Utilize the ENTER™ Quality Checklist Before Recommending Stocks

ENTER™ Quality Checklist (to be used <u>before</u> starting the communication of a stock recommendation)	1=Strongly disagree 5=Strongly agree
<u>Expectational</u>	3,7 3
I have a <u>forward-looking</u> view in terms of the stock and the critical factor(s) likely to move the stock	
 I have identified the catalyst(s) likely to move my stock and important dates when the catalyst is most likely to cause the stock to move to my price target 	
When I believe the company management's forecast is relevant, I frame it in terms of my independent financial forecast (rather than just repeat management)	
 When I review historical information or events, it is in the context of considering the <u>future</u> implications to my investment thesis. (I don't dwell on the past for other reasons.) 	
<u>N</u> ovel	
 I have a piece of information or insight that is new and not widely understood within the financial markets 	
 I know where my unique (or superior) view falls within the FaVeS[™] framework (unique <u>F</u>inancial forecast, <u>V</u>aluation method/multiple, or unique view about market <u>S</u>entiment) 	
I know why the market does not have my view	
<u>T</u> horough	
 For critical factors that are key to the stock call, I research more than one source or confirm the insight with an independent source 	
 If the stock call is based on a unique financial forecast, I conduct detailed modeling in the area surrounding the critical factor(s) 	
I avoid using management guidance as the primary justification for the call	
<u>E</u> xaminable	
 If asked, I can provide the following details of my analysis to a trusted colleague(s): Data or insights about the critical factor(s) Detailed financial forecast or valuation analysis, if key to the investment thesis 	
 I clearly separate: Opinion or forecast from Views of others from 	
o Undisputable facts	
Revealing	
 I utilize upside, downside, and base-case scenarios to identify where the investment thesis could have flaws 	
I identify specific risks beyond the macro	
I provide my conviction level to others, even if it is not strong	

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Utilize ENTER™ Quality Framework to Ensure Content Has Value

Philosophy	Put into Action
Expectational : Always be thinking about the future, all in an effort to convey how your expectations differ from consensus, and resist the temptation to focus on the past. Understanding historical trends is important (and much easier than forecasting the future), but only spend time in this area if it helps in forecasting a future stock price move. Think of all of the pointless quarterly write-ups that are the equivalent of reporting last week's weather (rather than predicting future trends).	 Ensure that you have a forward-looking view of the most important critical factors for each company. Identify important dates or events that could be catalysts to cause the stock to perform significantly different from its peers or the broader market. When responding to news flow, such as a company's earnings release, keep asking yourself, "How does this change my <i>forward</i> view?"
<u>N</u> ovel: Identify the piece of information you have that's not in the consensus view, or if responding to news flow, ask yourself, "How is the market misinterpreting the information?" If a company's quarterly results don't change your future view, how is spending time beyond digesting the information helping others? (It's probably not).	 Determine where your information fits into the FaVeS* framework for stock picking. If it doesn't cover one of those areas or a catalyst, it's probably not worth communicating. Ask yourself, "Why would an owner of the stock be interested in learning my insight today?" Avoid the common mistake of communicating information that's not unique (telling someone that a stock is at a 12x P/E multiple, when it should be at a 14x multiple is not novel).
Thorough : Ensure the thoroughness of your research is commensurate with the potential impact on your stock(s) by obtaining insights to accurately forecast critical factors. Most analysts are employed by firms that ask clients to pay for their thorough researchwhich should go beyond just accepting management guidance.	 Have more than one source of information to confirm an out-of-consensus critical factor when it's imperative to your stock call. Create a financial forecast that's detailed enough to test your hypothesis (e.g., if it's a call on product pricing by segment, there should be historical and forecasted segment pricing in the model). Use management guidance sparingly (discuss management guidance to show how it <i>contrasts</i> with your view, not as your primary source of information).
Examinable : The best way to raise the quality of any piece of professional work is to expose it to talented peers. It's not necessary to reveal proprietary sources, but effort should be made to provide enough depth to others (investment committee, trusted colleague, etc.) to see if they would draw the same conclusion.	 Collect all of the important data points for others to arrive at your conclusion, including upside and downside scenarios. Clearly separate: Your opinion or forecast from Views from others from Undisputable facts Prepare your financial forecast and valuation framework so you can provide others enough detail to see the assumptions for your critical factors and price target(s).
Revealing: Identify specific risks not in your base-case scenario, both positive and negative, by determining why the market believes the stock's current price is more correct than your price target. For an out-of-consensus stock call, assess your conviction level to allow others to gauge the risks to your thesis.	 Conduct upside and downside scenarios in addition to your base-case scenario. Don't just identify only general macro risks, such as, "the economy might slow" or "inflation may accelerate," but include risks to the critical factors where you are out of consensus. For your own use, write down why you have your current level of conviction, and what it would take to change it.

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Best Practices for Making Accurate Stock Recommendations

Best Practices for Making Accurate Stock Recommendations Using the TIER™ System:

<u>Target</u> realistic price(s)

When forecast is reliable (discussed in preceding framework), derive a range of price targets by applying an objective and defendable valuation multiple(s) and method(s) (using our SHARE™ framework)



Identify &
 forecast
 catalyst(s)

If price target differs materially from current stock price, identify and forecast catalyst(s) most likely to lead to convergence



Make stock recommendation, if:

Ensure ideal entry point

- The out-of-consensus element (FaVeS™) is wellresearched; and
- The catalyst is likely to occur during the investment time horizon; and
- The risk-adjusted return to the price target is better than alternative investments; and
- There are no clear near-term risks that will offer a better execution point





<u>R</u>eview performance & thesis

Remove stock recommendation if:

- The risk-adjusted return to price target is below alternative investments; or
- Out-of-consensus view or catalyst is not likely to occur during investment time horizon

Best Practices for Making Accurate Stock Recommendations

Perspectives for Generating Informed Insights (these fall under the "G" of our GAMMA PI™ framework, and are critical before starting TIER™)

Accuracy vs. Speed:

Successful research
balances the need to
collect enough insights
to be reasonably
accurate, without
spending so much time
that the new insights are
ultimately discovered by
the broader markets

Don't drown: Some analysts are asked to cover too many stocks, which prevents them from developing differentiated insights required for successful stock calls



Perspectives for:

Generating Informed Insights



Be unique: The key to developing unique insights is to have unique information sources (relying heavily on widely-available data will not lead to alpha-generating stock calls)



Focus on critical factors:

Successful analysts narrow their research focus to a few (usually 2-4) critical factors per stock in an effort to develop uniquely differentiated insights not found in consensus (we recommend using AnalystSolutions' 4-step process for identifying and monitoring a stock's critical factors)

Best Practices for Making Accurate Stock Recommendations

Perspectives for <u>A</u>ccurately Forecast (these fall under the first "A" of our GAMMA PI™ framework, and are critical *before* starting TIER™)

Don't look for precision if it doesn't add value:

Minimal research time should be dedicated to forecasting:

- Required rate of return for equity or the risk-free rate. Nobody has the perfect number. There are experts who can provide great precision, but even these come with a list of caveats. Great stock picks come from identifying a critical factor missed by the market -- not from computing a DCF variable
- Factors that cannot be forecast with accuracy (e.g. commodity prices, the next recession, political unrest)

Analyze analysts:

Buy-side analysts, who use sell-side analysts for financial forecasting, should check with third-party services to ensure that the ones they use have a good track record of high forecast accuracy



Avoid blind faith:

Analysts should avoid the common rookie mistake of having forecasts higher than consensus, simply based on greater faith in an unproven or weak management team

Assume you're wrong: When analysts' financial forecasts differ materially from consensus, they should assume their forecasts are wrong until they can substantiate otherwise (the collective wisdom of consensus is often correct). Steps to find the most valid "consensus" estimate:

- If there is a material difference between the most accurate sell-side analysts ("informed" consensus) and the overall consensus number, put more weight on the accurate forecasters
- Ensure the published consensus estimate includes many estimates, and is not isolated to just a few who happen to have forecasts for the time period being reviewed (such as 2 or 3 years out)
- Ensure the individual estimates are not stale, and that there is no disagreement in terms of special items that may be in the number

Best Practices for Making Accurate Stock Recommendations

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

Create an accurate financial forecast(s)

Conduct research to develop informed insights about the few critical factors most likely to move a stock, following the ENTER™ quality framework (discussed in Chapters 8 and 23 of Best Practices for Equity Research Analysts), to derive a base-case financial forecast more accurate than consensus. Create plausible upside and downside forecasts to stress test the base-case scenario.



Select valuation method(s)

stock.

Identify the most common valuation method used for valuing the stock and potential new methods likely to be used at time of price target (driven by company or sector changes). Consider using an alternative valuation method only if it will help in identifying a mis-priced



Historical & current sentiment



Identify if a stock's current valuation is 1) on trend compared to past; and 2) in line with stocks that have similar characteristics



Adjust for future time period



Adjust the current multiple for the future price target by assessing: 1) The future direction of strongly-correlated company-specific and macro variables; and 2) Comparisons with other stocks that have similar prospects









Evaluate as

circumstances

change

Apply the appropriate valuation multiple(s) to the financial forecasts to derive a range of price targets, which provides an objective risk/return profile:

- •Rather than set a single-point price target, set a range of targets, based on upside, downside and base-case scenarios above
- In advance of making a stock recommendation, set a range of exit thresholds (they may be within the "upside" and "downside" scenarios), which will reduce biases from creeping into decisions at a later date
- •Help reduce anxiety by rigorously developing a "worst-case" scenario before recommending the stock (which may be worse than the "downside" scenario)



Update price target when:

- •There is a new financial forecast, including as time passes, leading to new forward forecast period (e.g. "next 12 months" changes each month)
- •There is a justifiable cause to revise the multiple (not just reverse engineering)
- There is a justifiable cause to revise the method (use this sparingly)

Best Practices for Making Accurate Stock Recommendations

Perspectives for <u>Target Realistic Price(s)</u> (Step 1 of TIER™)

Momentum stocks can defy rational valuations:

Rapidly growing stocks (e.g. technology) are often owned by momentum players, and can defy rational valuation levels until approaching more average growth levels

Avoid "incrementalism":

Avoid raising your price targets in small, incremental steps while waiting for "further clarification" because it prevents others from seeing the true upside in your call



Perspectives for:

TARGET REALISTIC PRICE(S)



Beware of the temptation to use unproven valuation methods: Avoid new valuation methods, because it's not clear they are necessary. The "price-to-eyeballs" method used to justify valuations at the peak of the dot-com era is noteworthy.

Avoid hitching your recommendation to simplistic valuation arguments:

Stock recommendations based solely on the expectation that a stock's valuation multiple will be re-rated (void of an impending financial forecast change), or that the market will change its preferred valuation methodology, are rarely successful. (Sell-side analysts may lose client trust and respect from buy-side clients when these calls lack support.) Major changes to valuation methodologies or multiples tend to occur only when companies or sectors are:

- •At the peak or trough inflection points of the business cycle
- Moving from one phase to another of a company's or industry's life cycle (e.g. growth to maturity)
- Going through a major secular transformation or restructuring

Best Practices for Making Accurate Stock Recommendations

Procedures for Identify & Forecast Catalyst(s) (Step 2 of TIER™):

Identify & forecast potential catalyst(s)

For stocks being recommended (buy or sell), identify and forecast potential catalysts that would need to occur in order for the market to accept your out-of-consensus thesis. Be specific by estimating the <u>future</u> earnings or cash flow impact in areas such as:

- Pricing
- Volume
- Costs
- Margins
- Free cash flow
- Returns
- EPS growth rate





Focus on catalysts that meet the optimal criteria

Narrow down to the optimal catalyst(s) and ensure it meets all of these criteria:

- •Pertains to a critical factor that is material enough to move the stock
- •Likely to occur during the investment time horizon
- Not currently appreciated by the market
- Can be forecast with some level of certainty



For recommended stocks, proactively put dates in a calendar for the following types of events, with the expectation that information pertaining to a catalyst will emerge and move the stock:

- •Outcome of your proprietary research (field trip, survey, etc.)
- 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 (sometimes announced at major industry conferences)
- •New product releases or significant product extensions
- •Interim sales data for the company or the sector
- Non-deal investor roadshows

Proactively prepare for next catalyst

Best Practices for Making Accurate Stock Recommendations

Perspectives for Identify & Forecast Catalyst(s) (Step 2 of TIER™):

Ensure your catalyst has a defined timetable:

Predict the catalyst before recommending a stock, or suffer the risk noted by John Maynard Keynes when he said, "Markets can remain irrational a lot longer than you and I can remain solvent."

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

Use "change in



Don't equate a "cheap stock" to a "good idea": Avoid recommending low-valuation stocks simply because they are "cheap" – often stocks are cheap for a reason, otherwise known as a value trap. Identify a reliable and likely catalyst that will make them "less cheap."

Review "value" stock calls that no longer screen as "value":

If a stock experiences a strong move and no longer looks cheap, identify a major catalyst that will justify higher valuations or attract a new class of investors (e.g., GARP or growth) before assuming the stock will move any higher.

Best Practices for Making Accurate Stock Recommendations

Procedures for Ensure Ideal Entry Point (Step 3A of TIER™), Validate Your View

Avoid costly psychological shortcuts

Avoid the mind traps we've identified as "costly psychological shortcuts" that tend to appear early in the process, including familiarity, availability, and recency biases as well as over-reliance on heuristics.



Ensure the stock recommendation is <u>differentiated from the consensus thinking</u> in at least one of the areas below (the FaVeS[™] framework discussed in Chapter 20 of *Best Practices for Equity Research Analysts*):

Forecast of financial results, such as EPS or cash flow

Valuation multiple or methodology

These often include:

Sentiment of the market toward the stock (void of an impending change to the forecast or valuation multiple/method)



Avoid the mind traps we've identified as "Pollyannaish or hopeful thinking" which include confirmation, over-confidence, self-attribution and optimism biases



Among the universe of available stocks to recommend, ensure factors beyond just absolute return are given priority as part of the pending recommendation (i.e. risks).

Weigh risk as well a return

- Predictability of earnings or cash flow forecasts that drive thesis
- Conviction in the catalyst occurring and moving the stock to the price target
- Reliability that management will deliver on its goals
- •Timing for when the catalyst will occur (e.g. next month or 2 years from now?)



Ensure no imminent

danger

_



Ensure there are no clear near-term risks that will offer a better execution point, such as the company falling short of current quarter expectations. This may seem like common sense, but too often an analyst will recommend a stock based on a long-term thesis and fail to appreciate that the stock will remain weighed down in the near-term. Examples include:

- Current guarter's consensus expectations are opposite your long-term view
- •A large class of investors are still exiting (growth investors selling after a stock appears to be moving into the maturity phase)
- The current economic cycle appears to be reaching its peak
- •A large management lock-up is about to expire



Document thesis

Avoid the "loss-aversion" mind trap by documenting the thesis and the price target specifics before making the recommendation. Also establish a stop-loss price to reduce the downside risk and as a place to re-evaluate if the unique insight isn't playing out as expected.



Before changing a rating, reduce anxiety and the overreaction bias by contemplating it overnight (assuming time allows). "Sleeping on it" usually provides more objectivity than making a quick decision during a workday.

For registered AnalystSolutions participants -- not to be re-distributed

Best Practices for Making Accurate Stock Recommendations

Procedures for Ensure Ideal Entry Point (Step 3B of TIER™), Assess and Influence the Market's View





Know consensus



Survey market sentiment



Avoid following the herd



Monitor technical indicators



Influence the market

Monitor trading data to understand the motivations of the current stock holders

- Changes in the types of investors who own the stock (e.g. value, GARP, growth, momentum). This can be done with Bloomberg's HDSM function. and FactSet's "Comprehensive Ownership Detail Report")
- Short interest
- · Company insider buying and selling
- Movement of stock compared to company's debt yield or CDS spreads



Analyze the consensus estimate, specifically determining:

- How many analysts comprise "consensus" (more than 1 or 2 in outer years?)
- Are their estimates disparate or similar?
- Are any estimates stale?
- •Does the consensus of the most accurate analysts differ from the overall consensus?



Assess market sentiment about the stock and sector (which is done by the best buy-side and sell-side analysts) by surveying experienced buyside and sell-side analysts, sell-side salespeople, traders, and investor relations contacts. Investigate:

- Biggest investor concerns (may or may not be a critical factor)
- •Expectations that are above or below the published consensus
- •The names and types of stocks receiving the most/least attention (where is everyone spending their time and what's being ignored?)
- General view toward the market (bullish or bearish) and risk (risk-on or risk-off)



Avoid the mind traps we've identified as "Following the herd" which include overreaction and momentum biases



Monitor technical indicators to the extent they provide a better understanding of a stock's momentum (beware they will not predict inflection points).



In order to get the consensus' thinking to come around to the analyst's out-of-consensus view:

- Sell-side analysts should publish their view and influence key market participants
- If allowed by their firm, buy-side analysts should inform the most influential sell-side analysts of their thesis, but only after the buy-side analyst's firm has built a position in the stock

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Best Practices for Making Accurate Stock Recommendations

Perspectives for Ensure Ideal Entry Point (Step 3 of TIER™), Part 1: General

Know why you differ: If the upside to your price target is materially different than the expected upside in the broader market, determine

Financial forecast? Valuation multiple?

which of your areas

disagrees with consensus:

Keep it simple: the more complex the investment thesis, the more things can go wrong or be misunderstood by the market.

Don't be a contrarian just to be a contrarian — the market tends to be right more than it's wrong. But when individual stocks or sectors appear to be moving too far too fast for irrational reasons (not based on fundamentals), consider the contrarian view.

Be adaptable to different investment styles: No single investing style will be successful over every time, period. Analysts should have a toolbox containing different approaches and know when to use them.



General perspectives for:
ENSURE IDEAL ENTRY POINT

Understand that shorting stocks has unique challenges:

Shorting stocks (without a corresponding long) is a challenge because equities, as an asset class, rise over time.

Understand that the "right time and place" for a stock call can be determined by the market's risk appetite: Avoid making individual stock calls in isolation of the market's appetite for risk (i.e. resist recommending weaker companies when the market's risk appetite is waning, such as near the end of an economic cycle). The market's relative appetite for risk can be gauged by monitoring:

- Treasury yields
- VIX
- The size of the deal calendar
- Recent stock performance of:
- Weak companies versus stable companies
- Emerging markets versus developed markets
- Small cap versus large cap

Spending time to avoid the blow-up is useful:

Don't waste time researching non-critical factors, but also understand conducting research on critical factors and then deciding not to recommend the stock can be very valuable. Namely, avoiding the blow-ups is often one of the best contributors to a successful stock picking record.

Best Practices for Making Accurate Stock Recommendations

Perspectives for Ensure Ideal Entry Point (Step 3 of TIER™), Part 2: Avoid Psychological Pitfalls

Avoid "over-confidence" biases by remaining humble and realizing that no professional investor is right 100% of the time Avoid the sunk-cost pitfall bias by being willing to reverse a recommendation if a mistake has been made, or a thesis failed to play out

Avoid the "familiarity" and "availability" biases by not recommending one stock over another simply because it's the one most researched

Don't force a rating:
There may not be any
substantially under- or
over-valued stocks within
an analyst's universe at a
given point in time and so
don't force a buy or sell
rating just because
you've sunk time into
your research (Sunk Cost
pitfall)

"Avoid Psychological Pitfalls" perspectives for:

ENSURE IDEAL ENTRY POINT

Avoid following the herd (see next page dedicated to this)

When there's hesitation to change a rating for reasons other than maximizing alpha, there may be emotions clouding the decision

Avoid "recency" bias by not making recommendations where the stimulus is primarily based on a recent meeting or call with company management, especially if the contact was initiated by the company

Best Practices for Making Accurate Stock Recommendations

Perspectives for Ensure Ideal Entry Point (Step 3 of TIER™), Part 3: Avoid Following the Herd

Understand that human emotions cause markets to always overreact on the upside and downside – nimble investors can exploit this Increase the urge to sell when everyone loves a sector or stock, and buy when no one wants to own it. Be especially cautious when a stock or sector has had strong relative performance for multiple quarters, by asking, "Who is left to buy?" A few telltale signs to sell are when:

- · Valuation is reaching or exceeding peak levels
- All or almost all sell-side analysts have buys on a stock
- The general view in sell-side reports and the financial press is, "It's different this time," or, "Nothing can go wrong."
- ·The stock no longer reacts positively to good news

Observe when bad news no longer makes stocks go down, or when good news no longer makes them go up; it's a sign that market psychology is shifting

Making impulsive stock calls usually leads to problems

If a substantial move in a stock was missed, be hesitant to chase it such as jumping on the bandwagon. Making the same trade as everyone else begs the question, "Who's going to take the other side of the trade when you want to get out?"

When a stock appears to have dropped too much due to new concerns, avoid waiting for the market to get "greater clarity" about the risk, because it will be too late. The lack of clarity creates an opportunity to exploit!

"Avoid Following the Herd" perspectives for:

ENSURE IDEAL ENTRY POINT

If long a stock, avoid panicking when other investors who are short the stock attempt to over-blow the impact of negative news flow.

Observe when a stock continually overreacts in one direction to news flow during a relatively short period of time, because it could be a sign of irrational buying or selling.

To be successful in deep value investing, watch for investors to capitulate before building a position

Use a short squeeze as a short-term selling opportunity, due to the panic buying (these tend to be short lived, and as such, shouldn't be used as the rationale for setting a price target.)

w concerns, iting for the get "greater out the risk, t will be too ack of clarity opportunity xploit!

Before making a recommendation, determine where your psyche is on the "greed vs. fear" spectrum compared with consensus. If it's in the same place as consensus, the trade may simply be

following the herd.

For registered AnalystSolutions participants -- not to be re-distributed

Best Practices for Making Accurate Stock Recommendations

Perspectives for <u>E</u>nsure Ideal Entry Point (Step 3 of TIER™), Part 4: Factors Influenced by Company Management

The "cockroach theory" is not just theory: Don't under-appreciate something otherwise deemed a "minor" issue with a company, that could foretell of bigger problems

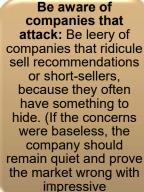
Are you being objective or courting favor?: If there is concern about upsetting company management (or clients) based on a rating change, there's likely a bias negatively influencing objectivity about the change

Question management guidance when:

- Always bullish
- Product order lead times are coming down
- It says "It's different this time"
- It says higher revenue growth will offset declining margins
- It looks to cost cutting or assets sales to drive most of its earnings growth

"Factors
impacted by
company
management"
perspectives for:

ENSURE IDEAL ENTRY POINT



performance.)



Management should focus on execution:

Be cautious of management when it spends more time talking about its stock price or stock performance than running its business

Does management have enough skin in the game:

To have a high conviction about a buy recommendation, the stock should be a large portion of top management's net worth (or management is acquiring more stock). Conversely, question a high conviction buy-rating if management has been selling stock.

Best Practices for Making Accurate Stock Recommendations

Procedures for Review Performance and Thesis (Step 4 of TIER™)

Dynamically rank and review



Review your comparison ("comp") table regularly (i.e. daily or a few times each week). To provide the best analysis, the table should:

- Update stock prices automatically
- Update your EPS (or CFPS) and consensus' forecasts automatically
- Include for each stock:
- Valuation relative to an index
- Valuation relative to stocks in other sectors with similar growth and return characteristics
- Historical relative valuation parameters (on a forward-looking basis)
- •The upside/downside to price target, adjusted for risk
- · Allow for quick sorting based on the metrics above

Avoid "fear of failure"



Avoid the mind traps we've identified as "Fear of failure" which include sunk cost fallacy, loss-aversion, anxiety and snakebite effect



Review original documentation

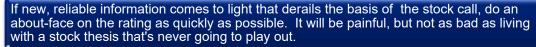


loss-aversion, anxiety and snakebite effect

Periodically review your original thesis (as documented at the time of the original recommendation, such as in your model, report or presentation) for these reasons:

- •When a stock call is going well, avoid the over-confidence and self-attribution biases by reviewing if the thesis is truly playing out or if it is more luck
- •When a stock goes poorly, be disciplined about using the stop-loss thresholds created at the time of the original recommendation. Due to the "loss aversion" psychological pitfall, it's much more difficult to create objective stop-loss points when a stock has not played out as expected.

Re-think recommendation if thesis wanes



Re-think recommendation if catalyst is ineffective



If the key catalyst for the stock recommendation occurs and the stock doesn't move to the price target, strongly re-think the recommendation and avoid the temptation to find another catalyst to justify the recommendation.



Review unbiased comparisons



Avoid placing blame or denying responsibility

Avoid sunk-cost, loss-aversion and other biases by periodically (once a month or quarter):

- Masking the company names/tickers within the comp table, looking only at the numbers to see if the ratings appear correct relative to potential risk-adjusted returns
- Ask, "If I switched firms tomorrow, would my stock recommendations at the new firm match my current ones?" If not, investigate why



When a stock call goes poorly, avoid placing blame on others for a bad stock call, or saying, "The surprise couldn't have been foreseen." Instead, ask yourself these questions:

- •What could have been done to know about this surprise earlier?
- •Did anyone else see this coming (sell-side or buy-side)?

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Best Practices for Making Accurate Stock Recommendations

Perspectives for Review Performance and Thesis (Step 4 of TIER™)

Don't mistake good stock picking with a bull market: Always evaluate performance relative to a similar basket of stocks. (This also holds true when evaluating company management's comments about its stock performance.)

Avoid "fear of failure" mind traps: Accept that past losses shouldn't impact future decisions



Perspectives for:

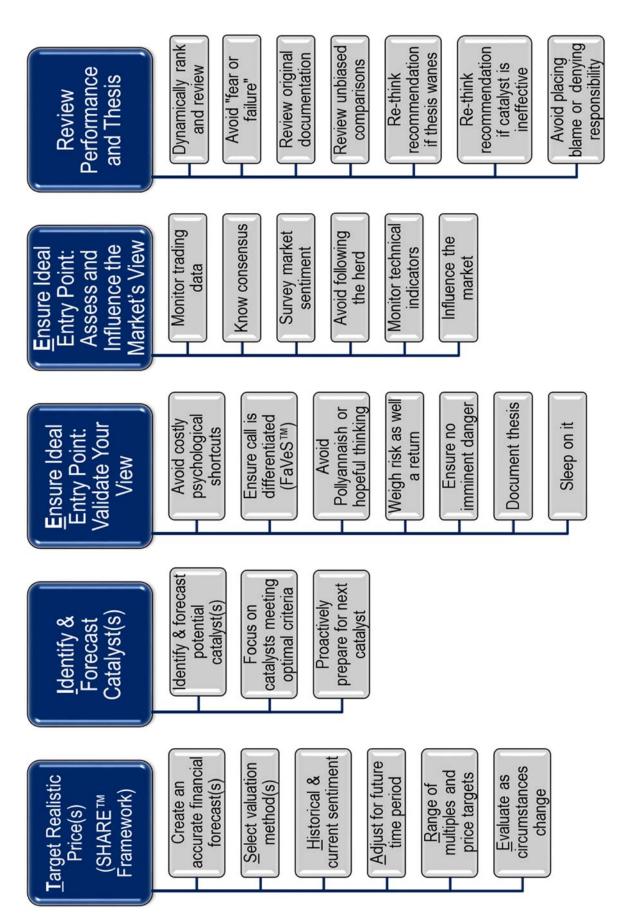
REVIEW
PERFORMANCE
AND THESIS



Mistakes can be valuable lessons:
Stock calls that go bad can have some salvage value, as long as the shortcoming is analyzed and internalized to avoid a similar bad call in the future

Automation will lead to more frequent reviews: Automate your comp table by having it draw key data directly from market data providers (and possibly from your financial models). This will reduce the laborious manual entry process which increases the frequency that this valuable table is reviewed.

Overview of TIER™ Framework for Making Accurate Stock Recommendations



For registered AnalystSolutions partcipants -- not to be re-distributed

Benefits and Limitations of Popular Valuation Methods

Details by Valuation Method

Method	Benefits	Limitations			
All Multiple- based methods below (all but DCF and Residual Income)	Relatively simple and quick to perform	 Rarely incorporates financial forecasts beyond the next 18 months Unlike DCF and RI (below), a company's expected growth rate and risk are not explicitly captured in the valuation (except for the "G" in the PEG ratio), making it difficult to compare companies on these important dimensions Multiple may not be computed in the same manner by all market participants, namely, the underlying financial data can be trailing, forward, or current year Other than P/E, difficult (or impossible) to analyze historical relative valuation levels for a given stock Absolute multiples for individual securities do not account for fluctuations in their overall asset class (e.g. equities) 			
P/E	 Understood by all because it's the most commonly used valuation method Can analyze historical relative valuation levels over time (P/E relative to a broad market P/E ratio) 	 Company management has more flexibility to manipulate earnings than cash flow Does not capture cash available to shareholders 			
PEG	Incorporates earnings growth rate (preferably over multiple future periods), which makes comparisons among companies and, potentially across sectors, more plausible (but not perfect)	 Earnings growth is not the same as the more important free cash flow growth No widely-accepted method to compute the growth rate (next 12-months, 2-years, 3-years?) If using consensus estimates, may be difficult to find reliable long-term growth forecasts 			
P/FCF	Incorporates free cash flow, which is the best measure of value	 Unlike DCF, it considers only one-time period of free cash flow Methodology can vary for reasons mentioned above as well as in estimating level of capital expenditures (maintenance vs. forecast) 			
EV/S	Can be helpful if there are no earnings or cash flow	Sales do not equate to free cash flow, which is the true measure of value			
P/B	For select industries where assets and liabilities (debt) can be valued using a public-market price, may be a good proxy for measuring a firm's value	 For most sectors, book value rarely equates to the company's market value of equity Book value can be subjectively influenced by interpretation of accounting rules, which can make comparisons between companies meaningless 			
EV/EBITDA	 Allows for comparisons of companies with very different capital structures Can be helpful when company does not generate pre-tax income 	EBITDA is not a measure of the all-important free cash flow or earnings			
Dividend yield	Can be helpful to measure a floor when stocks collapse	 Dividends are not the same as free cash flow, although they can move in tandem over the long run Difficult to forecast when management will cut a dividend 			

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Benefits and Limitations of Popular Valuation Methods

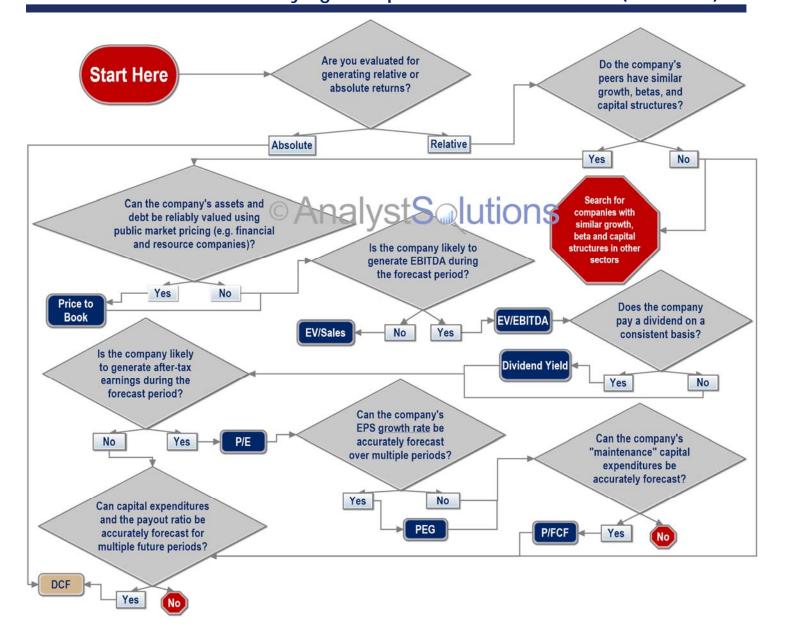
Method	Benefits	Limitations			
DCF and RI	 Capture a company's ability to generate free cash flow over the life of the enterprise, which is the best measure of value Helps to place the focus on the level of, and returns from, incremental capital spending (ROIC) More likely to identify overheated and oversold stocks and markets than multiples-based methods 	 Can be highly sensitive to minor input changes for factors often difficult to quantify Time consuming because multiple periods are required for forecast Complex models are prone to mistakes and reverse engineering During times of highly-priced equity markets, may be challenging to find attractive equity investments using these methods 			

Comparison of Valuation Methods by Specific Criteria

Benefit	Relevance*	P/E	PEG	P/FCF	EV/ EBITDA	DCF	P/B	EV/S	Dividend Yield
Good proxy for free cash flow to shareholders	3	→	→	1	•	•	•	•	⇒
Captures multi-period growth	2	•	1	Ψ	•	1	Ψ.	•	•
Relatively simple and quick to perform (low risk of mistakes)	2	^	^	⇒	⇒	•	^	^	1
Can be utilized when comparing companies not in the same sector	1	→	⇒	→	→	•	•	•	⇒
Captures risk/volatility	1	Ψ.	•	Ψ.	•	1	4	1	•
Eliminates potential effects of management using aggressive accounting tactics (not fraud)	1	•	•	↑	⇒	•	Ψ	•	•
Not overly-sensitive to minor changes to assumptions	1	^	⇒	1	^	•	1	^	1
Allows for accurate valuation of company's assets at current market prices	0	•	•	•	•	•	⇒	•	•
Helpful in identifying attractively valued stocks in an overheated market	0	→	⇒	⇒	→	1	⇒	→	1
In general, computation is consistent by all market participants	0	⇒	⇒	•	⇒	•	⇒	•	•
Useful if there are no earnings or cash flow during the forecast period	0	•	•	•	^	•	1	1	1
Total, weighted		→	^	1	•	1	4	•	→
		^	= Always or almost always meets criteria		⇒	= Sometimes meets criteria		•	= Rarely or never meets criteria

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Considerations for Identifying the Optimal Valuation Method (flowchart)

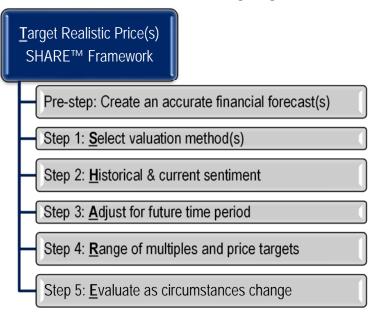


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Best Practices for Targeting Realistic Prices (SHARE™ Framework)

Summary of the SHARE™ Process

Exhibit 1: SHARE™ Framework for Targeting Realistic Stock Prices



STEP 1 ("S" in SHARE™): Select Optimal Valuation Method(s)

- Identify the valuation method(s) currently being used for the stock and sector as well as any other methods used
 in the past by reviewing publicly-available research reports and speaking with market participants who have been
 involved with the stock over an extended period of time (e.g. buy-side analyst, portfolio manager, sell-side
 analyst, sell-side salesperson, investor relations contact of target stock, investor relations contact of competitor of
 target stock, etc.)
- 2. If there has been more than one valuation method used by the market in the past identify:
 - a. Why it changed; and
 - b. What catalyst(s) caused it to change; and
 - c. What similar catalysts could cause investors to look at a new valuation method over your investment time horizon
- 3. If the primary valuation method used by the market for a specific stock differs from its peer group, identify the justification
- 4. Be reluctant to create a future price target based on a valuation method that has not been widely used by the market in the past or at present (stocks rarely out- or under-perform due to the market changing to a previously-unused valuation method for that stock)
- 5. Review QRCs:
 - a. "Benefits and Limitations of Popular Valuation Methods" to understand the potential shortcomings of the primary valuation method(s)
 - b. "Considerations for Identifying the Optimal Valuation Method (flowchart)" to identify the valuation methods that are applicable to the stock

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Best Practices for Targeting Realistic Prices (SHARE™ Framework)

Terms and Definitions Required for the Next Steps

It is important to understand the terms below for Step 2 and Step 3 of the SHARE™ process:

- "Relative multiple" is the stock's or peer's forward valuation multiple divided by a similar forward multiple for an appropriate peer or index (e.g. SBUX's P/E is 15 and S&P 500 P/E is 10x would mean SBUX's relative P/E is 150%)
- "Index" refers to the most appropriate index for the stock
- "Peers" refers to the company's comparable peers. If there is not a clean set of peer companies with similar characteristics, a new universe of peers may need to be created, such as finding companies in other sectors with similar growth, beta, payout ratio, etc.
- "Y1" = year 1, "Y2" = year 2 and "Y3" = year 3
 - For the discussion that follows, assume we are at January 1 of year 1 which means "Y2" begins 12 months from now and "Y3" begins 24 months from now
- When collecting historical forward-looking valuation data, consider using these time periods:
 - From last recession to now: Useful for understanding the valuation trends for the current business cycle
 - Past 10 years: Useful for understanding valuation trends over an entire economic cycle (possibly two)
 - Past three economic cycles (or more): Useful for understanding recurring trends at the different stages of the business cycles for mature cyclical stocks
- Historical and current valuation data should always be forward-looking (e.g. the "E" in a P/E ratio should be next twelve months, or another forward time period). Obtain the historical forward-looking consensus expectations of the key financial metric for the preferred valuation method (e.g. EPS, FCF, book value, sales, etc.) for the stock, its peers and the appropriate index (EQRV in Bloomberg). When it is difficult or impossible to obtain or construct these data series, some or all steps that follow will be difficult to complete. The following table highlights the relative ease or complexity typically involved in obtaining the forward-looking metric, based on the desired valuation method:

Best Practices for Targeting Realistic Prices (SHARE™ Framework)

Exhibit 2: Availability of Historical Forward-Looking Valuation Metrics

Valuation Method	Need NTM forward consensus estimates for this method	Ease to obtain for stock, peers and index*	Readily available?*			
P/E	EPS	Readily available	Most market data service providers have this as a designated field that can be downloaded monthly, going back over 10 years for widely developed stocks in developed markets			
EV/S	Sales	Can potentially be obtained depending on data service provider	Some market data service providers have historical NTM consensus forecasts of enterprise value and company sales although it may not go back as far as NTM consensus EPS			
P/CF	CF	May be constructed without too much effort	May be more difficult to obtain because some services do not capture consensus cash flow. If not available from the data provider, this can potentially be constructed by starting with NTM consensus EPS above and adding back depreciation and amortization (D&A) (assuming it's not volatile from year to year).			
PEG	Earnings growth	Can potentially be constructed depending on data service provider data service provider service provider data service provider maintain "Current Year" and "Next Year" consensus EPS forecasts, but as you get later into a given year, be aware t growth rate can be skewed due to non-recurring events in the current year that suppress the full year earnings (thus artificially raising the growth rate). available, use the growth rate between year 2 and year 3 to avoid this problem.				
EV/EBITDA	EBITDA	May be constructed with some effort	If not available from the data provider, NTM EBITDA can potentially be constructed by starting with NTM consensus EPS above and adding back D&A (assuming it's not volatile from year to year) and taxes (at a standard tax rate). Also requires obtaining data series of net debt in order to back out equity value from EV.			
P/B	Book Value	May be constructed with some effort	If not available from the data provider, can potentially be constructed by starting with the actual BV at the end of the prior period (e.g. at the end of each quarter) and add NTM consensus EPS above less dividends (assume dividends grow at a historical rate into the future) adjusted for planned buybacks or issuance of equity.			
DCF and Residual Income (EVA)	Free Cash Flow	Difficult to impossible to obtain or construct	Both of these methods rely on very long-term forecasts and given that most consensus estimates go no further out than 3 years, it would be very difficult to obtain or construct a historical NTM consensus data series for either valuation method			

In the steps that follow, one goal will be to identify the factor(s) that drive a stock's valuation levels. To eliminate the overall market movement, we will be looking at relative valuation, in this case the stock's P/E ratio relative to an index, which is the S&P 500 in the examples that follow.

Having removed fluctuations caused by the overall market's moves (systematic risk), we will look for the variables that can explain the rise and fall of an individual stock's valuation multiples, such as the company's expected EPS or cash flow growth rate. These variables are useful when researching if a stock's current valuation level is in line with *its past* or *currently with similar stocks in other sectors*. Exhibit 3 contains a list of the relevant variables to regress based on the valuation method being used. This exhibit will be used in Steps 2 and 3 (throughout this DRC, we will refer to "variables to regress" which are those found in the table below).

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Best Practices for Targeting Realistic Prices (SHARE™ Framework)

Exhibit 3: Variables to Regress

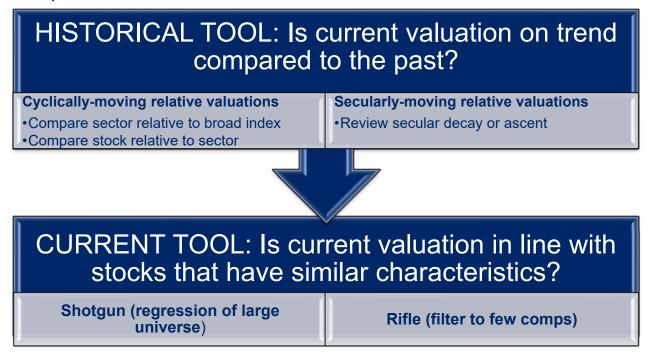
Valuation Method	Factors to Regress
Price Earnings Ratio	Expected Growth, Payout, Risk*
Price to Book Ratio	Expected Growth, Payout, Risk*, ROE
Price to Sales Ratio	Expected Growth, Payout, Risk*, Net Margin
EV to EBITDA	Expected Growth, Reinvestment Rate, Risk*, ROC, Tax rate
EV to Capital Ratio	Expected Growth, Reinvestment Rate, Risk,* ROC
EV to Sales	Expected Growth, Reinvestment Rate, Risk,* Operating Margin

* Proxies for risk include beta and firm size. Source: page 70 of "Valuation Approaches and Metrics: A Survey of the Theory and Evidence" Aswath Damodaran, November 2006

STEP 2 ("H" in SHARE™): Historical and Current Sentiment

Identify if a stock's current valuation is in line with *its past* and *currently with similar stocks in other sectors* by following the two-step process summarized in the exhibit below:

Exhibit 4: Step 2 of SHARE™ Framework



Using "HISTORICAL TOOL": Determine if the Current Valuation Is On Trend Compared to the Past

- 1. For stocks that have a trading history beyond the beginning of the last economic cycle, determine if the stock's relative forward valuation multiple (relative to the market) has predominately moved *cyclically* or *secularly* in the past (if both are evident, use the more recent trend):
 - a. If the relative multiple typically moves in *cycles* (reaching similar highs and lows each cycle), identify the cause (EPS growth influenced by the economy, appetite for risk as found in beta, etc.), which will be required to forecast the valuation multiple for the future price target
 - b. If the relative multiple has moved *secularly* (reaching new lows or highs year after year beyond one economic cycle), identify the cause of the secular change, which will be required to forecast the valuation multiple for the future price target
- 2. Based on your conclusion in the step above, follow this step for stocks that have relative valuation multiples that move on a *cyclical* basis:

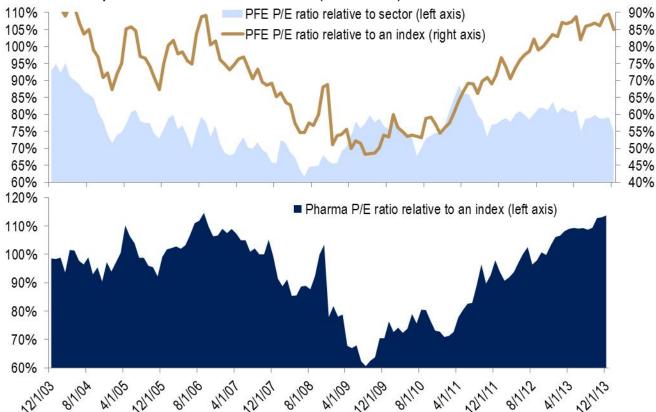
Best Practices for Targeting Realistic Prices (SHARE™ Framework)

- a. Compare sector relative to broad index. Identify if the stock's sector (peer group) is trading near its average historical P/E ratio relative to the broad index. If not, identify the cause (e.g. macro-economic, industry issue, etc.).
- b. **Compare stock relative to sector**: Identify if the stock is trading near its average historical P/E ratio relative to its peer group. If not, identify the cause (e.g. growth opportunities, changes in ROIC, etc.).

Example for this step, Cyclically-Moving Relative Valuations:

- Note in Exhibit 5 below, the top portion of the chart has a tan line (using the right axis) showing the stock's P/E relative to the market index (S&P 500 in this case). Recall earlier we identify if this key data series is currently ontrend with its past
- The light blue area chart (using the left axis) is the stock's P/E ratio relative to the sector
- The bottom chart of dark blue area (using the left axis) is the sector's P/E ratio relative to the index
- The purpose of the exhibit is to determine the element driving the tan line…sector vs. index or stock vs. sector?"
- Mathematically, the light blue area multiplied by the dark blue area gets us the tan line. Viewed another way, we can dissect the tan line as being influenced by the stock, sector or both
 - In the example below, note the tan line is moving much more like the dark blue area which shows that PFE's relative P/E ratio is influenced significantly by sector issues





Best Practices for Targeting Realistic Prices (SHARE™ Framework)

Exhibit 6 below shows the data in another format.

- The first bar shows the pharmaceutical sector's P/E ratio relative to the S&P 500 over the ten years up to this analysis (2003 to 2013), which was 93%, or a 7% discount to the S&P 500's P/E ratio
- The second bar shows how much the sector's valuation at the time of this analysis was above its ten-year average. In this case 20% higher than normal, putting it at 114%, or a 14% premium to the S&P 500 (which is represented as the third bar in the chart)
- Over the ten years up to this analysis, PFE traded at a 21% discount to the sector (fourth bar in chart)
- Assuming PFE should currently be trading at this 21% discount, it should be trading at 92% (fifth bar in chart) of the S&P 500's P/E ratio (an 8% discount)
- In reality, at the time of this analysis, PFE was trading at a further 7% discount to this implied 92%, putting it at 85% of the S&P 500 (last bar on right)

Based on this analysis, it's clear additional research must be conducted to determine why the market is affording the sector a 20% premium to its ten-year average and why PFE is trading at a 7% discount to its historical average.

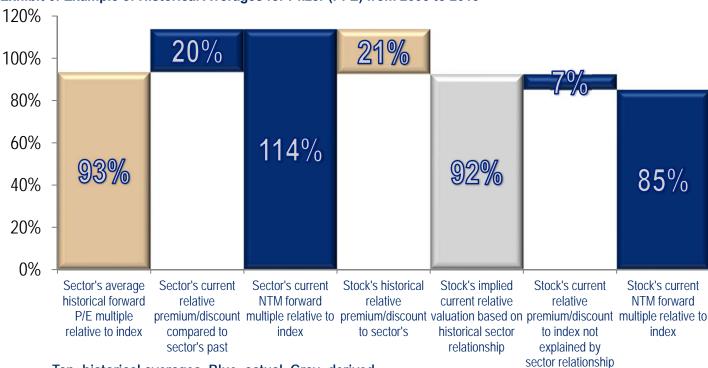


Exhibit 6: Example of Historical Averages for Pfizer (PFE) from 2003 to 2013

Tan: historical averages, Blue: actual, Gray: derived

To help better understand the anomalies discussed above, find sector, company-specific or macro factors that influence the stock's relative valuation to see if they also contain an anomaly. The four charts below show examples of sector, company and macro factors that have strong relationships with the sector's and stock's relative P/E ratio. Note the first two charts show the pharmaceutical sector's P/E ratio relative to the S&P 500, whereas the second two charts show PFE's P/E ratio relative to the sector's P/E ratio.

Best Practices for Targeting Realistic Prices (SHARE™ Framework)

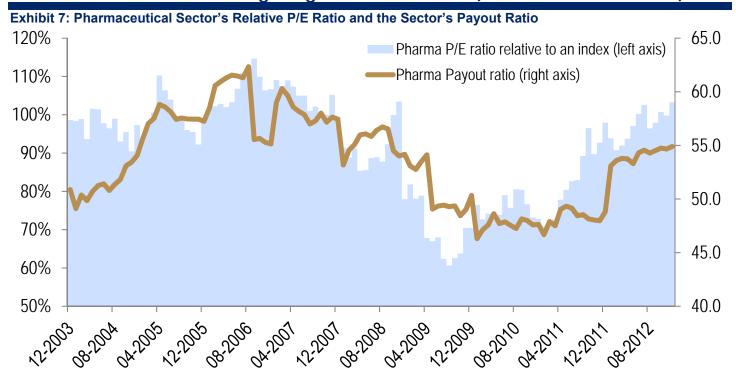
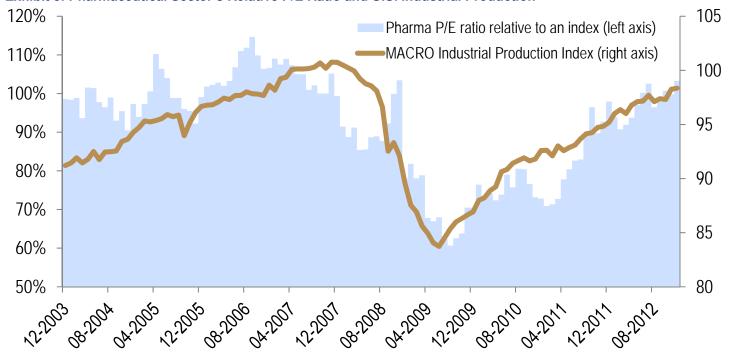


Exhibit 8: Pharmaceutical Sector's Relative P/E Ratio and U.S. Industrial Production



Best Practices for Targeting Realistic Prices (SHARE™ Framework)

Exhibit 9: Pfizer's Relative P/E Ratio and Its Payout Ratio

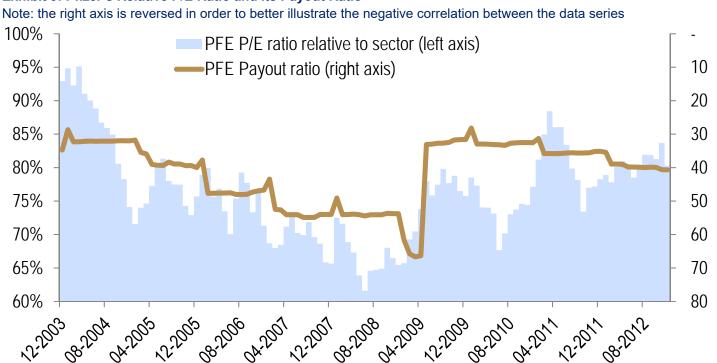
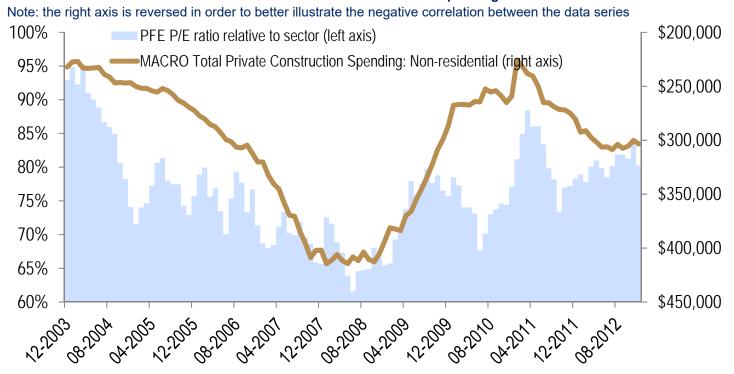


Exhibit 10: Pfizer's Relative P/E Ratio and U.S. Private Construction Spending



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Best Practices for Targeting Realistic Prices (SHARE™ Framework)

While the charts above appear to show relationships between relative P/E ratios and sector, company and macro data, this can be better assessed by conducting a regression analysis. For example, by conducting a regression analysis of the sector's relative P/E ratio and the sector's payout ratio yields the following formula (this can be done in Excel):

Pharma sector's relative PE Ratio = $-0.33 + (Payout\ ratio\ x\ 2.35)$

At the time of this analysis, the pharmaceutical sector's payout ratio was 54.9%. Plugging this ratio into the equation above results in an implied sector relative P/E ratio of 96%. At the time of this analysis, the sector's relative P/E ratio was 100% (a market multiple), which suggests the sector is "on-trend" with its ten-year average, even though Exhibit 6 showed the sector 20% higher than the ten-year average. A similar analysis can be done for the variables found in the other three charts above.

End of Example for Cyclically-Moving Relative Valuations

- c. If EPS growth is being evaluated as the variable that explains a stock's relative P/E ratio level (which is often the case), rather than using the consensus EPS growth rate from FY1 to FY2, consider using FY1 to FY3 because it will provide a larger time horizon which may have a stronger correlation.
- d. Be on the lookout for greater forces beyond a stock that may be impacting the entire sector's multiple (e.g. desire to own tech stocks in 1999, defensive names during the sub-prime melt-down, and clean energy stocks in 2008). Assume any current "irrational exuberance" for a stock or sector will eventually revert to more reasonable historical levels.

See more examples of this step in the appendix

- 3. Follow this step for stocks with relative valuation multiples that move on a secular basis.
 - a. Treat stocks that have valuations moving on a secular basis different from those that move on a cyclical basis. The rationale is that cyclically-moving relative valuations have historical peaks and troughs to provide upside and downside parameters whereas secularly-moving stocks have not reached a floor (or sometimes ceiling) yet.
 - b. Review the historical decay or ascent of the stock's relative forward multiple compared to changes in the variables to regress found in Exhibit 3. For example, regress the historical change in NTM EPS estimates (between Y1 and Y2), payout ratio and beta with the stock's relative multiple at the time. If a strong historical relationship is found (R square of 0.50 or higher), and the current valuation is not on trend, identify the cause.

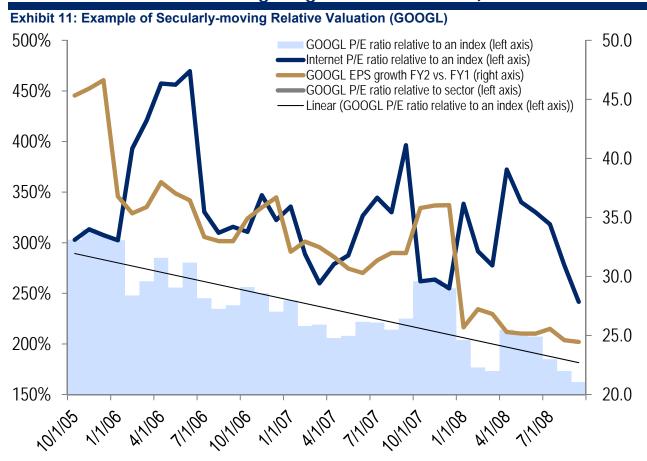
Example for Secularly-Moving Relative Valuations:

We conducted a regression analysis to identify the trend for GOOG's declining relative P/E ratio which dropped from 300% (of the S&P 500's P/E) in mid-2005 to 200% by mid-2008. At that point it would have been important to know if GOOG's relative P/E was on trend with its historical decay. We regressed the variables found in Exhibit 3 and GOOG's relative P/E ratio on a monthly basis between mid-2005 and mid-2008. The relationship had an R square of 68%, with the equation as:

 $GOOG's\ relative\ PE\ Ratio = 2.15 + (YoY\ Change\ in\ NTM\ EPS\ x\ 1.82) + (Beta*-0.36) + (Payout\ ratio*\ 0)$

This equation shows, with a high degree of reliability, where GOOG's relative P/E ratio has been based on the variables above. Specifically, this illustrates that for every percentage point GOOG's EPS growth rate slowed, resulted in a 1.82 point reduction in the stock's relative P/E ratio. In addition, as GOOG's beta dropped, it resulted in a slower reduction of the stock's relative P/E ratio (e.g. when GOOG's beta went from 2.0 to 1.0, statistically it resulted in GOOG's relative P/E increasing by 17%, but this was not visible because the decline in EPS growth was causing a more dramatic downward move to the company's relative P/E ratio). AnalystSolutions partcipants -- not to be re-distributed

Best Practices for Targeting Realistic Prices (SHARE™ Framework)



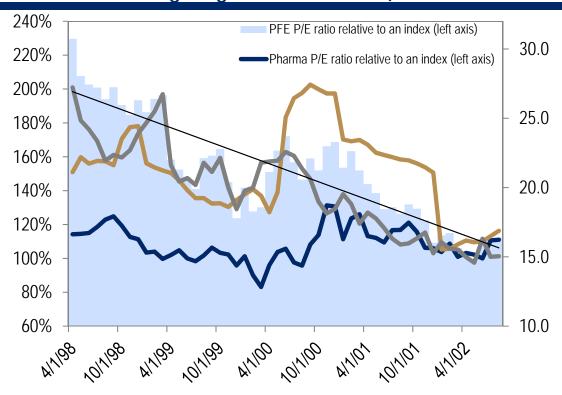
In Exhibit 12 we show the variables for four stocks during periods when their relative P/E ratios were in a secular decline. Note: we have put a box around the EPS growth rate because this usually explains most of the decline. We call these the "decay coefficient" which can be used to see if a stock is on trend. Apply these to the earnings or cash flow growth forecast to get a general idea where the stock's relative P/E ratio will be in the future. Note: this works quite well when a stock is still in a hyper-growth rate (e.g. EPS growing over 25% per year) but as it comes down to more typical relative valuation levels, the relationship breaks down because the stock begins to trade with a cyclically-moving relative valuation.

Exhibit 12: Decay Coefficients for Stocks with Secularly-Moving Relative Valuations

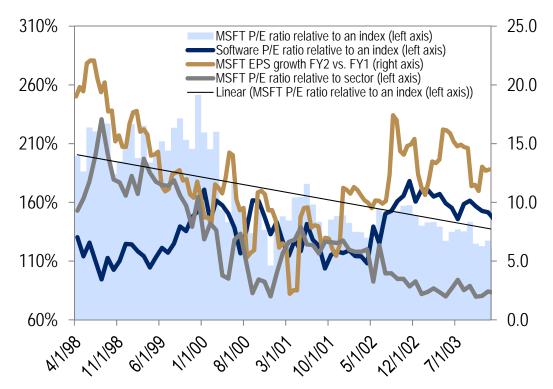
	PFE	MSFT	GOOGL	BBBY
Starting Period	4/30/98	12/31/99	6/30/05	12/31/01
Ending Period	8/30/02	12/31/03	6/30/08	12/31/05
R Square	0.77	0.72	0.68	0.73
EPS growth FY2 vs. FY1	3.11	2.55	1.82	4.90
Payout ratio	-1.74	-1.78	0.00	0.00
Beta	1.54	-1.85	-0.36	0.54

Two of the examples above in chart format below:

Best Practices for Targeting Realistic Prices (SHARE™ Framework)



Relative PE Ratio at that time = $0.23 + (YoY\ Change\ in\ NTM\ EPS\ x\ 3.11) + (Beta*1.54) + (Payout\ ratio*-1.74)$ Adjusted R squared of 0.77



Relative PE Ratio at that time = $4.5 + (YoY Change in NTM EPS \times 2.55) + (Beta * -1.85) + (Payout ratio * -1.78)$ Adjusted R Squared 0.72

End of Example for Secularly-Moving Relative Walluations participants -- not to be re-distributed

Best Practices for Targeting Realistic Prices (SHARE™ Framework)

Determine if the Current Valuation is in Line with Stocks That Have Similar Characteristics

Identify if the stock is currently trading near the same valuation level as stocks in other sectors with similar growth and return characteristics. If not, identify *why* the stock is trading at a discount or premium. There are at least two methods for this process:

- 1. Regression Analysis ("shotgun" approach)
 - a. Start by collecting a sample of at least 300 stocks (preferably over 500) that are in the same financial market as the target stock and do not have substantially different levels of "variables to regress" (found in Exhibit 3) as the stock being analyzed
 - i. For example, if the stock has 10% EPS growth rate, screen for stocks with growth rates of 8% to 12% (keep the universe as large as possible while removing only the significant outliers)
 - ii. We find that the EPS growth rate is the most important factor to screen when using P/E ratios as the valuation method (adding a screen for payout ratio and beta adds little to the regression accuracy and can actually make it worse by reducing the universe due to these filters)
 - iii. Keep the filters wide enough so that there are at least 40 stocks in the remaining population for the next step.
 - b. Regress the "variables to regress" for the filtered universe of stocks against their current valuation multiple (on forward data). Similar to above, the regression output formula should look something like this:

Predicted Relative PE Ratio = a + (b1 * forward EPS growth Y2 vs.Y1) + (b2 * payout ratio) + (b3 * beta)

- c. If the regression above results in a relatively low R squared, remove the most significant outliers. Recall we are not using this equation to pick stocks but rather to get an understanding of the market psychology towards a stock compared to a basket of other stocks in the same market.
- d. Assuming the regression equation has an R square of 50% or higher, compute the implied valuation multiple for the target stock. If it differs materially from the stock's current valuation, determine the reason. Recall, if you don't know the cause of an anomaly, you can't forecast the optimal valuation multiple for the future.

Example for Regression Analysis ("shotgun" approach):

At the time of this analysis we regressed over 500 large cap stocks in the U.S. market to find the relationship between their P/E ratios and these three variables: NTM EPS growth rate, beta and payout ratio. The regression formula (78% R square) was used to determine if the stocks below were currently "on-trend" with stocks in other sectors that had similar characteristics:

- Coca-Cola's (KO) predicted P/E ratio based on the regression was 18.2x while the stock was trading at 18.9x. This essentially says investors are willing to pay 4% more for KO's EPS growth, payout ratio and risk profile (beta) when compared to the 500 other stocks in the analysis (based on the regression equation), but it's a relatively small difference which is why we would not consider it to be material. Essentially KO is trading in-line with other stocks based on the market's emphasis on growth, payout ratios and risk.
- At the same time, Microsoft's (MSFT) predicted P/E ratio based on the regression was 16.5x while the stock was trading at 15.6x. This essentially says investors are willing to pay 6% less for MSFT's EPS growth, payout and risk profile when compared to the 500 other stocks in the analysis (based on the regression equation). If this gap were to get much wider it would be critical to understand the market's psychology behind this discount before setting a future price target for the stock.

End of Example for Regression Analysis ("shotgun" approach):

Best Practices for Targeting Realistic Prices (SHARE™ Framework)

- 2. Screen for Similarities ("rifle" approach).
 - a. Start with a sample of at least 300 stocks that are in the same financial market as the target stock (it can be the same sample as used in the regression analysis above)
 - b. Filter the stocks using the "variables to regress" to yield a universe of 5 to 20 comparable stocks that are near similar levels to the target stock
 - i. For example, if the consensus EPS growth rate for the target stock is 15% (note: this is for the period between the next 12 month period and the 12 month period that follows afterwards), create a universe of stocks that have the same characteristics.
 - c. Compute the average valuation multiple for those stocks. If it differs materially from the stock's current valuation, determine the reason.

Example for Screening for Similarities ("rifle" approach):

In our analysis for Microsoft, we started with 500 U.S. large cap stocks and narrowed down using the criteria in Exhibit 13 to be left with the seven comparable stocks in Exhibit 14. Note: for this analysis we had consensus forecasts for Y3 and so we used growth rates between Y1 and Y3 as well as between Y2 and Y3.

Exhibit 13: Process 2 "Rifle Approach" Screening Criteria Table (for MSFT analysis)

Factor	MSFT	Min for Screen	Max for Screen
Expected Growth (Y3 vs. Y1)	16%	13%	19%
Expected Growth (Y3 vs. Y2)	9%	7%	11%
Payout ratio	42%	25%	60%
Beta	0.96	0.76	1.16
Market capitalization	\$373B	\$5B	None

Exhibit 14: Process 2 "Rifle Approach" Screened Comparable Stocks (for MSFT analysis)

Co. Name	GICS Sub-industry	P/E Ratio on Y2 EPS	Forward EPS Growth (Y3 vs. Y1)	Forward EPS Growth (Y3 vs. Y2)	Payout ratio	Beta	Mkt cap(MM) Current
Microsoft	Systems Software	15.6	16%	9%	42%	0.96	\$373,921
U.S. Bancorp	Diversified Banks	12.6	19%	10%	32%	0.78	\$76,707
Medtronic Inc.	Health Care Equipment	14.4	14%	7%	28%	1.09	\$63,183
General Dynamics Corp.	Aerospace & Defense	15.0	16%	8%	34%	1.14	\$40,923
Energizer Holdings Inc	Household Products	15.7	16%	8%	28%	0.98	\$7,441
Hancock Holding	Regional Banks	13.7	15%	8%	41%	1.05	\$2,810
Progressive Corp	Prop. & Cas. Insurance	14.1	14%	8%	30%	0.76	\$14,860
Average w/o MSFT		14.3	16%	8%	32%	0.97	\$34,321
MSFT vs. Average		10%	4%	12%	30%	-1%	989%

As shown in Exhibit 14, at the time of the analysis, MSFT was trading at 14.3x earnings, which is a 10% premium to stocks in other sectors with similar characteristics. As noted earlier, it's critical to understand why portfolio managers are willing to pay more for MSFT when compared to the others stocks in the table.

End of Example for Screening for Similarities ("rifle" approach)

Considerations for Step 2 of SHARE™ (Historical and Current Data Review)

Growth stocks, especially companies that are still early in their lifecycle, often look very expensive on NTM earnings when compared to more mature stocks. The flaw in this analysis is that "NTM" only looks out 12 months and yet it could take 10 years before the company's growth rate slows to the level of the broader market or its peers. Investors who concluded GOOG's 45x earnings was too rich in 2005, would have missed the 500% out-performance (vs. the

Best Practices for Targeting Realistic Prices (SHARE™ Framework)

S&P 500) that took place over the following 5 years. It's important to compare growth stocks to companies with similar longer-term growth rates (Y2 to Y3 or even beyond if possible) so as to capture the company's longer-term earnings or cash flow power. It's also helpful to conduct a longer-term DCF or residual income valuation analysis for these types of stocks, although these methods are not without their own shortcomings.

- When comparing a stock to a peer group, it's important to remove significant outliers from the group or use the median rather than the mean
- If a number of the peers have negative earnings (resulting in no "E" for a P/E), consider computing an earnings yield (E/P)
- For the regressions, be aware the relationship between the "variable to regress" and the stock's valuation multiple may not be a linear relationship (e.g. hyper-growth companies may be afforded a much higher multiple than the implied estimate found on the regression line). A more detailed discussion on this can be found on pages 252 and 281 of the book *Damodaran on Valuation* (second edition).

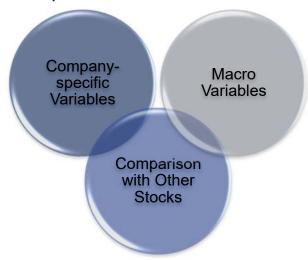
STEP 3 ("A" in SHARE™): Adjust for Future Time Period

This is arguably the most important and difficult step in the SHARE™ framework. Specifically, adjustment of the stock's current valuation metric to forecast its level when the price target is to occur (e.g. one year from now). The most important driver to a stock's future valuation multiple will be expectations of the company's free cash flow (or EPS) growth and so much more emphasis should be put on forecasting cash flow or earnings than the valuation multiple. With that said, the valuation multiple should not be an afterthought or reverse engineered, which occurs all too often.

If a valuation multiple is declining because the market expects the consensus EPS estimates to come down, then the multiple really isn't dropping as much as consensus is just slow to lower estimates. Once the consensus drops the "E", the math causes the P/E ratio to rise back to normal levels, assuming all other elements are kept constant. The same holds true if a stock's P/E ratio is above normal because the market believes consensus EPS needs to rise. It's incorrect to use this temporarily higher P/E multiple for a future price target because once the consensus estimates come up, the multiple will likely go back to more normal levels. Put another way, often, above- or below-trend relative valuations are a sign of impending earnings revisions. If the investment thesis is based on consensus making an impending revision, using an above- or below-trend multiple could be double-counting.

Assuming the EPS (or cash flow) forecast is accurate based on thorough research, these are the 3 approaches that can be used to adjust a stock's current valuation for future time period to generate more accurate price targets:

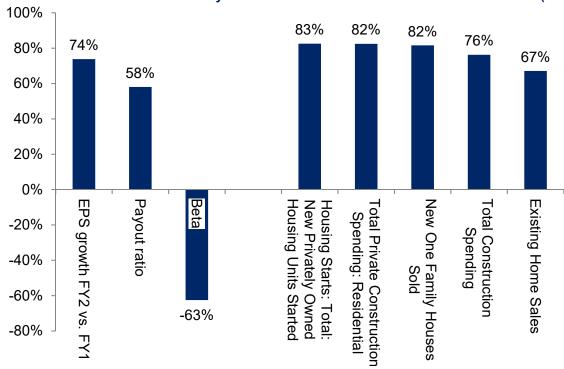
Exhibit 15: Step 3 of SHARE™ Framework



Best Practices for Targeting Realistic Prices (SHARE™ Framework

- Company-specific and Macro Variables
 - a. For company-specific and macro variables, find those that have the strongest historical correlation with movements in the stock's relative valuation such as its relative P/E ratio. For example, Exhibit 16 is a sample of data series that have the highest correlation with Raytheon's relative P/E ratio movements over a ten-year period (company-specific on the left and macro on the right). You'll see from the first bar, the stock's EPS growth rate has a 74% correlation coefficient with Raytheon's relative P/E ratio. Looking on the right side of the chart, which are macro data series, housing starts have the strongest correlation with Raytheon's relative P/E ratio, with a correlation coefficient of 83%.

Exhibit 16: Correlation Coefficients for Raytheon's Relative P/E Ratio and Selected Variables (2003 to 2013)



b. By regressing the stock's relative P/E ratio with the strongest company-specific and strongest macro data series above, we get the regression output found in the first three rows of Exhibit 17 (separate analysis for each data series). By using this data and a forecast for these variables one year from now, we can forecast the stock's relative P/E one year from now. Using the forecast in Exhibit 17, the expected relative P/E ratio is 84% using EPS growth as the predictive variable and 88% using housing starts as the predictive variable (by late-2014, Raytheon's relative P/E ratio had moved to 86% of the S&P 500's).

Exhibit 17: Regression Output for Raytheon's Relative P/E Ratio and Variables to Regress

	EPS growth FY2 vs.	Housing Starts (New
	FY1	Privately Owned)
R Square*	74%	82%
Intercept	0.72	0.60
Variable (multiplier)	1.53	0.0287
Forecast for 1 year from now**	7.7%	1,000K
Expected relative P/E ratio in 1 year (December 2014	84%	88%

Regression based on data between December 2003 and December 2013

** "Now" is assumed to be June 2013 For registered AnalystSolutions partcipants -- not to be re-distributed

Best Practices for Targeting Realistic Prices (SHARE™ Framework)

- 2. Comparison with Other Stocks: In addition to looking at company-specific and macro data, the third approach that can be used to adjust a stock's current valuation for future time period to generate more accurate price targets, is to revisit the comparisons to stocks in other sectors (shotgun and rifle approaches)
 - a. Regression ("Shotgun") Approach
 - Recall in Step 2, when determining if Coca Cola's and MSFT's relative valuations were <u>currently</u>
 (at the time of the analysis) above or below stocks in other sectors, we created a regression
 formula of 500 stocks called the "shotgun" approach
 - ii. Now use that regression formula to forecast a relative P/E ratio for the stock one year from now. Recall the regression formula needs a next-12-month ("NTM") growth estimate to forecast the relative P/E ratio. Rather than use the consensus expected growth rate over the NTM (which was used to find the *current market* expectations), use your forecast of EPS growth between Y2 and Y3 to forecast a one-year relative P/E ratio. If this is a bit confusing, think of it this way: the months that are currently 13 to 24 from now ("Y2") will be the "NTM" one year from now and the months that are currently 25 through 36 from now ("Y3") will be second time period which is required to compute a NTM EPS growth rate one year from now.
 - b. Screening ("Rifle") Approach
 - i. Recall in Step 2, when determining if MSFT's relative valuation was <u>currently</u> (at the time of the analysis) above or below stocks in other sectors, we screened a universe of stocks to just six that had similar characteristics to MSFT (called the "rifle" approach)
 - ii. Now do the same screening analysis, but rather than use the stock's consensus expected growth rate over the NTM as the screening criteria, use your forecast of EPS growth between Y2 and Y3. This will show how much the market is currently paying for stocks with this level of EPS growth, which is a reasonable gauge of the relative P/E ratio the stock will command in a year.

STEP 4 ("R" in SHARE™): Range of Multiples and Price Targets

Apply your range of valuation multiple(s) to your future financial forecasts (upside, downside and base-case) to derive a range of price targets, which provides an objective risk/return profile:

- 1. Rather than set a single-point future price target, set a range of targets, based on your upside, downside and base-case assumptions for each of the two elements of a price target, the *financial forecast* and the *valuation multiple*:
 - a. **Financial Forecast**: Create scenarios for your financial forecasts (we recommend creating these during the forecasting phase, which is one step before the TIER™ process begins)
 - b. Valuation Multiple: Create scenarios for your valuation multiples:
 - i. Recall Steps 2 and 3 of the SHARE™ framework included a process of using company-specific and macro variables to predict the stock's relative P/E ratio. Use the regression formulas in those steps and substitute your downside and upside EPS growth rates to derive downside and upside relative P/E ratios
 - ii. Also use your comparison to stocks in other sectors ("shotgun" and "rifle" analysis) to generate valuation scenarios:
 - 1. For the regression/shotgun approach, utilize your downside and upside financial forecasts (for years Y2 to Y3) for variables to put into the regression equation to derive downside and upside valuation multiples one year from now
 - 2. For the screening/rifle approach, use the standard deviation of the screened universe to identify realistic downside and upside scenarios (one standard deviation is a good place to start but you can go to two if you want to really stretch your thinking)
- 2. Document a range of exit thresholds in advance of making the recommendation (they may be within the "upside" and "downside" scenarios), which will reduce biases from creeping into decisions at a later date:

Best Practices for Targeting Realistic Prices (SHARE™ Framework)

- a. **Upside exit threshold**: to begin selling <u>some</u> of the position when it's playing out as expected. This would be the point to stop reiterating the call to your colleagues/clients.
- Upside exit threshold: to sell the entire position unless new information materializes. This is the point to downgrade the stock.
- c. **Downside exit threshold**: to seriously reexamine the investment thesis (for example, the stock moves 15 percent in the opposite direction of the call)
- d. Stop-loss exit threshold: to sell position because the thesis is not playing out

STEP 5 ("E" in SHARE™): Evaluate Price Target as Circumstances Change

There are usually only 3 reasons why you'll want to change a price target. In Exhibit 18, we've attempted to draw these to scale in terms of frequency in which they help in stock picking.

Exhibit 18: Catalysts for Changing Price Targets



- Revised Forecast: As your financial forecast (e.g. EPS or cash flow) changes, it will warrant a change to the price target
 - If your valuation is driven by next-12-months (NTM) EPS or cash flow, as each month passes, the estimate will likely change. If the change is relatively small, you may want to wait until the end of the quarter to make these updates
 - Avoid the temptation of changing your financial forecast unless you have an objective, defendable justification (otherwise you may be simply reverse engineering your price target)
- **Revised Multiple**: There may be times when the valuation multiple should be revised:
 - When peer multiples fluctuate (such as a stock's immediate peers as well as stocks in other sectors that have similar characteristics -- the shotgun and rifle approaches)
 - When highly-correlated variables change
 - Company-specific, such as EPS growth rate
 - Macro, such as consumer sentiment
 - For DCF or residual income, when the underlying assumptions change such as risk-free rate, equity premium, or stock's beta
- **New Method**: On rare occasions, there may be justification to change the valuation *method*:
 - If there is more than one valuation method that has been used in the past for a stock or sector, identify the
 catalyst(s) that caused the method to change, and then determine if there are similar catalysts that could cause
 investors to look at a new valuation method over a reasonable investment time horizon
 - Examples of when it may be justifiable to shift to an alternative valuation method: buted

Best Practices for Targeting Realistic Prices (SHARE™ Framework)

- At the peak or trough inflection points of the business cycle
- Moving from one phase to another of a company's or industry's life cycle (e.g. growth to maturity)
- Company is going through a major secular transformation or restructuring

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

Best Practices for Targeting Realistic Prices (SHARE™ Framework)

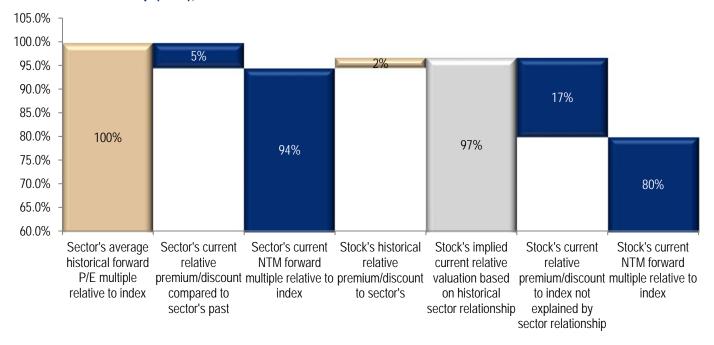
Appendix Additional Examples for Step 2

Best Practices for Targeting Realistic Prices (SHARE™ Framework)

Kohl's (KSS)

As shown in Exhibit 19, the apparel retailer sector is trading at only a 5% discount to its ten-year historical average (second bar from the left), which suggests it's "on-trend" and therefore not an issue that requires attention. The stock historically receives a 2% premium to the sector which is currently 17% below this level (second bar from right).

Exhibit 19: Kohl's Corp (KSS), Chart 1

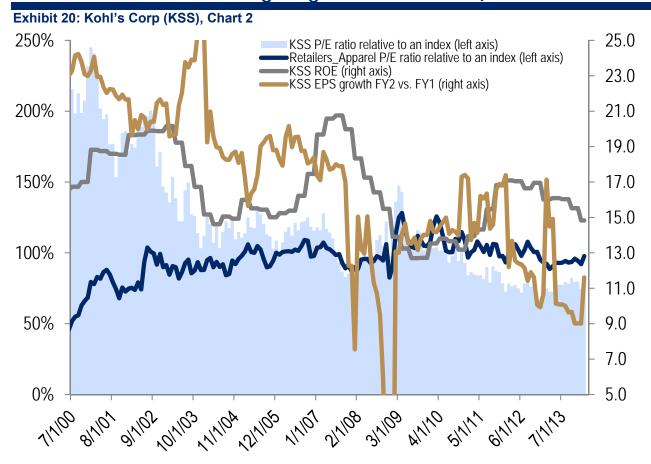


In Exhibit 20 below, which shows these trends over time, it's important to first note that KSS appears to have transitioned from a secularly-moving valuation to one that is cyclically-moving (typical for high-growth stocks as their growth slows). Therefore, the ten-year averages in the chart above for the stock are not very useful. The options are to either look at the stock relative to the sector for only the time when the stock's relative P/E ratio begins to move cyclically, or remove a comparison to the sector altogether.

If we begin with the assumption that KSS' relative valuation cyclicality began at the lowest "bottom" of its secular decline, the stock's relative P/E ratio has been cyclical since early 2008. It hit a 'cyclical" high of 147% in March of 2009 and was 80% at the end of 2013. With this in mind, we review three of the data series in the chart to help identify the factor that best explains the fluctuations:

- The apparel retailer sector's relative P/E ratio (dark blue line, using left axis) from 2008 to 2013 (during this
 "cyclical" period for KSS's relative P/E movement) has been relatively steady, between 90%-100% of the S&P
 500, suggesting KSS' decline is not due to sector-wide factors.
- KSS's earnings growth rate (tan line, using right axis) has declined from 15% to 10% during that time period, suggesting it is the cause of the contracting relative P/E ratio (correlation coefficient is 56%). The analyst would likely want to continue looking for the other factor(s) that help explain changes in the stock's relative P/E ratio before drawing the conclusion that it appears to be on-trend with the company's EPS growth rate (which visually appears to be the case).
- And lastly, KSS's ROE (gray line, using right axis), has increased slightly, from 14% to 15% during that time period, suggesting it is not a factor in causing KSS's relative P/E ratio to contract

Best Practices for Targeting Realistic Prices (SHARE™ Framework)



Best Practices for Targeting Realistic Prices (SHARE™ Framework)

Canadian National (CNI)

As shown in Exhibit 21, the railroad sector is trading at a 9% premium to its ten-year historical average (second bar from the left), which is an issue that needs to be investigated before setting a future price target for CNI. Meanwhile, the stock is trading at only a 1% premium to the relationship it has with the sector over the past ten years (second bar from right).

Exhibit 21: Canadian National (CNI), Chart 1

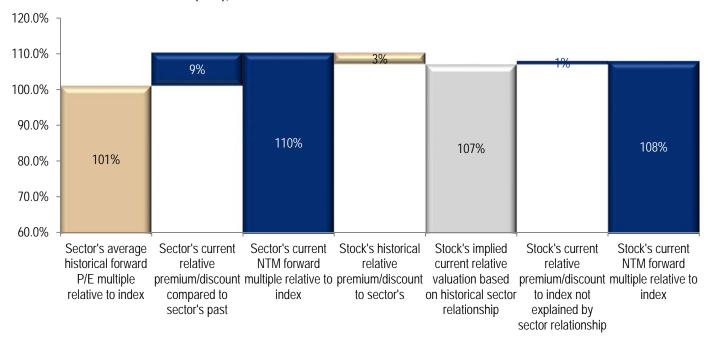


Exhibit 22 below shows these trends over time. Note that the railroad sector's relative P/E ratio (dark blue line using left axis) has expanded from 45% in July 2000 to 110% at the end of 2013, which explains why the sector is currently above its ten-year average. Looking at the chart, there is some cyclicality, but there also appears to be a secular trend. Is the sector's 9% premium compared to its ten-year average due to a longer-term secular issue or just the result of an expanding economy? Reviewing the two charts below, we can draw these conclusions:

- Exhibit 23 shows the sector's relative P/E ratio (blue bars) has risen with its ROE (correlation coefficient of 77%), helping illustrate this factor is more sector-specific than company-specific
- CNI's earnings growth rate (tan line, using right axis) has been flat to slightly declining during this time period, suggesting it is not the explanation for the stock's higher relative P/E ratio
- CNI's ROE (gray line, using right axis), has grown from 9% to 21% during that time period (suggesting cash flow growth is accelerating even in the face of a declining EPS growth rate), which is also a sector trend

Best Practices for Targeting Realistic Prices (SHARE™ Framework)

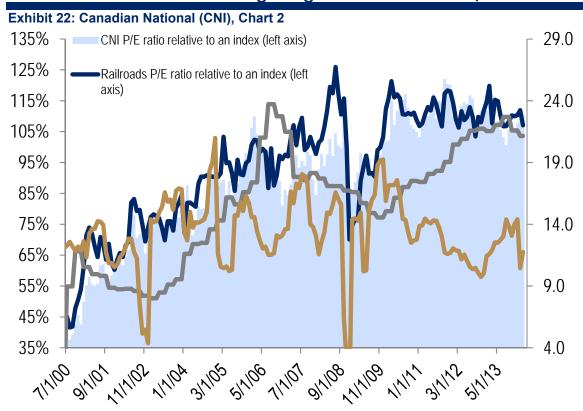


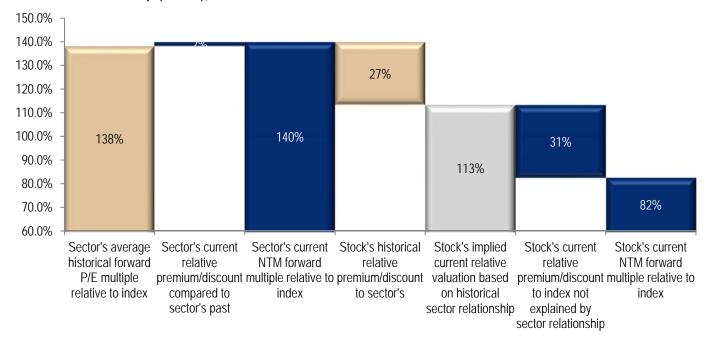
Exhibit 23: Canadian National (CNI), Chart 3 20.0 135% CNI P/E ratio relative to an index (left axis) Railroads P/E ratio relative to an index (left axis) 125% Railroads ROE (right axis) 18.0 115% 16.0 105% 95% 14.0 85% 12.0 75% 65% 10.0 55% 8.0 45% 35% 6.0

Best Practices for Targeting Realistic Prices (SHARE™ Framework)

Oracle Corp (ORCL)

As shown in Exhibit 24, the software sector is trading at only a 2% premium to its ten-year historical average (second bar from the left), which suggests it's "on-trend" and therefore not an issue that requires attention. The stock historically receives a 27% discount to the sector which is currently 31% below this level (second bar from right).

Exhibit 24: Oracle Corp (ORCL), Chart 1



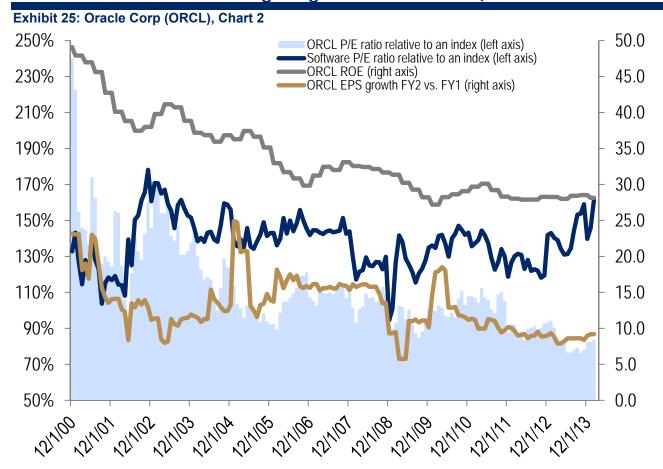
In Exhibit 25 below, which shows these trends over time, it's important to first note that ORCL appears to have transitioned from a secularly-moving valuation to one that is cyclically-moving (typical for high-growth stocks as their growth slow). Therefore, the ten-year averages in the chart above for the stock are not very useful. The options are to either look at the stock relative to the sector for only the time when the stock's relative P/E ratio begins to move cyclically, or remove a comparison to the sector altogether.

It's not entirely clear from the chart because ORCL's relative P/E does not appear to have found a definitive "floor", although given that its relative P/E ratio is only 82% of the S&P 500 suggests it's not likely to go much lower.

If we begin with the assumption that the cyclicality began at the last "bottom" of its secular decline, the stock's relative P/E ratio has been cyclical since early August 2009 when it troughed at 92%. It hit a 'cyclical" high of 109% in September 2011 and is currently at 82%. With this in mind, we review three of the data series in the chart to help determine the cause of the move:

- The software sector's relative P/E ratio (dark blue line, using left axis) was 120% in mid-2009 and has increased to 140% by the end of 2013, suggesting ORCL's recent relative P/E ratio decline is not due to industry factors.
- ORCL's earnings growth rate (tan line, using right axis) has been declining from 11% to 9%, suggesting it may be the cause of the lower relative P/E ratio
- ORCL's ROE (gray line, using right axis), during the more recent period has been steady at 29%, suggesting it is not the cause

Best Practices for Targeting Realistic Prices (SHARE™ Framework)



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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- side or sell-side)	Best place to gauge investor expectations	May not be representative of the larger investor base			•
Company's competitor (publicly-traded or privately-held)	Knows the sector and the competitive dynamics	May not be familiar enough with other company's factors to speak with authority. May try to bash the competition	•	•	
Company's executives (including investor relations)	Usually forthcoming about opportunistic factors	Usually downplay or ignore potentially negative factors			
Conference speaker or author of book/academic paper	Usually willing to speak with others	May not fully understand implications for company or stock	•	•	
Consultant, expert, or company retiree	Very close to the issue	Can be difficult to find	•	•	
Customer of, or supplier to, the company (publicly-traded or privately-held)	First-hand knowledge of the company's value proposition	Contact may not be representative of the larger customer base			
Government officials or staffers	Often the closest to regulatory or legislative changes	Often won't speak on the topic. If so, may not provide accurate forecast			
Industry association or forecasting service representative	Understands complex industry issues	May be biased in the sector's favor and may not fully understand implications for company or stock			
Industry journalist/blogger	May understand complex issues and provide direction to other sources of information	May not fully understand implications for company or stock	•	•	
Sell-side analyst (for the buyside) considered among top 3 in sector	May be the only place to gauge consensus thinking and to obtain proprietary research	Subjectivity or low-quality work can result in incorrect output	•	•	٠
Sell-side salesperson (with deep knowledge of specific stock)	Close to many buy-side investors	Generalist salespeople may not have full understanding of any single stock			
Trader of stock (with deep knowledge of specific stock)	Usually familiar with short-term psychology of stock	May not fully understand company or long-term issues			

Legend: ■ = best first source, □ = good source

^{*} Source must have been active with the stock/company at time of historical anomaly

Quick Reference Card (QRC)

Information Sources Pros and Cons

Read Only

Source for Information	Pros	Cons
Company-released information	Free. May be only source for certain information	Tends to be biased positively
Data service	Often the best at providing granular product or sector data	Not always provided in a timely manner. Can be expensive. Not proprietary
Economic data	Often reliable and relatively objective	Not company-specific. Past trends don't forecast the future
Financial media	Low cost and somewhat objective	May not fully understand implications for company or stock
Forecasting service	Often the best at forecasting trends for the factor	Not always provided in a timely manner. Can be expensive. Not proprietary
Industry trade journal, website, or blog	Low cost. Somewhat objective. Understands complex issues	May be biased in the sector's favor. May not fully understand implications for company or stock
Proprietary survey	Output is proprietary	Expensive and can take a significant amount of time
Sell-side report (for buy-side analysts)	Easy to access and search (if client)	May be biased by analyst's rating
Third-party research firm	The study answers your specific questions and you own the data	Expensive and can take a significant amount of time

A View from Dilbert...



