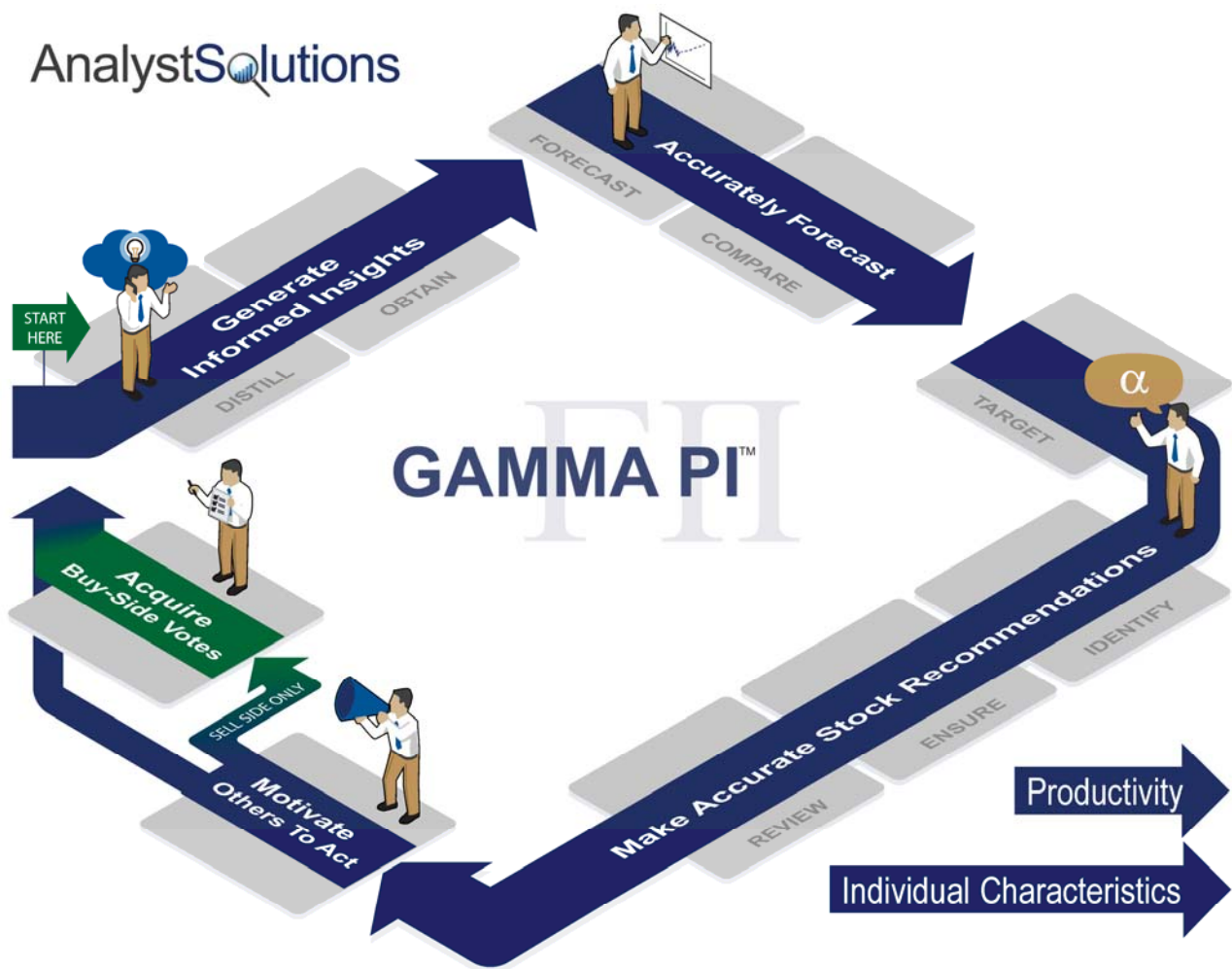
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# Part 1: Identify & Monitor Your Stock's Critical Factors

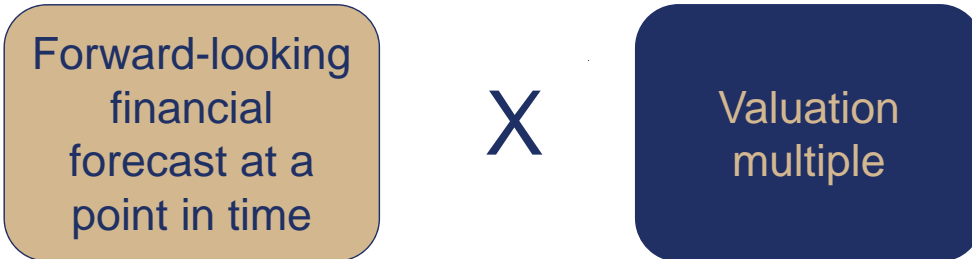
# Part 2: Get Noticed With Differentiated Stock Calls

CE Qualified Activity  CFA Institute

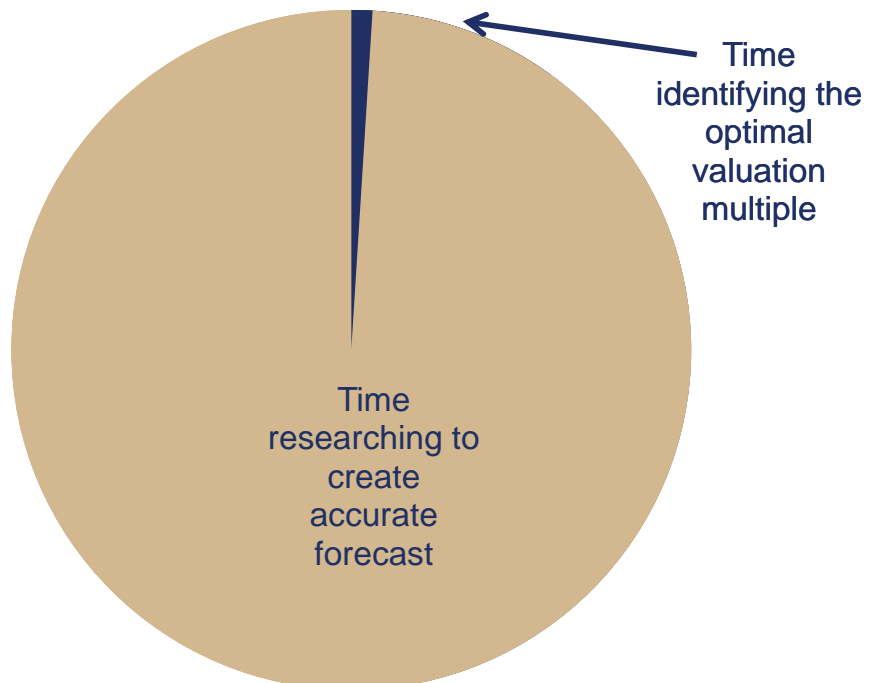
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# Price Target in Its Simplest Terms



# Time Developing Price Target



# HOW DO YOU DIFFER?

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## Ensure a Differentiated Stock Call with a Superior FaVeS™ Insight

### Forecast

- Financial forecast superior to the market (used at least 85%)

### Valuation

- Valuation methodology or valuation multiple superior to the market

### Sentiment

- Forecast of short-term investor sentiment superior to the market



## Forecasting Financial Results that Differ from Consensus

- Start by assuming you're wrong
- Ensure that the “differentiated” element of a forecast is concentrated in an area of expertise or has been thoroughly researched
- Forecast an upside, downside and base-case scenario before making a big stock call to stress test your thesis



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## Ensure a Differentiated Stock Call with a Superior FaVeS™ Insight

### Forecast

- Financial forecast superior to the market (used at least 85%)

### Valuation

- Valuation methodology or valuation multiple superior to the market

### Sentiment

- Forecast of short-term investor sentiment superior to the market

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# Use “Change in Valuation” Sparingly

Stock recommendations tend to fail when they are based solely on the analyst's expectations that:

- The stock's valuation multiple will be re-rated (void of an impending financial forecast change); or
- The market will change its preferred valuation methodology



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## It Might Look Like This...

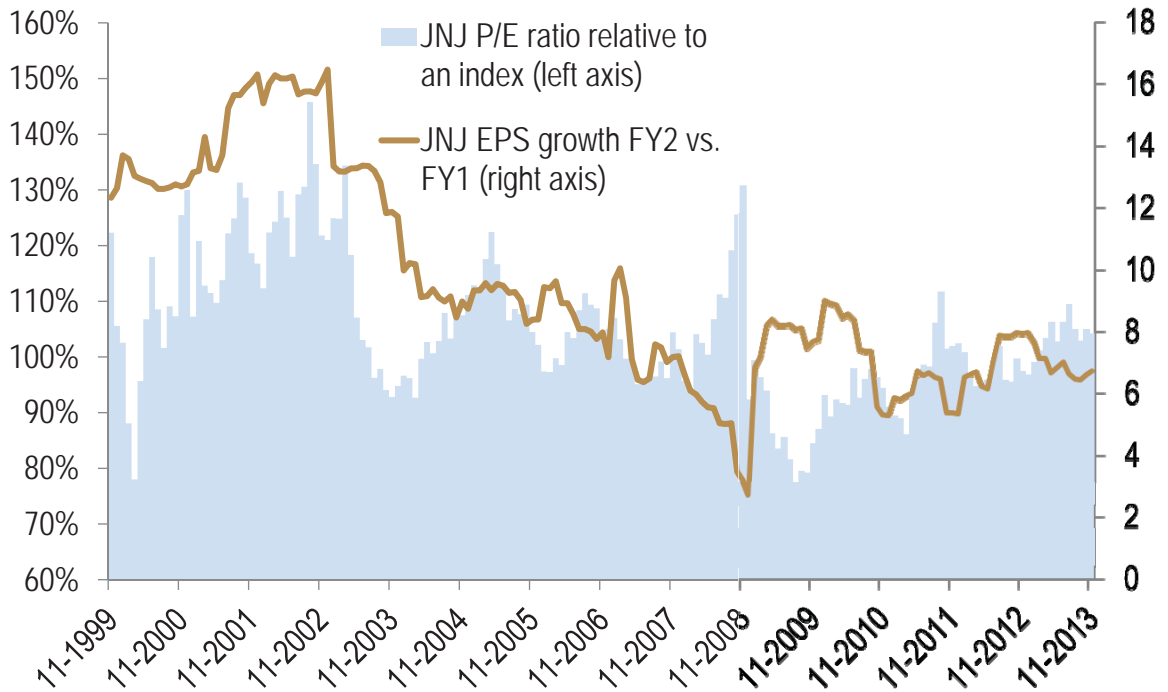
- “We’re upgrading JNJ to a buy-rating with an \$81 one-year price target” (35% upside)
- “Our price target is based on the stock trading at its current 30% premium to the S&P 500 on our \$4.80 EPS forward forecast one year from now”



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# Forecast Future Valuation Multiple?



Covered in workshop: *Apply Practical Valuation Techniques for More Accurate Price Targets*

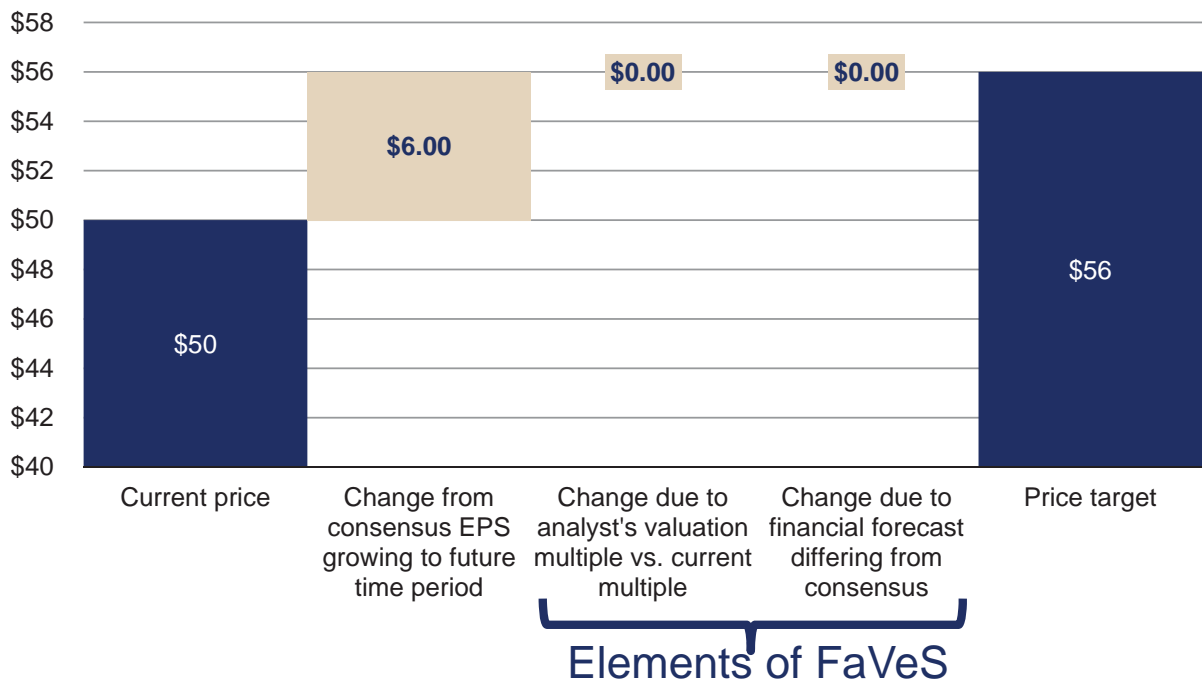
## Get In the “Mind of the Market”



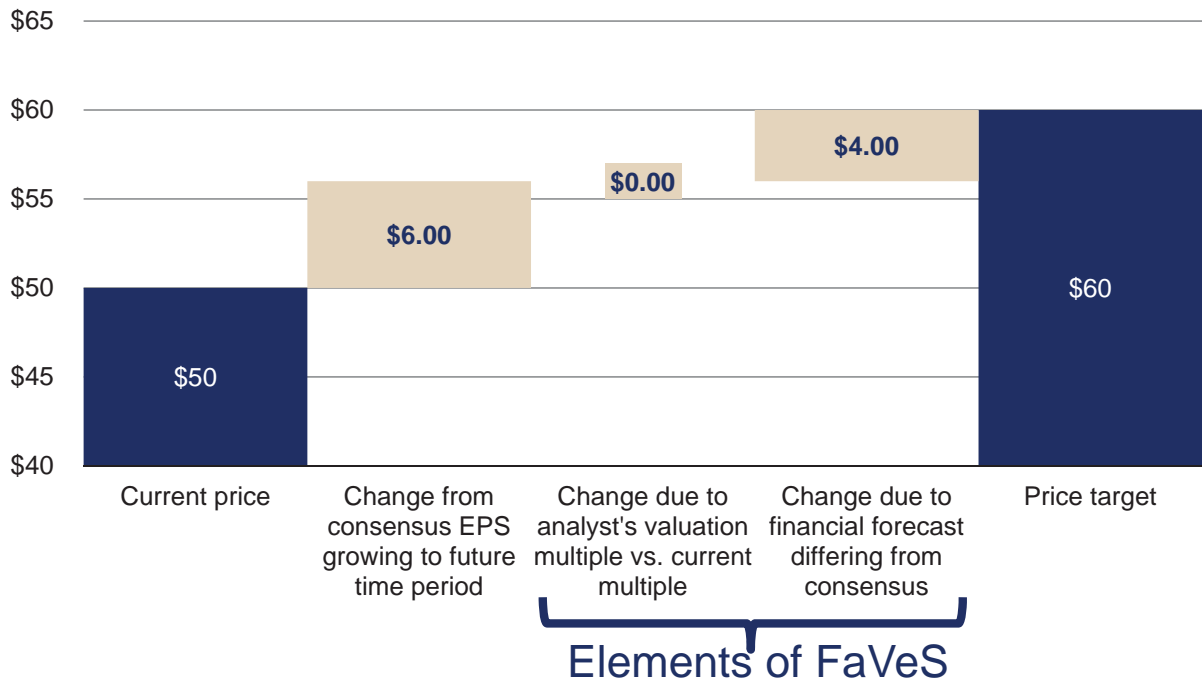
# Quantify “How Do You Differ?”

	Scenario			
	A	B	C	D
<b>1. Current data</b>				
Current stock price	\$50.00	\$50.00	\$50.00	\$50.00
Next 12-month (“NTM”) consensus EPS forecast at present (we call this “Year 1”)	\$5.00	\$5.00	\$5.00	\$5.00
Stock’s current valuation multiple based on Year 1 EPS	10.0	10.0	10.0	10.0
Current market multiple	15.0	15.0	15.0	15.0
Stock’s current premium or discount to the market multiple	-33%	-33%	-33%	-33%
<b>2. Change from consensus EPS between Year 1 and Year 2</b>				
NTM consensus in Year 2 (i.e. forecast at beginning of Year 2 for Year 2)	\$5.60	\$5.60	\$5.60	\$5.60
Difference between Year 2 and Year 1 consensus forecasts	12%	12%	12%	12%
Item #2 above is due to passage of time while #3 and #4 below are influenced by the analyst				
<b>3. Change due to analyst’s financial forecast differing from consensus</b>				
Analyst’s NTM EPS forecast in one year (i.e. forecast for Year 2)	\$5.60	\$6.00	\$6.00	\$6.60
Premium or discount of analyst’s EPS estimate in Year 2 compared to consensus’	0%	7%	7%	18%
<b>4. Change due to analyst’s future valuation multiple differing from current multiple</b>				
Analyst’s estimate of market multiple at beginning of Year 2 (typically keep same as present)	15.0	15.0	15.0	15.0
Analyst’s estimate of stock’s premium or discount to market multiple at beginning of Year 2	-33%	-33%	-27%	-20%
Valuation multiple used for price target at beginning of Year 2	10.0	10.0	11.0	12.0
Difference between analyst’s future multiple and stock’s current multiple				
<b>5. Price target</b>				
Change from current price	12%	20%	31%	58%

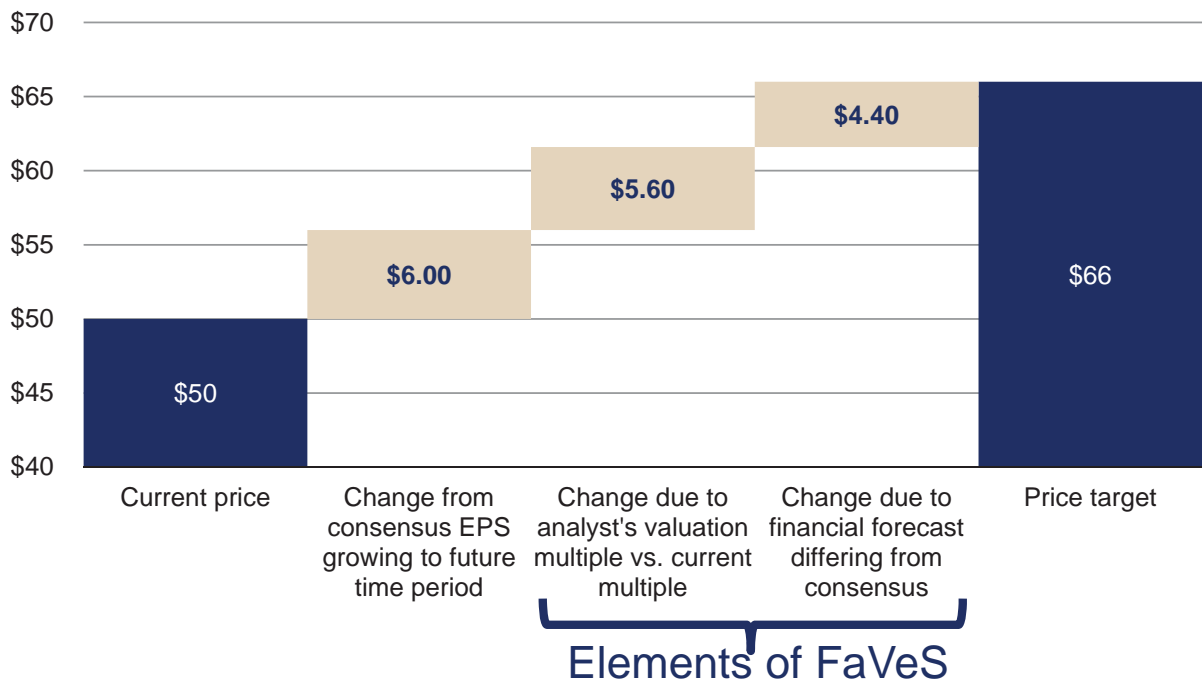
## Dissect How You Differ (A)



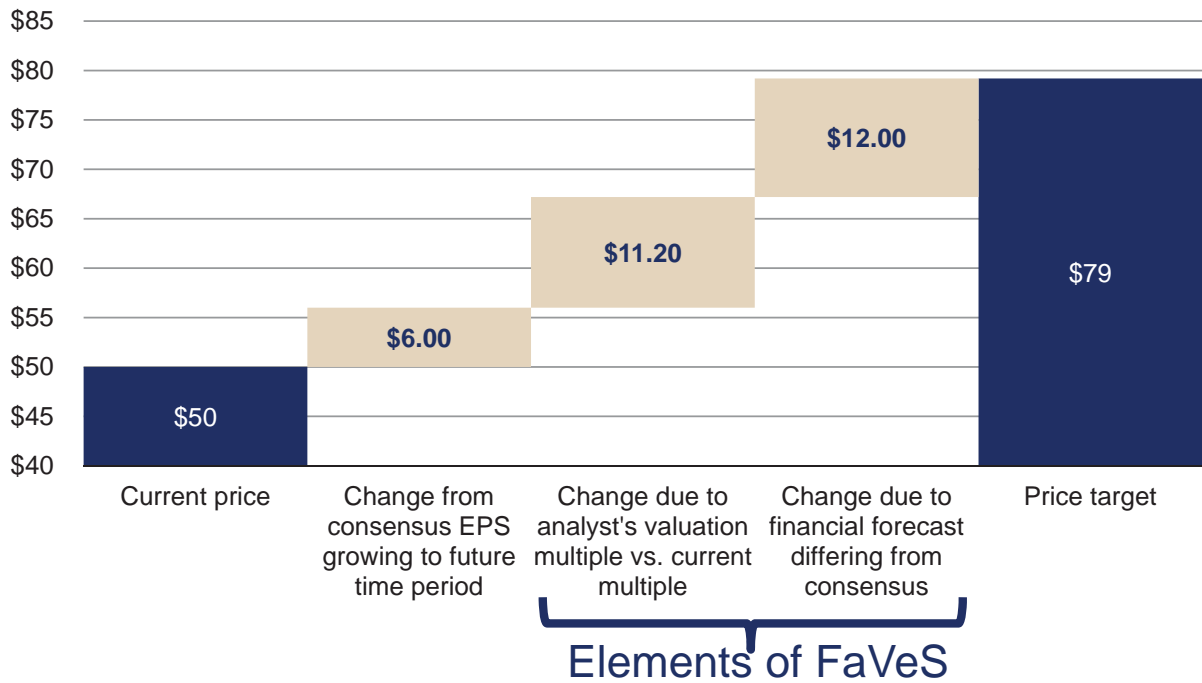
# Dissect How You Differ (B)



# Dissect How You Differ (C)



# Dissect How You Differ (D)



## “HOW DO YOU DIFFER?” EXERCISE

# FIND THE F's EXERCISE

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## Heuristics Mind Trap

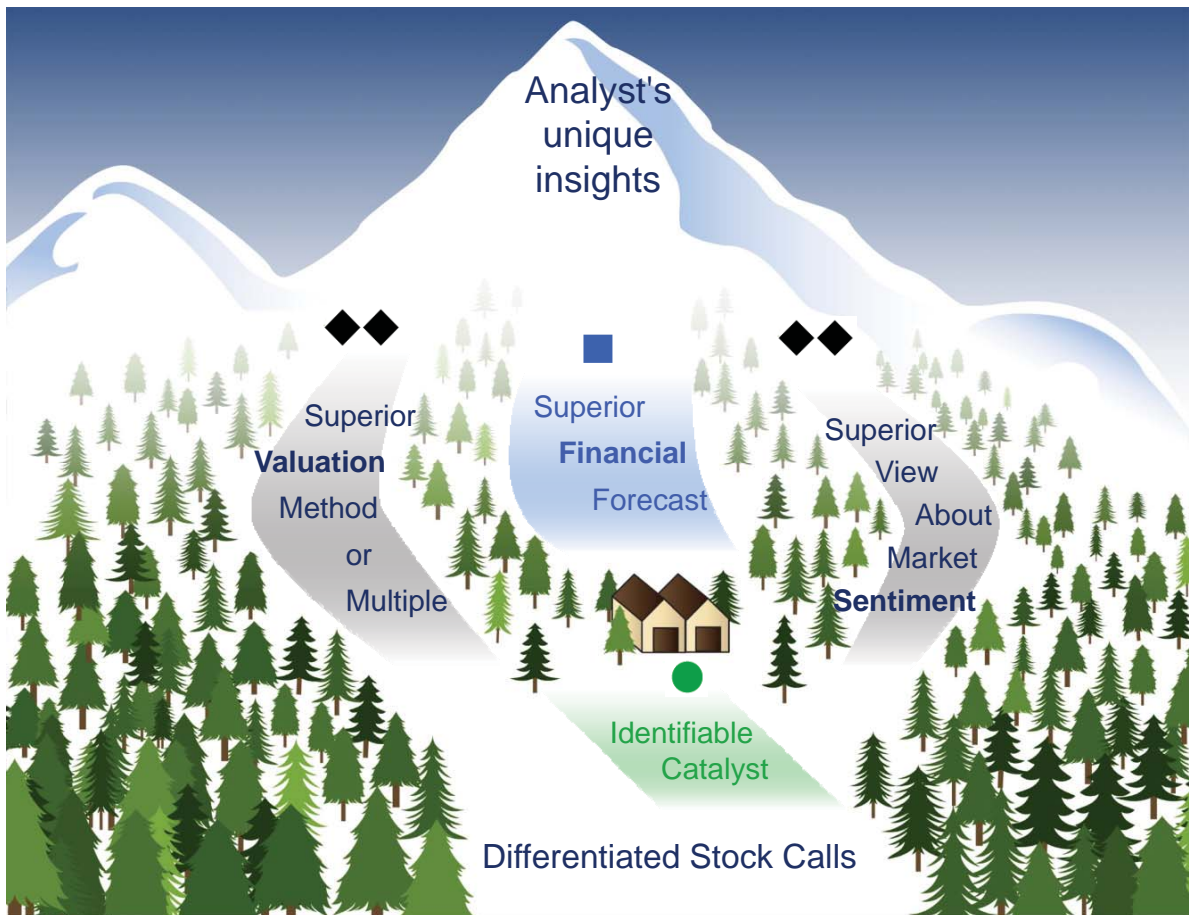
- Problem: Blindly relying on or over-using mental shortcuts (“rules of thumb”) to make investment decisions without checking to ensure they are reliably accurate
- Manifestation:
  - You rarely use rigorous valuation techniques
  - You blindly rely on heuristics without checking the underlying reasoning

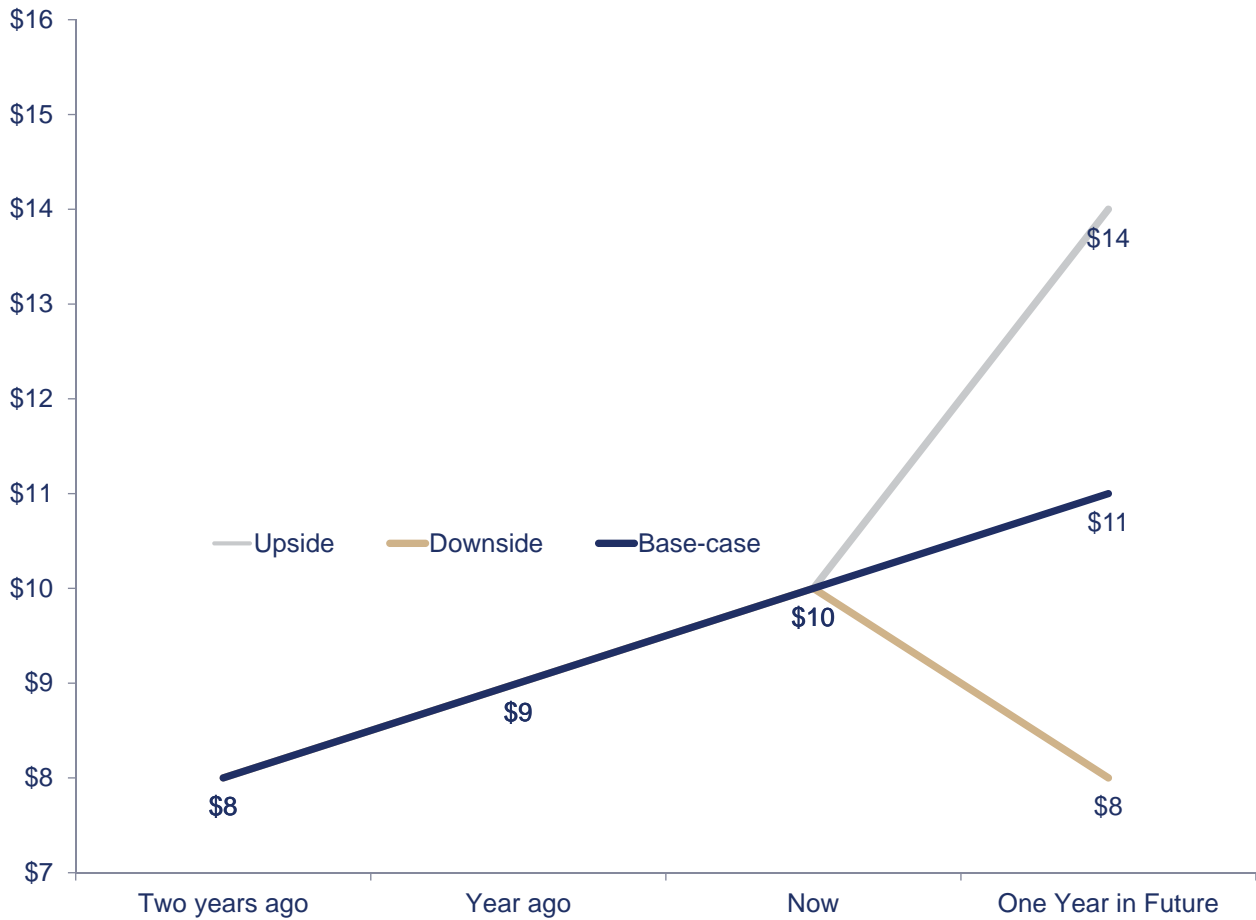


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# Avoid Heuristics Mind Trap

- Make sure that any heuristics you use come from proven facts or historic trends
- If someone tells you to follow a “simple rule” in forecasting or valuation, test it with historical analysis before applying it





## 3 Steps For Communicating Stock Recommendations



### STEP 1: ENSURE CONTENT HAS VALUE (ENTER™ framework)

- Expectational
- Novel
- Thorough
- Examinable
- Revealing



### STEP 2: UTILIZE THE OPTIMAL CHANNEL

- In-person conversation
- Telephone conversation
- Leaving voicemail
- Presenting, five minutes or less
- Presenting, in-depth
- Sending an email or text message
- Writing a report



### STEP 3: ENSURE MESSAGE HAS VALUE (ADVICE™ framework)

- Aware
- Differentiated
- Validated
- Conclusion-oriented
- Easy-to-consume



# Review QRC

## Quick Reference Card (QRC)

Utilize ADViCE™ Template to Maximize Message Delivery Impact

Answer the following questions before proceeding to the “Level 1” Exhibit

# ADViCE™ Framework (1 of 5)

Element	Wording	Why important	Portion of ADViCE™ framework
Level 1 (email, page 1 of report, slides for brief presentation or voicemail script)			
Brief Conclusion	We are or I am... <ul style="list-style-type: none"> <li>recommending the purchase of...</li> <li>upgrading/downgrading...</li> <li>more bullish/more bearish towards...</li> <li>raising/lowering our estimate/price target for...</li> <li>reinforcing/revisiting our positive/negative view towards...</li> </ul> [AND] ...[stock name(s) followed by ticker(s)] because... <ul style="list-style-type: none"> <li>our work shows/suggests...</li> <li>we can now conclude...</li> <li>we have discovered...</li> </ul> [AND] ...[the critical factor(s)] is/will likely... <ul style="list-style-type: none"> <li>be better/worse than consensus/we expected</li> <li>not in consensus expectations</li> <li>occur sooner/later than consensus/we expected</li> </ul>	Allows others to decide if they want to spend more timing consuming your message	Conclusion-oriented



# ADViCE™ Framework (2 of 5)

Element	Wording	Why important	Portion of ADViCE™ framework
Level 1 (email, page 1 of report, slides for brief presentation or voicemail script)			
FaVeS™ element that is being changed (be brief)	<p>Our/my view about [critical factor] compels/allows/motivates us/me to... [here is where you <u>briefly</u> discuss the change in your superior view, as defined by at least one of the following 1) a superior forecast 2) superior valuation method/multiple; or 3) superior short-term read of sentiment]</p> <ul style="list-style-type: none"> <li>...raise/lower our/my earnings/cash flow/growth rate forecast for this year/next year from X to Y, which puts us/me XX% higher/lower than consensus.</li> <li>...justify a valuation multiple of XX, which is XX% above/below its current/historical level.</li> <li>...expect the stock to move XX% up/down in the near-term [only use this option if you have a superior view toward the short-term sentiment towards the stock].</li> </ul> <p>[You may want to explain the FaVeS™ element you are <u>not</u> changing, such as "we assume the stock continues to trade at its current relative valuation multiple."]</p>	Briefly highlights your a) superior forecast (vs. consensus); and/or b) superior valuation method/multiple; and/or c) superior read on short-term sentiment towards the stock	<p><u>A</u>ware (if you are disclosing a change in thinking)</p> <p><u>D</u>ifferentiated</p>

# ADViCE™ Framework (3 of 5)

Element	Wording	Why important	Portion of ADViCE™ framework
Level 1 (email, page 1 of report, slides for brief presentation or voicemail script)			
Price target math	Applying a X [valuation multiple] multiple on our/my XX.00 [EPS, CFPS, BV] estimate for 20XX [time period], results in a year-end/six-month/one-year price target of XX, which is XX% above yesterday's close.	Provides the elements of your price target and return	<u>C</u> onclusion-oriented
Research to support unique FaVeS™ element	<p>[If there is more than one critical factor driving the story, you may want to communicate this element and the one directly below for each critical factor at a time]</p> <p>Our/my conclusion/above/below-consensus estimate is based on... our/my analysis of... discussions with... data we/I collected from... our/my unique modeling of...</p>	Validates view based on fundamental research and not just a hunch or guesstimate	<p><u>D</u>ifferentiated</p> <p><u>V</u>alidated</p>

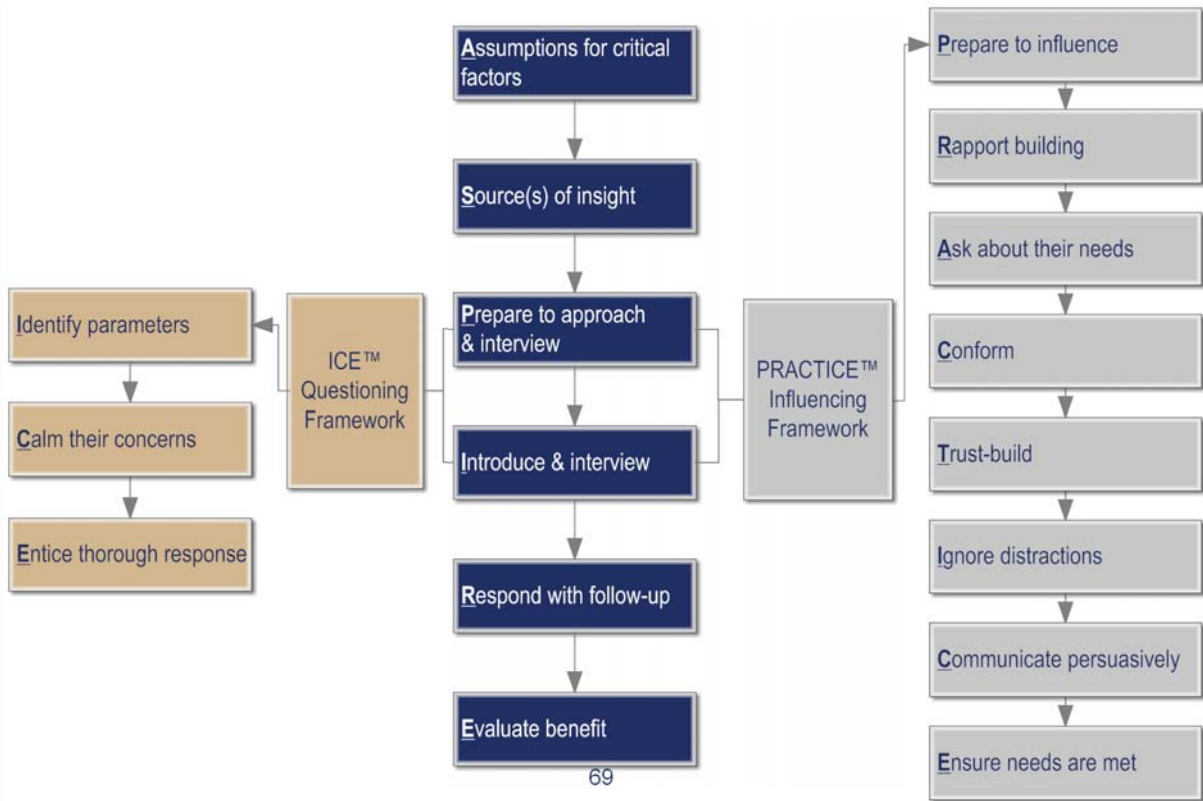
# ADViCE™ Framework (4 of 5)

Element	Wording	Why important	Portion of ADViCE™ framework
Level 1 (email, page 1 of report, slides for brief presentation or voicemail script)			
Quantify unique FaVeS™ element	<p>Specifically, we/I believe this results in \$XX/XX%...</p> <ul style="list-style-type: none"> <li>• higher/lower EPS/CF/BV...</li> <li>• faster/slower EPS/CF growth rate...</li> </ul> <p>...for 20XX [time period] than...</p> <ul style="list-style-type: none"> <li>○ current consensus expectations**</li> <li>○ our/my prior estimate</li> </ul> <p>AND/OR</p> <ul style="list-style-type: none"> <li>• expansion/contraction of the stock's relative/absolute valuation multiple from X to Y</li> </ul>	Answers "materiality" question by quantifying how your view differs from consensus	<u>D</u> ifferentiated <u>C</u> onclusion-oriented
When and why will consensus adopt your view?	<p>We/I...</p> <ul style="list-style-type: none"> <li>• differ from consensus because...</li> <li>• believe consensus does not understand/appreciate...</li> </ul> <p>[reason why consensus hasn't come around to your way of thinking yet]. [AND]</p> <p>We/I believe consensus will adopt/understand our/my view by [specific quarter or time of year] due to [catalyst that will drive the market to your way of thinking].</p>	Explains how view of the catalyst(s) differs from the consensus thinking and when it will become clear to the market	<u>D</u> ifferentiated <u>C</u> onclusion-oriented

# ADViCE™ Framework (5 of 5)

Element	Wording	Why important	Portion of ADViCE™ framework
Level 1 (email, page 1 of report, slides for brief presentation or voicemail script)			
What could go wrong?	<p>We/I have a high/low/modest degree of conviction/confidence in our/my call because [explain why your analysis above is valid or uncertain]. Our/my downside scenario results in a stock price of XX (XX% below yesterday's close) and our/my upside scenario is XX (XX% above yesterday's close).</p>	Conveys your conviction level and provides alternative scenarios to demonstrate you're not oblivious to where you could be wrong	<u>A</u> ware

# Key Frameworks



## Review QRC

# Quick Reference Card (QRC)

### Information Sources Pros and Cons

#### Individual Conversation

Source for Information	Pros	Cons	Confirm or Refute Historical Factors*	Assess New or Emerging Critical Factors	Assess Market Psych.
Buy-side analyst or portfolio manager (as source for buy-	Best place to gauge investor expectations	May not be representative of the larger investor base	□		■

# “RANK YOUR ABILITY” EXERCISE

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## Overconfidence Mind Trap

- Problem: assuming you're smarter than everyone else, which prevents you from exploring the real risks or reasons that a stock is not currently at your price target
- Manifestation:
  - You often put too much confidence in yourself
  - After string of success, you think you can't lose
  - You tend not to properly assess the downside or risk of an investment



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## Avoid Overconfidence Mind Trap

- Remind yourself that no professional investor is right 100% of the time
- Require yourself to fully understand the other side of the trade before making a recommendation
- Ask a trusted colleague or investment committee to scrutinize your thesis
- Any time you think “I can’t lose”, think through the downside or risks of the investment

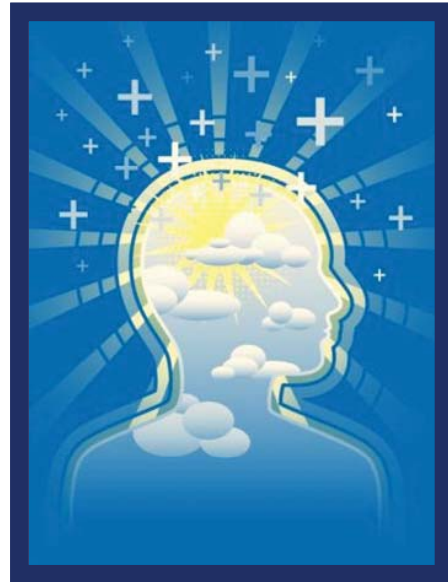
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## “HOW DOES YOUR FUTURE LOOK?” EXERCISE

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# Optimism Bias Mind Trap

- Problem: being too optimistic about your stock's valuation and future earnings potential
- Manifestation:
  - You assume nothing will go wrong
  - You overlook, or fail to investigate, risks of prospective investments
  - You set price targets based on valuations well above historical markers
  - You spend more time thinking of potential gains than weighing potential losses



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# Avoid Optimism Bias Mind Trap

- Research history of your companies and industries (growth rates and multiples). If your forecast is well above historical trends, explain a sound reason for doing so
- Spend as much time identifying risks as opportunities (assume something will go wrong)
- Seek to share your investment thesis with a trusted colleague or investment committee

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# Review QRC

## Quick Reference Card (QRC)

### Best Practices for Eliminating Psychological Biases

Bias	Manifestation	Example	Increasing Self-Awareness
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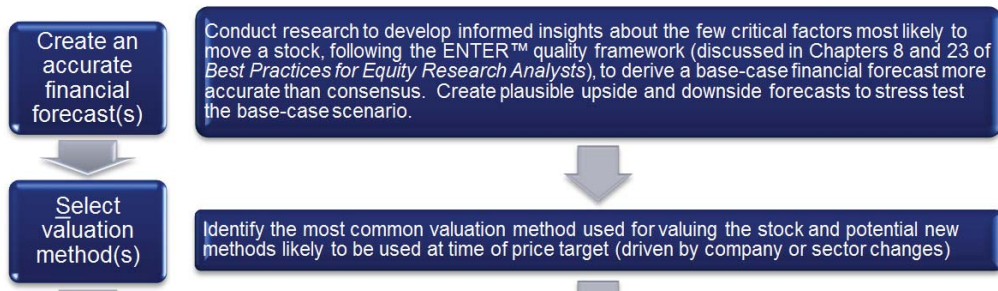
77

# Review DRC

## Detailed Reference Card (DRC)

### Best Practices for Making Accurate Stock Recommendations

**Procedures for Target Realistic Price(s) (Step 1 of TIER™ which includes the SHARE™ framework):**



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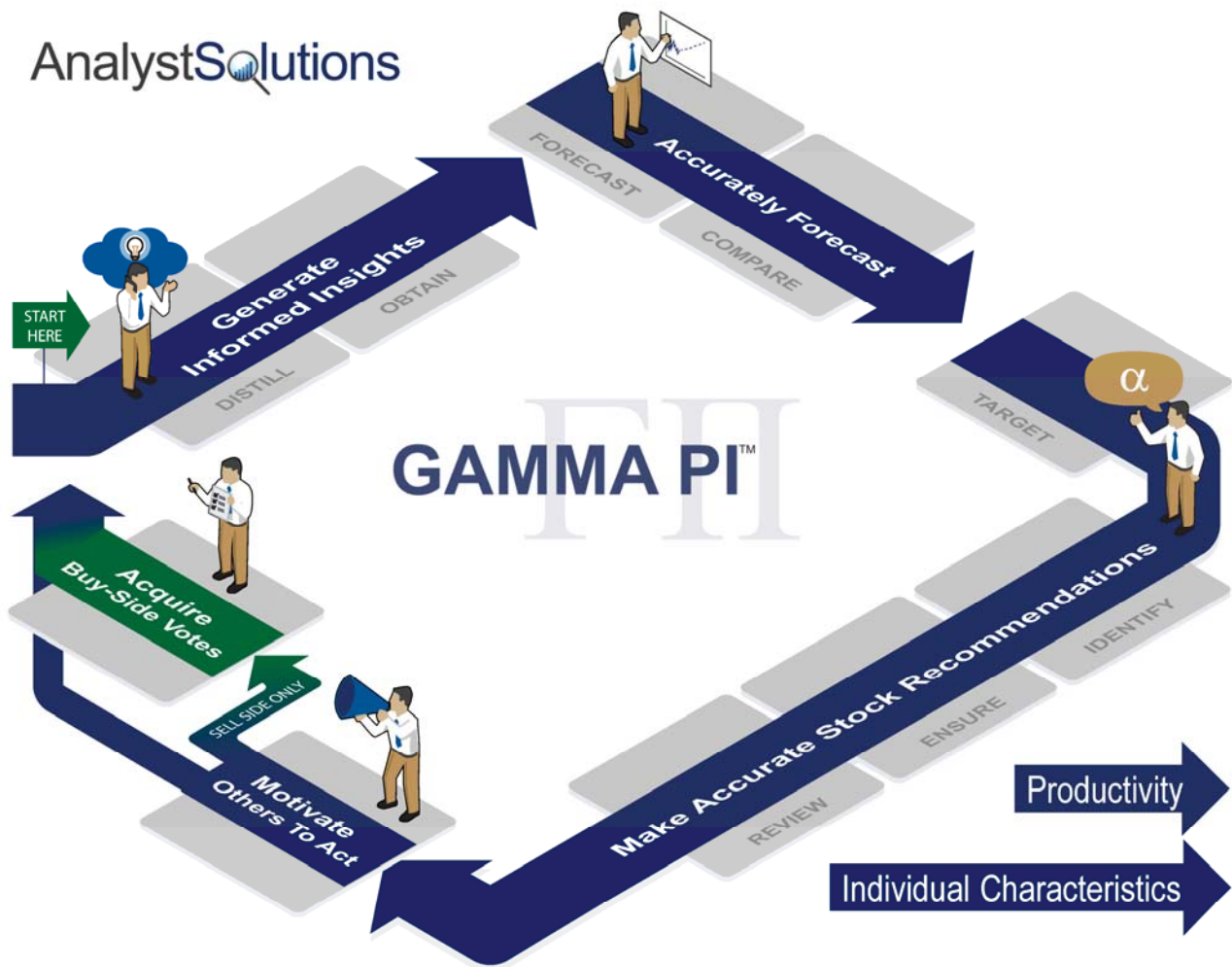


# Review QRC

## Quick Reference Card (QRC)

10 Questions to Ask Before Communicating a Stock Call\*

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# Our Tools



Workshops



One-on-one coaching



Assessments



Consulting



Keynote/offsite presentations

# Workshops that Address Universal Analyst Needs



Identify & Monitor a Stock's Critical Factors



Generate Differentiated Insights Through Better Discovery, Questioning and Influencing



Apply Practical Valuation Techniques For More Accurate Price Targets



Master the Stock Call Techniques of Highly Experienced Analysts



Communicate Unique Stock Calls Successfully So Others Take Action



Maximize Your Time for Alpha Generation

# Best Practices Bulletins

## 10 Steps for Equity Research Analysts to Perform Better



According to Reuters, one of its sister companies, Lipper, finds that roughly 85% of active large-cap stock funds are lagging their benchmarks year-to-date through late November. Investors are voting with their feet as shown by the \$206 billion of inflows into ETFs through the first 10 months of 2014 vs. only \$36 billion for the...

## Portfolio Managers' #1 Frustration With Equity Research Analysts



While I was studying the Japanese language during college, I initially didn't take notice that the word "chigau" (ちがう) is used to convey both "different" and "wrong." But after moving to Tokyo and learning the importance of conforming to the group, I developed a newfound appreciation for why these two English words require only one...

[Read the Entire Bulletin >](#)

# Questions and Feedback

