

AnalystSolutions

CE Approved
Provider  CFA Institute

AnalystSolutions

Workshop Schedule

- Role of equity research analyst
- Use ENTER™ quality framework to assess research
- Introduction to setting price targets
- Identifying critical factors
- Generating differentiated insights
- Accurately forecast
- Setting price targets
- Stock picking techniques of highly-experienced analysts
- Communicating stock calls

Skills > Tools

- This class isn't about tools
- It's about learning skills
- Institutional investment employers are looking for critical thinkers



Investment Firms

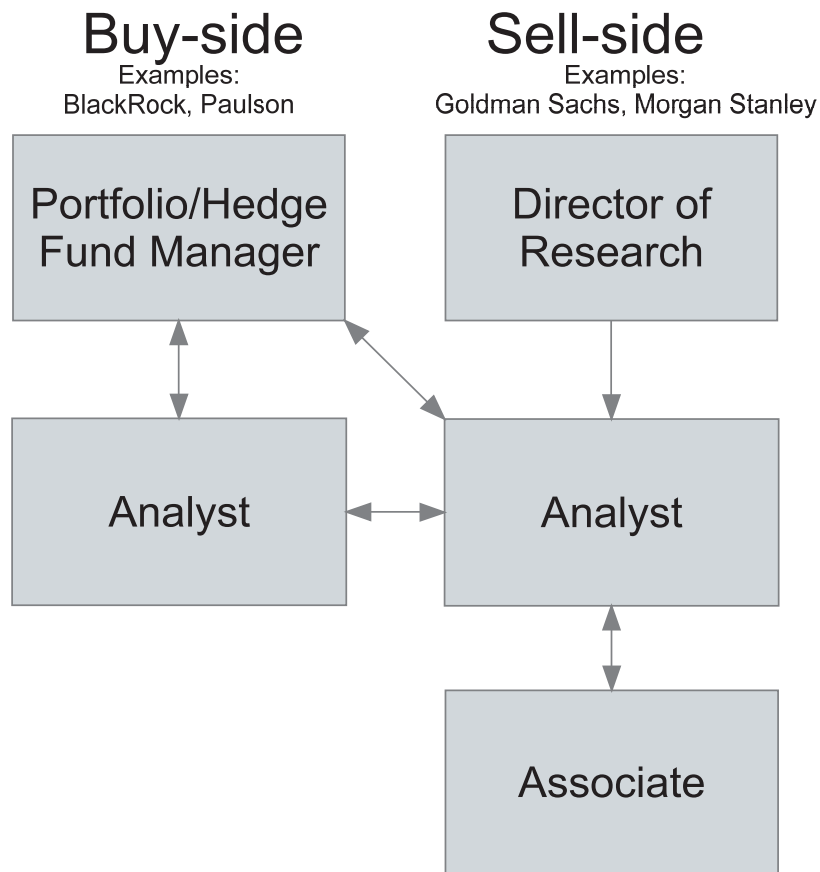
Buy-Side

- Invest client assets (usually in funds)
- Types of funds:
 - Mutual funds
 - Hedge funds
 - Pension funds
- Examples:
 - BlackRock
 - Citadel (most analysts of any firm in the world)
 - T. Rowe Price

Sell-side

- Provide services to buy-side and corporate clients
- Types of services:
 - Research
 - Trading
 - Investment banking
 - Retail brokerage
- Examples:
 - Goldman Sachs
 - Merrill Lynch
 - Morgan Stanley

Some firms have large franchises in both (e.g. J.P. Morgan, Morgan Stanley)



“Stock Picker” Careers

Day Trader	Professional Trader	Portfolio Manager or Buy-side Equity Research Analyst	Sell-side Equity Research Analyst
Personal capital	Firm's or client's capital	Client's or Firm's capital	Doesn't invest capital
Short-term (less than a week and often daily)		Usually 6 to 18 months	1 day to 18 months, depending on client needs
Looking for near-term shifts in market sentiment	Looking for near-term shifts in market sentiment or filling client order	Forecast where mid-to-long-term stock-specific expectations are wrong	
Rely on financial media, equity research analysts and peers		Should rely on independent or sell-side research	Should conduct independent research

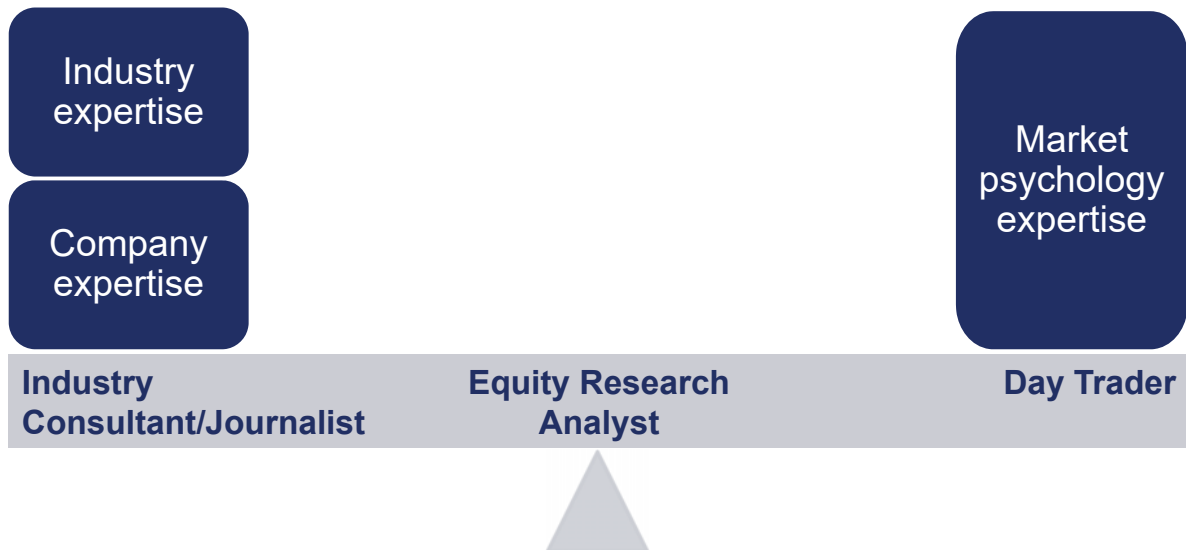
Financial Consultants (“Stock Brokers”) are generally not paid for picking stocks for clients

Key Elements of Great Stock Pickers

- Dispassionate -- Namely, they don't allow non-relevant factors to cloud their judgment
- Stick to their discipline and strategy over the long-term
- Self-aware of where they have expertise and where they don't



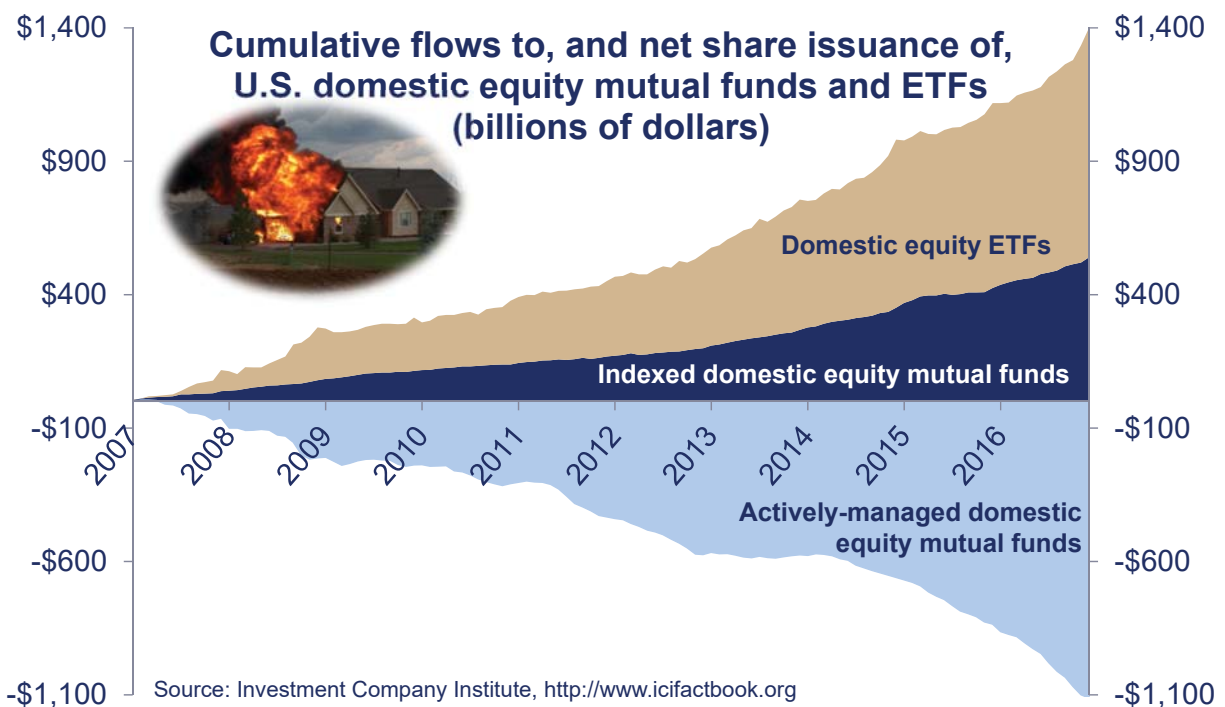
Are You In Balance?



How Do You Differ from Sector (or “Beat”) Journalists?

Task	Equity Research Analysts	Experienced Sector Journalists
Understand industry fundamentals	Y	Y
Listen to company conference calls	Y	Y
Read company press releases	Y	Y
Review company regulatory filings	Y	Y
Cultivate a list of insightful industry contacts	Y	Y
Interview industry experts to identify changes in the industry	Y	Y
Speak with company management	Y	Y
Write about developments within a company and across the industry	Y	Y

Worthy of Analysis



Potential Questions

- Typical day as a equity research analyst?
 - What are the good and bad points of this job?
 - Is excel modeling a big part of the job?
- What separates a successful and excellent analyst from an average analyst?
 - What mistakes do equity research analysts make often?
- Future career outlook of the role? How competitive is the field?
- What are employers looking for?
 - What are the required skill sets?
 - Is the CFA a prerequisite to starting a career in equity research?
- Finding a job:
 - See my blog post: <https://www.analystsolutions.com/get-a-job-as-an-equity-research-analyst/>
 - How do I stand out as a candidate?
 - How should a Finance student without internship experience find his/her way into this role?

**Have you done
enough
research to
ENTER™ the
investment
debate?**



The First “E” in ENTER™ represents being Expectational



- Forward-looking view for the critical factors and their catalysts
- Identify important future dates
- If researching the past, it should be to help forecast the future

The “N” in ENTER™ represents a Novel perspective

Novel research includes:



- Insights not already known by the broader market...
- Or explaining how widely-known information is being misinterpreted
- Providing new or unique insights to explain your out-of-consensus view

The “T” in ENTER™ represents Thorough

Thorough research:



- It's more than a “hunch” or “guestimate”
- Obtain insights to forecast critical factors better than consensus
- Have multiple sources to confirm out-of-consensus critical factor when imperative to stock call
- Thoroughness should be commensurate with potential impact on the stock's performance

The Second “E” in ENTER™ represents Examinable

Examinable research should:



- Provide decision-makers research you developed to draw conclusions
- Provide important data points so others can arrive at your conclusion for themselves
- Provide enough depth to allow others to examine your work
- Separate facts from opinions

The “R” in ENTER™ represents Revealing


Revealing research:



- Identifies specific risks not in your base-case scenario (positive and negative)
- Shows an understanding of “the other side of the trade”
- Specifies your level of conviction about your out-of-consensus call

Will You Be Able to Recall the ENTER™ Quality Framework When You Need It?

 E _____

 N _____

 T _____

 E _____

 R _____

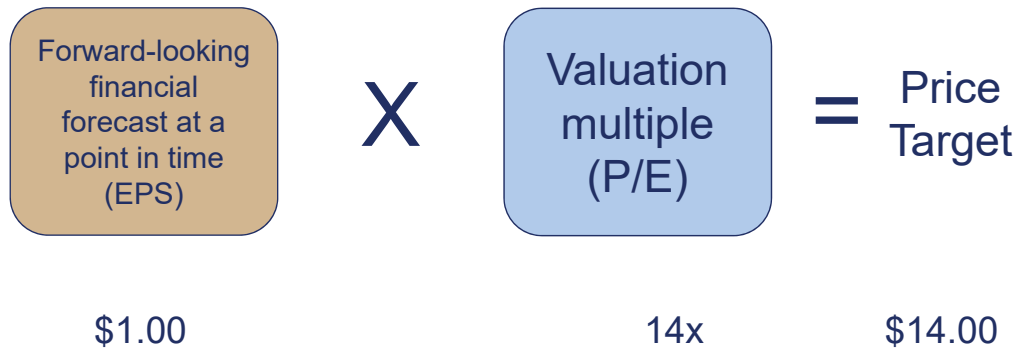
Exercise: Evaluate Two Analysts Using ENTER™ Framework

- Review the evaluation framework
- Images will be pixilated
- Set-up for Analyst #1 (TLSA)
- Set-up for Analyst #2 (NFLX)

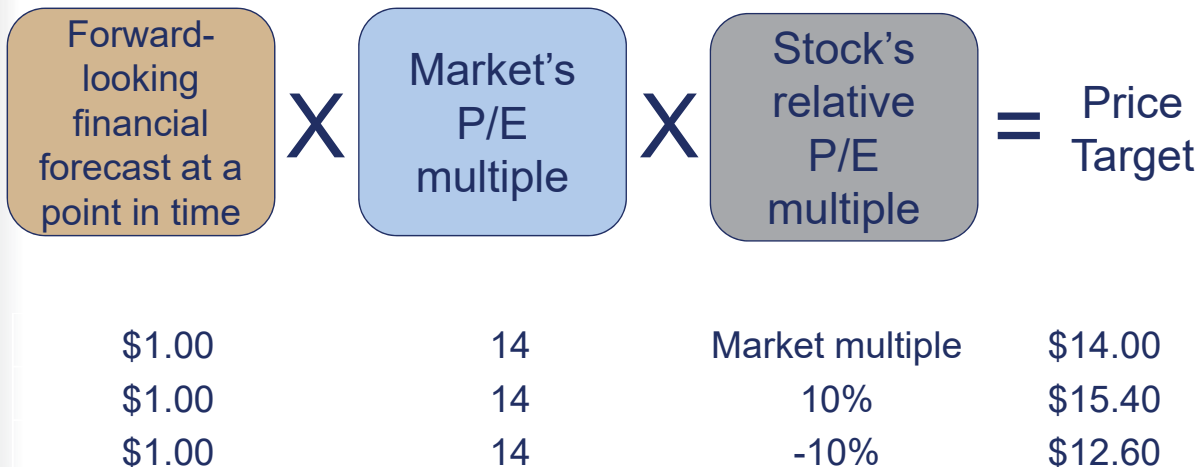
Setting Price Targets

- Step 1. Derive EPS Growth Rate
- Step 2. Derive Base-case EPS Estimates for Year 1 and Year 2
- Step 3. Derive a Realistic Valuation Level for the Overall Market (S&P 500)
- Step 4. Derive a Base-case Relative Valuation and Price Target for a Stock
- Step 5. Derive Upside and Downside EPS Estimates for Year 1 and Year 2
- Step 6. Derive Upside and Downside Price Targets for a Stock
- Step 7. Compute How the Price Target Differs from Consensus

Price Target Components for Relative P/E Ratio Valuation



Price Target Components for Relative P/E Ratio Valuation



Be Aware of the Market Multiple You Select



				Difference from base-case
\$1.00	18	Market multiple	\$18.00	
\$1.00	14.5	Market multiple	\$14.50	-19%
\$1.00	11	Market multiple	\$11.00	-39%

Complete Your TAP

Section 1

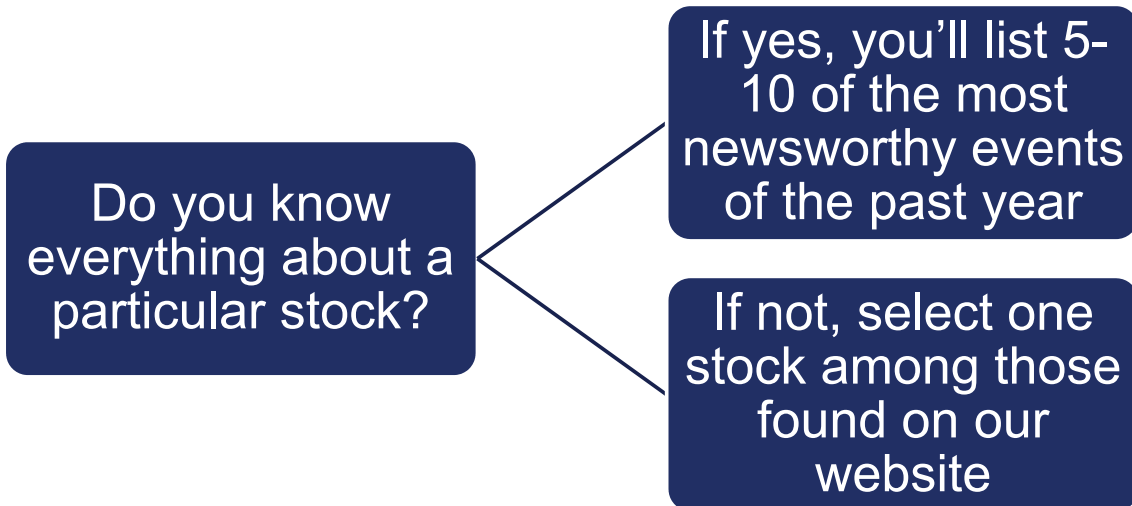
Transformation Action Plan (TAP)



Instructions for the Transformation Action Plan (TAP):

- Throughout this workshop complete the TAP below
- Apply the key points after the workshop to help you improve your performance
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Choose Your Option



Complete Your TAP

Section 2, Part 1

Transformation Action Plan (TAP)



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Exercise: “List Everything”

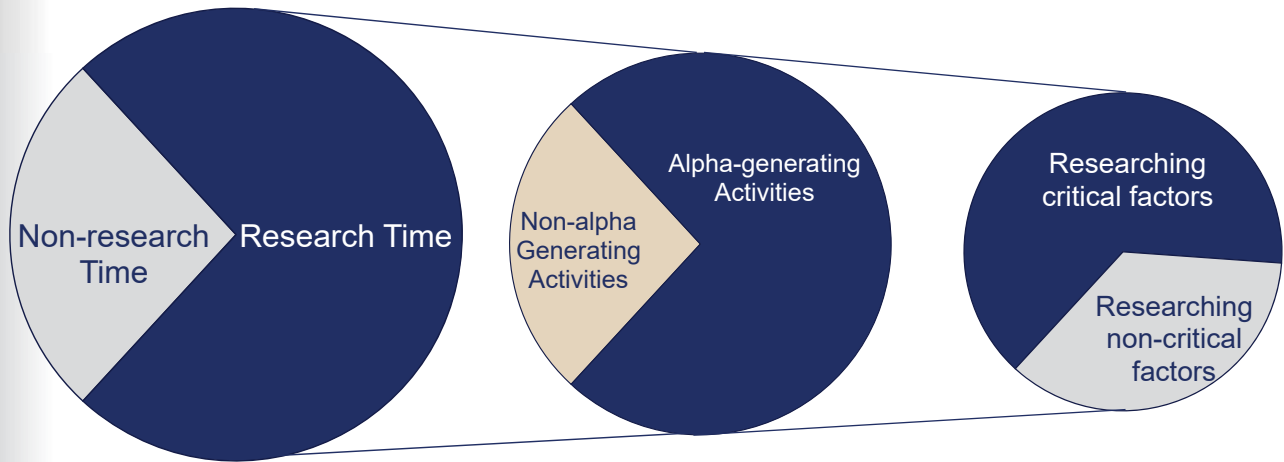
<https://www.analystsolutions.com/LE>

Make the Alpha-Generating Time Matter

Total Work Time

Research Time

Alpha-Generating Activities



Fish Where There's Alpha



Is It a Critical Factor? (Scenario 1)



- The government just awarded a contract to Yellow Mobile Corp (YMC), a mobile telephone company, to exclusively provide service for all government employees in the country
- Is it a critical factor for YMC?

Is It a Critical Factor? (Scenario 2)



- All unionized truckers who serve the largest port in the area are calling for a two-day strike
- Is it a critical factor for Tortoise Trucking?

Scenario 1: YMC Telecom



New information...

The government just awarded a contract to Yellow Mobile Corp (YMC), a mobile telephone company, to exclusively provide service for all government employees in the country

Is it a critical factor?

Potentially yes, if the company...

- Priced the service at reasonable margins
- Has capacity to accommodate the additional demand

Scenario 2: Tortoise Trucking

New information...

All unionized truckers who serve the largest port in the area are calling for a two-day strike



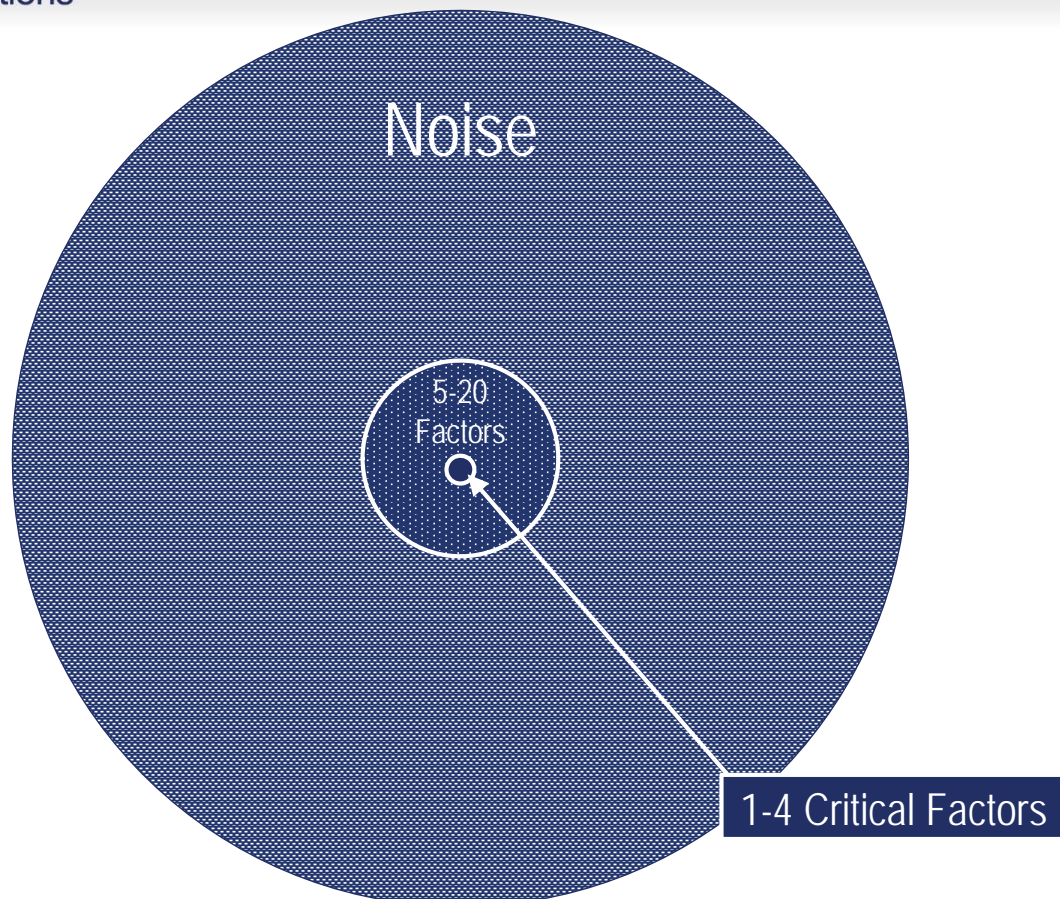
Is it a critical factor?

Potentially yes, if the...

- Strike will have an impact beyond two days; and
- TT's employees are unionized (part of the strike); and
- TT has significant exposure to the port

Examples of Critical Factors

Stock	Critical Factor
Amazon.com	Market share shift from traditional retailers
IBM	Migration to cloud-based solutions
Nike	Top line growth rate keeping up with historical trends
NVIDIA (graphics tech)	Growth of virtual reality as mainstream product
The Gap	Apparel pricing deflation
Time Warner Cable	Growth of competing content providers such as Netflix, Amazon and HBO
T-Mobile	Competitive pricing among the wireless carriers
VMware (software)	Growth of Open Source software vs. traditional vendors
Walgreens (drug retailer)	Generic drug price inflation



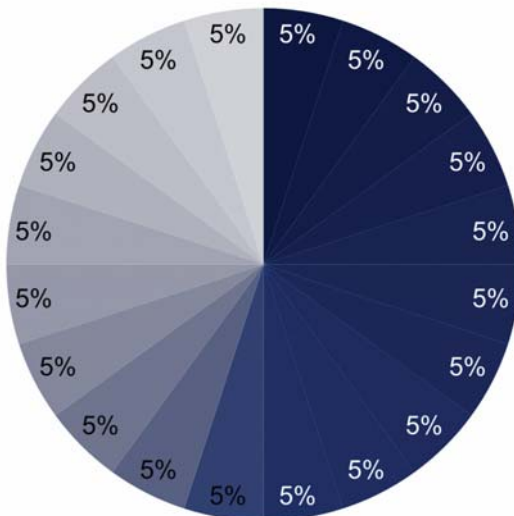
Sea of Mediocrity



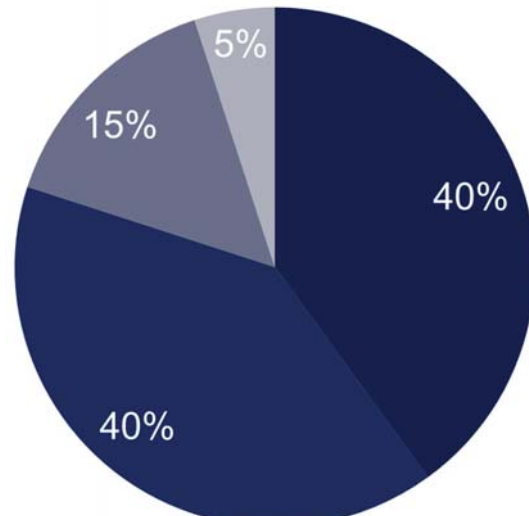
- “90% of everything is crap”
 - Sturgeon’s Law (1951)
- “Four-fifths of everybody’s work must be bad. But the remnant is worth the trouble for its own sake.”
 - Rudyard Kipling (1890)

What Will Your Day Look Like?

Critical Factors Not Defined



Critical Factors Defined



Definition of Critical Factor

- An under-appreciated stock-related factor, that can be forecast with reasonable accuracy to occur during the investor's investment time horizon, leading a stock to out- or under-perform an index
- Everything that can move a stock is not automatically a critical factor

EPIC™ Stock Calls Require Critical Factors Meet All Four Criteria



Exceeds Materiality Threshold?

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



Exceeds Materiality Threshold?

“Materiality” can mean different things to different people:

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



Create Tool to Compute Materiality

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



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

Your “Materiality” Threshold



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

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

Example: Computing Materiality

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

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

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

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

Example: Computing Materiality

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

1. Compute backwards, starting with 5% change to EPS:
 $\$0.88 \times 5\% = \0.04
2. Compute net income impact:
 $\$0.04 \times 53.9 = \2.4 million
3. Convert after-tax to pre-tax:
 $\$2.4 \div (1 - 0.34) = \3.6 million

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



Example: Computing Materiality

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

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

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

2. Compute required change in revenue from pricing:

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

3. Compute required change in expenses:

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

Is It Worth Your Time?



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

Materiality Tool

Ticker:	FDX	IBM	SBUX	WMT
Period (year)	2016	2016	2016	2016
Amount EPS needs to change to be "material":	10%	10%	10%	10%

Step 1: Compute 10% of net income

10% change to EPS	1.08	1.37	0.19	0.44
Materiality threshold as measured in net income	\$302	\$1,317	\$286	\$1,414

Step 2: Convert to pre-tax EBIT (MAGIC NUMBER)

Materiality threshold as measured in pre-tax EBIT	\$375	\$1,359	\$424	\$2,036
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Step 3: Compute threshold for changes from pricing and expenses

Materiality threshold as measured in changes to pricing ¹	0.7%	1.7%	2.0%	0.4%
Materiality threshold as measured in changes in expenses ²	0.8%	2.0%	2.5%	0.4%

Step 4: Compute threshold for change in revenue from sales/volume

Materiality threshold as measured in changes from sales/volume ³	\$3,767	\$8,117	\$2,135	\$40,980
As a percent of revenue	7.5%	10.2%	10.0%	8.5%

Complete Your TAP

Section 2, Part 2

Questions #1 & #2

Transformation Action Plan (TAP)



Instructions for the Transformation Action Plan (TAP):

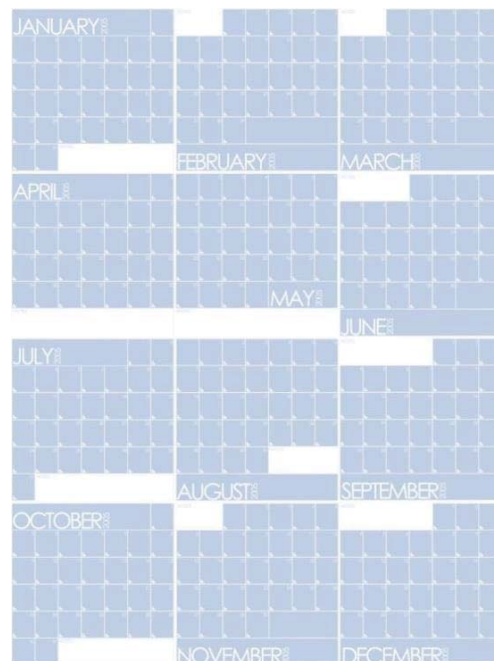
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EPIC™ Stock Calls Require Critical Factors Meet All Four Criteria

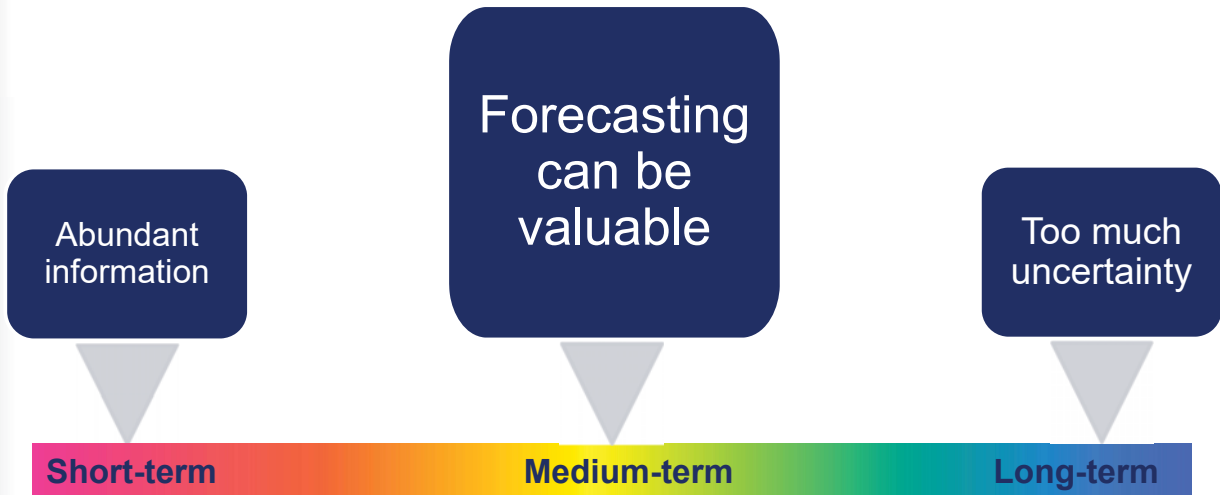


Probably Going to Occur?

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



Sweet Spot of Forecasting



Exceed Materiality vs. Probability

		<u>E</u> xceed Materiality	
		LOW	HIGH
<u>P</u> robability	HIGH	Potential Time Drain <ul style="list-style-type: none"> Company may enter new market that is very small Company is likely to discontinue a product that isn't generating material profit or losses 	Potential Critical Factor <ul style="list-style-type: none"> New subscriber growth likely to be 10% versus 6% historical trend Merger synergy not likely to be realized
	LOW	<ul style="list-style-type: none"> Company could lose frivolous lawsuit Dissident shareholder proposal has been made to limit the company's ability to spend on political activities 	<ul style="list-style-type: none"> Company could win away major contract from competitor that doesn't expire for 3 years Non-union employees of well-run company may decide to unionize at some point in the future
		Easy to Avoid	Evaluate if Monitoring Required

Complete Your TAP

Section 2, Part 2

Question #3

Transformation Action Plan (TAP)



Instructions for the Transformation Action Plan (TAP):

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EPIC™ Stock Calls Require Critical Factors Meet All Four Criteria



I'm Good at Forecasting?



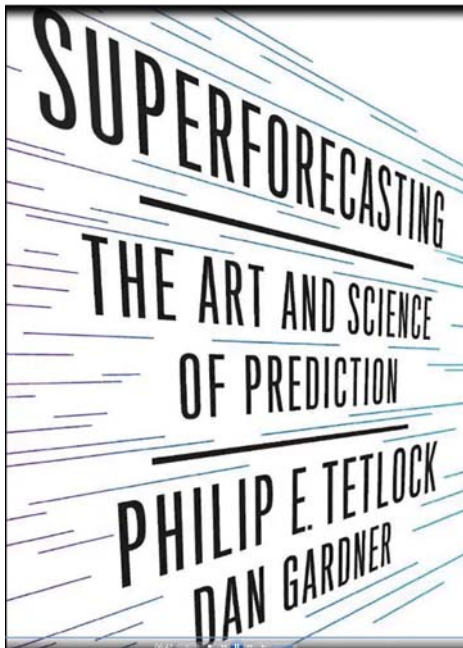
- It's not just "guesstimating"
- Can we forecast most alpha-generating events?
 - Systematic vs.
 - Unsystematic
- What other element needs to be forecast, beyond financial estimates?

High Quality Catalyst(s)

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



Exercise: Fermi-ize



Break down the question into:

- Knowable; and
- Unknowable

ASPIRE™ to Gain Insight



Assumptions for critical factors



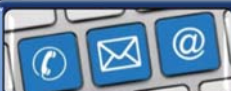
Source(s) of insight



Prepare to approach and interview



Introduce and interview



Respond with follow-up



Evaluate benefit

Complete Your TAP

Section 2, Part 2

Questions #4, #5 and #6

Transformation Action Plan (TAP)



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EPIC™ Stock Calls Require Critical Factors Meet All Four Criteria



An Analyst's Goal...

Identify where consensus is wrong

Consensus is Poor at Forecasting?

- Tough to generate alpha when others have done work in the same area
- Does consensus have the answer already...
 - If not, why not?
- How can you determine if consensus will be poor at forecasting?



Complete Your TAP

Section 2, Part 2

Question #7

Transformation Action Plan (TAP)



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EPIC™ Conclusion



Not a Critical Factor

- These are not critical factors (can you base a stock call on any?)
 - Changes of most macro-economic factors
 - Changes in most commodity prices
 - Most market-moving events (e.g. Fed policy change, Brexit, unexpected political leadership change)

Exploit Non-factors

If you are well-versed on why a factor is “not critical”, there may be times to exploit a short-term trade when the market overreacts by treating it as a critical factor

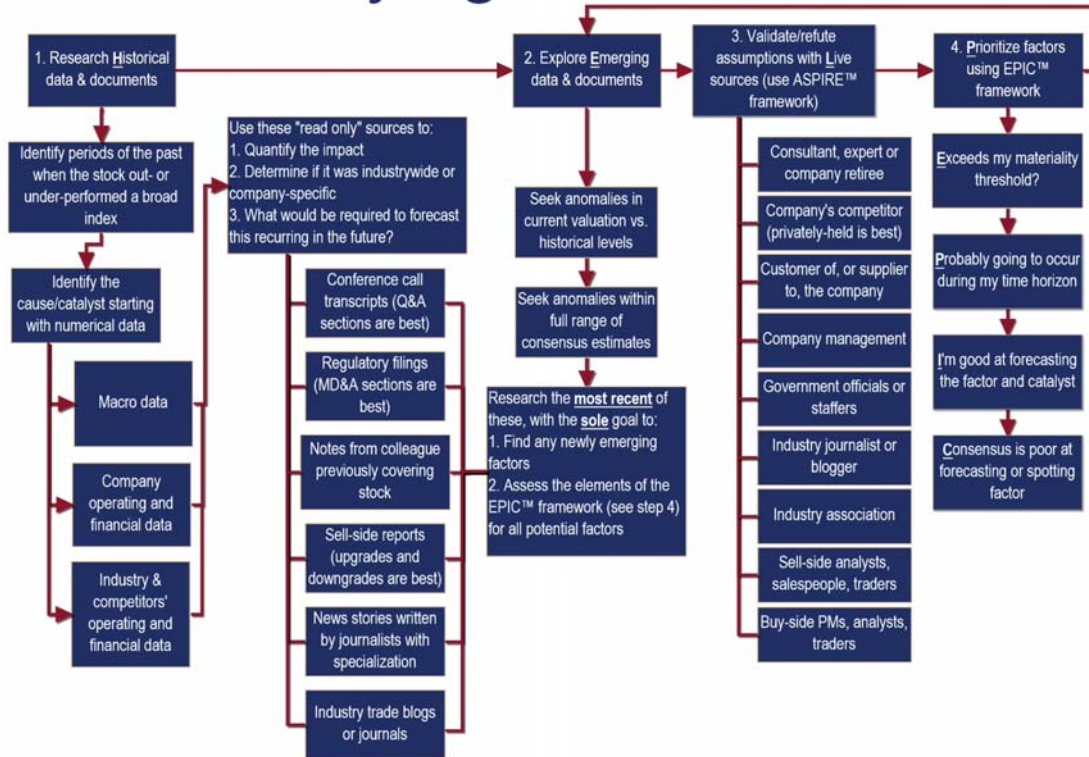
Hunting for Critical Factors



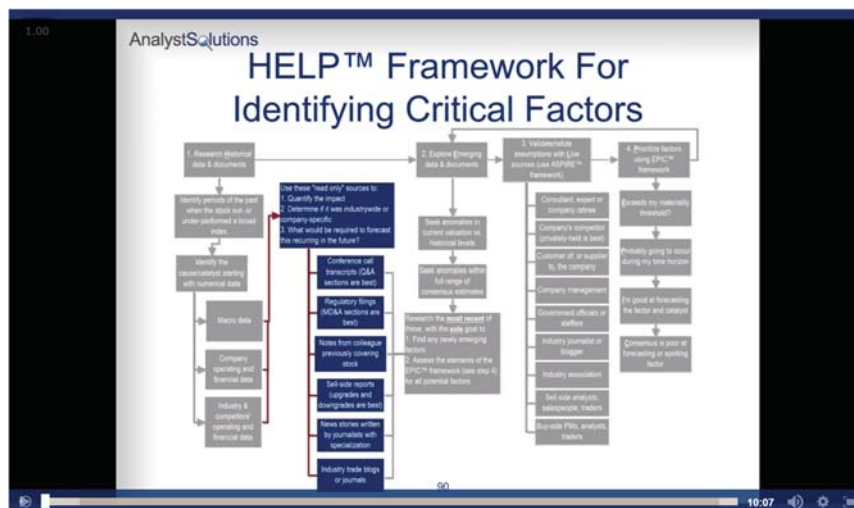
HELP™ Framework for Identifying Critical Factors

-  Research Historical data & documents
-  Explore Emerging data & documents
-  Validate/refute assumptions with Live sources
-  Prioritize factors using EPIC™ framework

HELP™ Framework For Identifying Critical Factors



Finding Critical Factors Using Bloomberg



https://www.analystsolutions.com/imscfg2file_requ-245y4warhfs/

Research If Corporate Actions Impact Performance

<HELP> for explanation. EquityCACS

33<Go> to save current settings to the current template

FDX US Equity 3) Templates 3) Actions 18 results Corporate Actions

Show Company Lev Date Announc 01/01/97 -01/01/07 2) Asset Types

Filter Actions Dividends Splits M & A IPO / ADDL Listings 2) Actions (6)

	Date	Action Type	Ticker / ID	Summary
1)	12/18/06	Acquisition	FDX US	Target: ANC Holdings Ltd, Sought: 100.00%
2)	11/02/06	Acquisition	FDX US	Target: Prakash Air Freight Pvt Ltd, Sought:
3)	05/26/06	Acquisition	FDX US	Target: Less-than truckload operations, Soug
4)	01/24/06	Acquisition	FDX US	Target: 50% of JV and other assets, Sought:
5)	09/23/04	Acquisition	FDX US	Target: Certain Assets, Sought: 100.00%
6)	08/09/04	Acquisition	FDX US	Target: Parcel Direct, Sought: 100.00%
7)	12/30/03	Acquisition	FDX US	Target: FedEx Office and Print Service, Soug
8)	07/14/03	Stock Buyback	FDX US	Open Market for Common; 5.000M Shares
9)	05/31/02	Stock Buyback	FDX US	Open Market for Common; 5.000M Shares
10)	01/31/02	Acquisition	FDX US	Target: Fritz brokerage ops, Sought: 100.00%
11)	09/24/01	Stock Buyback	FDX US	Open Market for Common; 5.000M Shares
12)	11/13/00	Acquisition	FDX US	Target: American Freightways Corp, Sought:
13)	08/01/00	Acquisition	FDX US	Target: Passport Transport, Sought: 100.00%
14)	04/04/00	Acquisition	FDX US	Target: World Tariff Ltd, Sought: 100.00%
15)	02/17/00	Acquisition	FDX US	Target: Tower Group International, Sought: 1
16)	09/27/99	Stock Buyback	FDX US	Stock Buyback for Common; 15.000M Shares
17)	08/06/99	Acquisition	FDX US	Target: GeoLogistics Air Services, Sought: 10
18)	10/06/97	Acquisition	FDX US	Target: Caliber System Inc, Sought: 100.00%

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 59 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2012 Bloomberg Finance L.P.
SN 674606 EDT GHT-4:00 H427-3139-3 03-Jun-2012 15:36:49

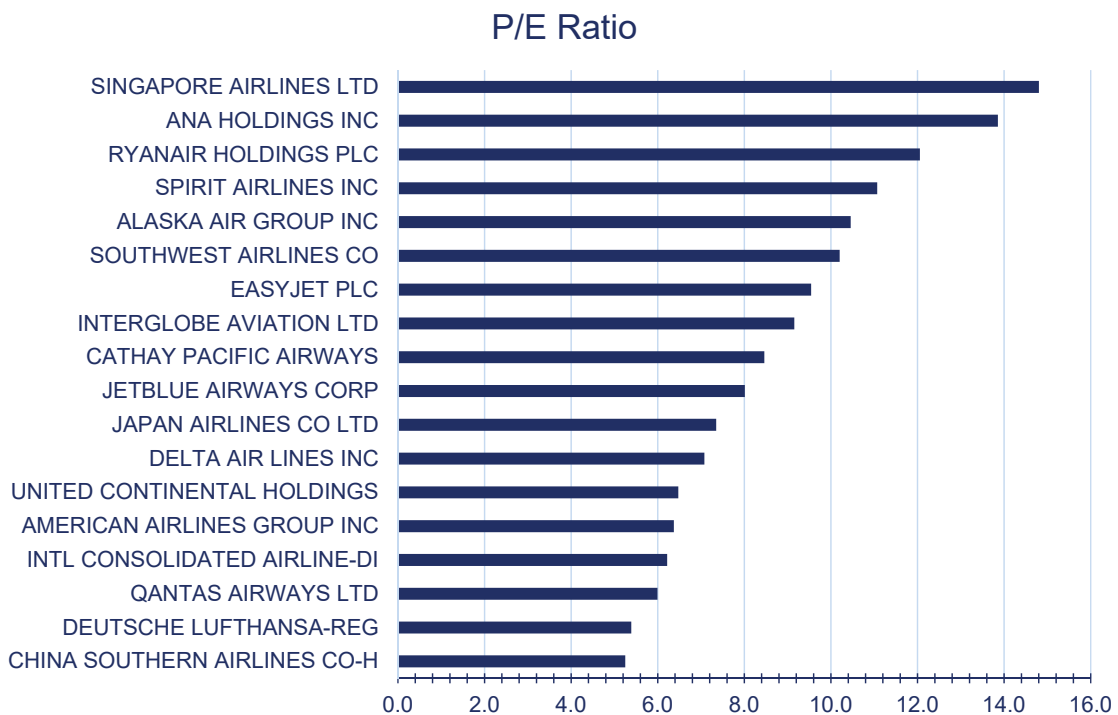
Understand the Comp Table and Consensus Expectations

- Review a valuation comp table to:
 - Identify where there are discrepancies between each company's current valuation and its historical valuation
 - Understand why companies are trading at a significant premium or discount to their peers
- Review a full range of sell-side earnings estimates to identify where earnings or cash flow expectations are the widest

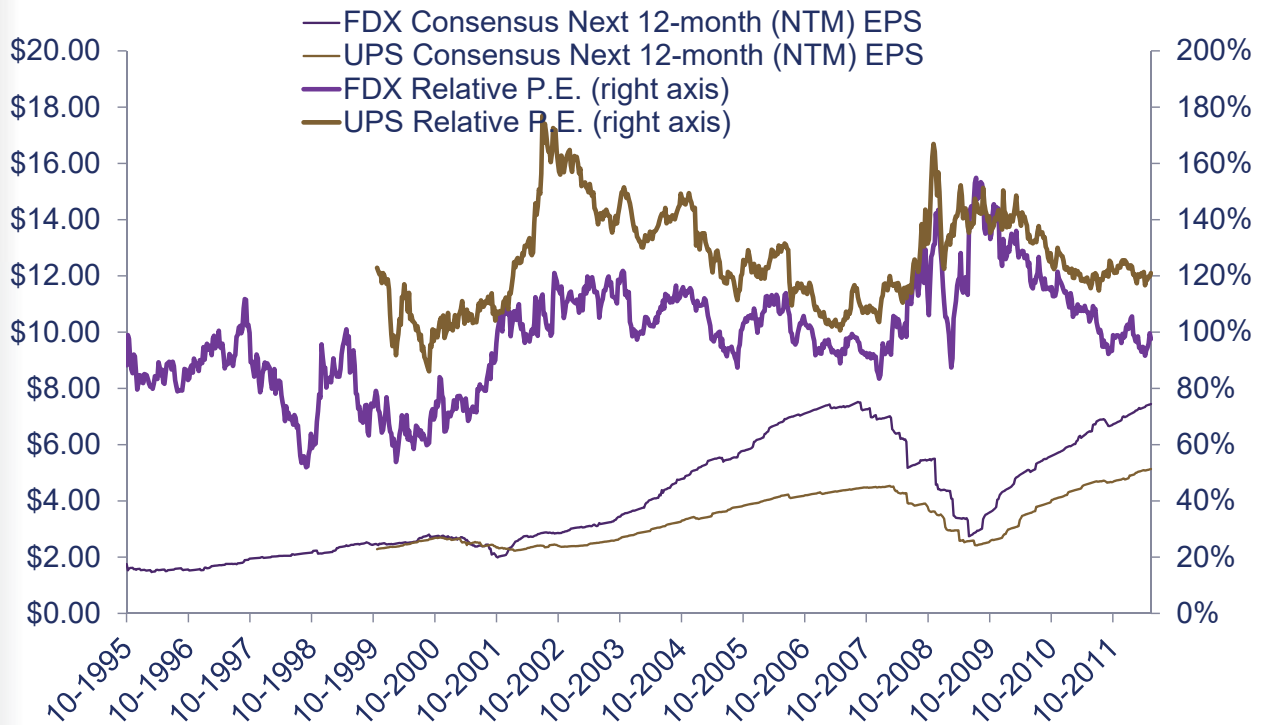
EXAMPLE COMP TABLE

Review Data Validation

Why Premiums or Discounts?



FDX and UPS Relative P/E; Rolling Forward Consensus Estimates



Start with the Most Recent Version of These...



- The MD&A and risks sections of company regulatory filings
- Transcripts and related material from recent company presentations
- Trade journals/websites
- Notes from colleague(s) who have participated in recent company calls and meetings
- Sell-side reports (for buy-side analysts)

Blackline & Redline

FEDEX CORP

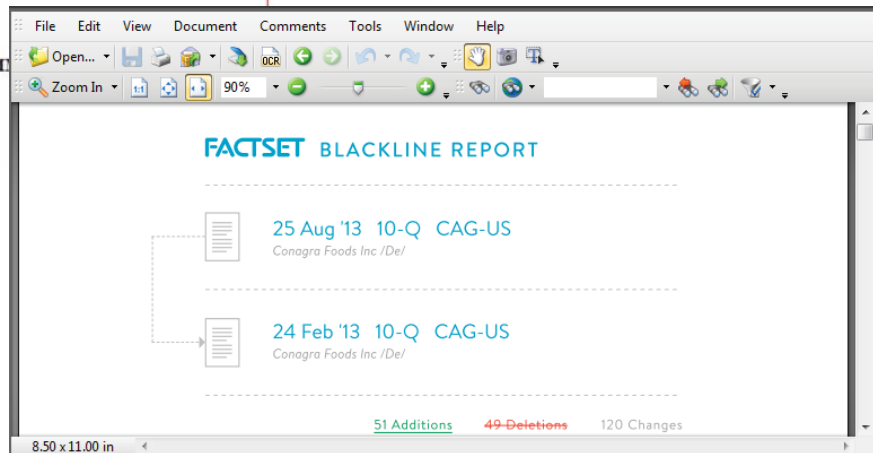
Redline Report

Additions: 126

Deletions: 132

Changes: 280

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q



Example “Emerging” Information

FedEx Express Segment Operating Income

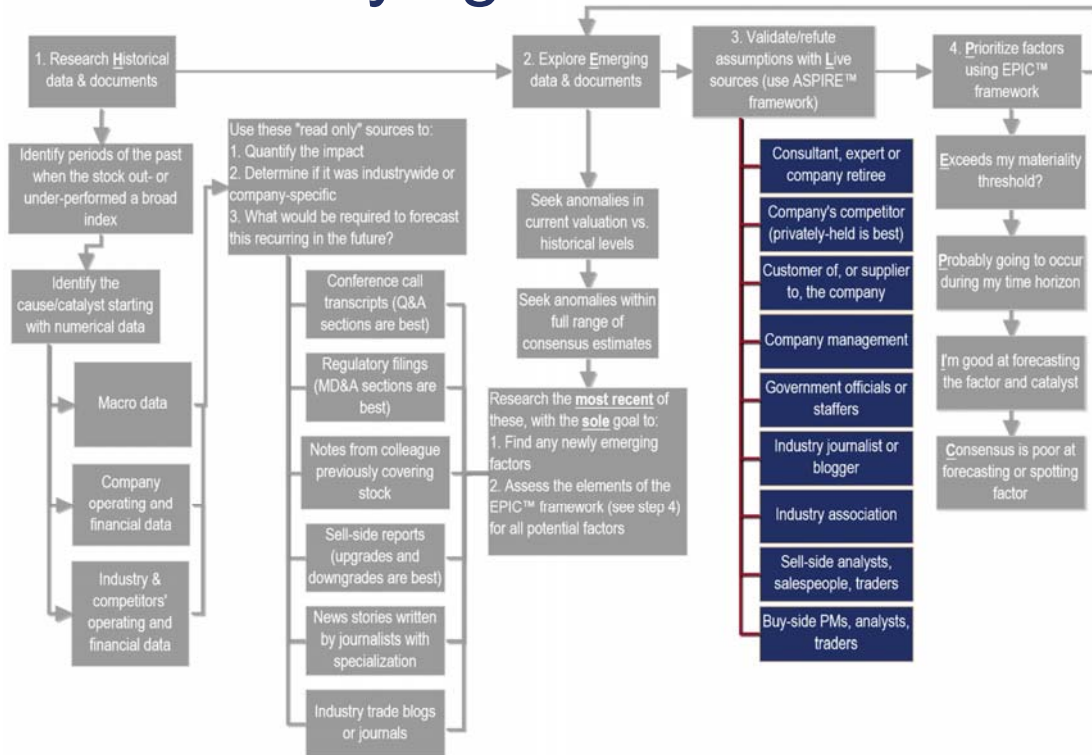
□.118 FedEx Express operating income and operating margin increased in the second quarter and the first half of 2014 driven by stronger base U.S. and international business and lower aircraft maintenance and pension expense, partially offset by higher depreciation expense. In addition, operating income in the second quarter of 2014 compared to 2013 benefited from the negative impact of Superstorm Sandy in the prior year. In the first half of 2014, operating income reflects a significant negative impact of the timing lag which exists between when fuel prices change and when indexed fuel surcharges automatically adjust and one fewer operating day. The demand shift from our priority international services to our economy international services continued to impact our overall business. □

□.119 In the second quarter and the first half of 2014, salaries and employee benefits included lower pension expense and the delayed timing or absence of annual merit increases for many of our employees. Intercompany charges decreased 4% in the second quarter and 6% in the first half of 2014 due to lower allocated sales and information technology costs. Purchased transportation costs increased 9% in the second quarter and 11% in the first half of 2014 due to costs associated with the expansion of our freight-forwarding business at FedEx Trade Networks and higher utilization of third-party transportation providers. Purchased transportation costs in the first half of 2014 were also negatively impacted by international acquisitions. Depreciation and amortization expense increased 11% during the second quarter and 13% during the first half of 2014 as a result of accelerated depreciation due to the shortened life of certain aircraft, and aircraft recently placed into service. □

□.118 Our results for the FedEx Express segment for the first quarter of 2014 were significantly constrained by the net negative impact of fuel and one fewer operating day. Despite the negative impact of these factors, FedEx Express operating income increased by 14% and operating margin increased by 50 basis points in the first quarter of 2014, driven by stronger base U.S. business and lower aircraft maintenance and pension expense, partially offset by higher depreciation expense. □

□.119 In the first quarter of 2014, salaries and employee benefits benefited from lower pension expense, one fewer operating day and the delayed timing or absence of annual merit increases for many of our employees, partially offset by the impact of prior year international domestic acquisitions. Intercompany charges decreased 8% due to lower allocated sales and information technology costs. Purchased transportation costs increased 12% due to prior year international business acquisitions, higher utilization of third-party transportation providers and costs associated with the expansion of our freight-forwarding business at FedEx Trade Networks. Depreciation and amortization expense increased 14% during the first quarter of 2014 as a result of accelerated depreciation due to the shortened life of certain aircraft and aircraft recently placed into service. □

HELP™ Framework For Identifying Critical Factors



Speak with Live Sources to Understand Anomalies

- **Goals**
 - Confirm or refute conclusions from research conducted to identify *historical* critical factors ("H" of HELP™)
 - Assess *new* or *emerging* critical factors ("E" of HELP™)
 - Assess *materiality* and *probability* surrounding potential critical factors ("E" and "P" of EPIC™)
 - Determine if *consensus* will be good at forecasting ("I" of EPIC™)
- For historical factors, ensure the individual was closely involved with the stock or sector for the time period you are analyzing

How much does the market expect AAPL's watch to drive EPS growth?

Did SBUX have a major problem by growing stores too quickly in 2007?



Understand What's in Consensus

Speak with market participants:

- Experienced buy-side analysts or PMs who currently own or have owned the stock in the fund
- Sell-side salespeople who have interest in the stock
- Sell-side traders who trade the stock
- The company's investor relations contact
- Sell-side analysts (if you're a buy-side analyst)



Example of Consensus Expectations

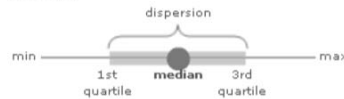


How do investors think the following factors will affect Nat Aust Bank stock over the next 12 months?

CHOOSE a time horizon:

3 months 12 months

LEGEND

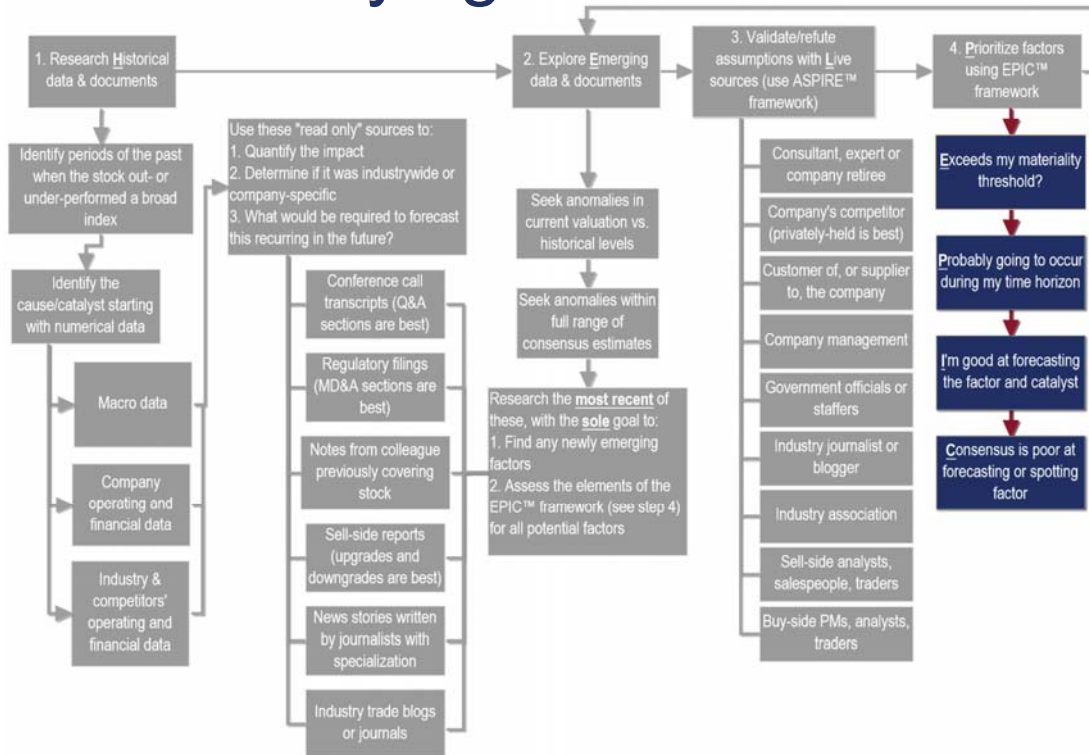


VERY NEGATIVELY NOT AT ALL VERY POSITIVELY

-3 -2 -1 0 +1 +2 +3



HELP™ Framework For Identifying Critical Factors



Example for FedEx

- See in your TAP immediately following this exercise

Factors for: FedEx in the 2005-2006 time period, ranked by "Total" column

Factor to Potentially Be Researched	If this factor were to occur or change from trend, it would cause changes in consensus' expectations to Exceed my materiality threshold	This factor will Probably deviate materially from consensus expectations during my investment time horizon	Based on my research on the factor, I'm good at forecasting this factor and its catalyst (it's not just a guess)	The overall Consensus will be poor at accurately forecasting or spotting an anomaly for this factor	Total
Cost management/productivity/Improved network efficiency	5	4	4	5	18
Level of fuel surcharge collected	5	4	4	4	17
Acquisition(s)	5	3	2	5	15

Complete Your TAP

Section 1, Part 2

Question #8

Transformation Action Plan (TAP)



Instructions for the Transformation Action Plan (TAP):

- Throughout this workshop complete the TAP below
 - Apply the key points after the workshop to help you improve your performance
 - This will not be collected and so write in a manner that will help you utilize the concepts being learned
-

DEBRIEF: WHERE IS THE MARKET WASTING ITS TIME?

Digesting Inbound Information is Like Drinking From a Fire Hose



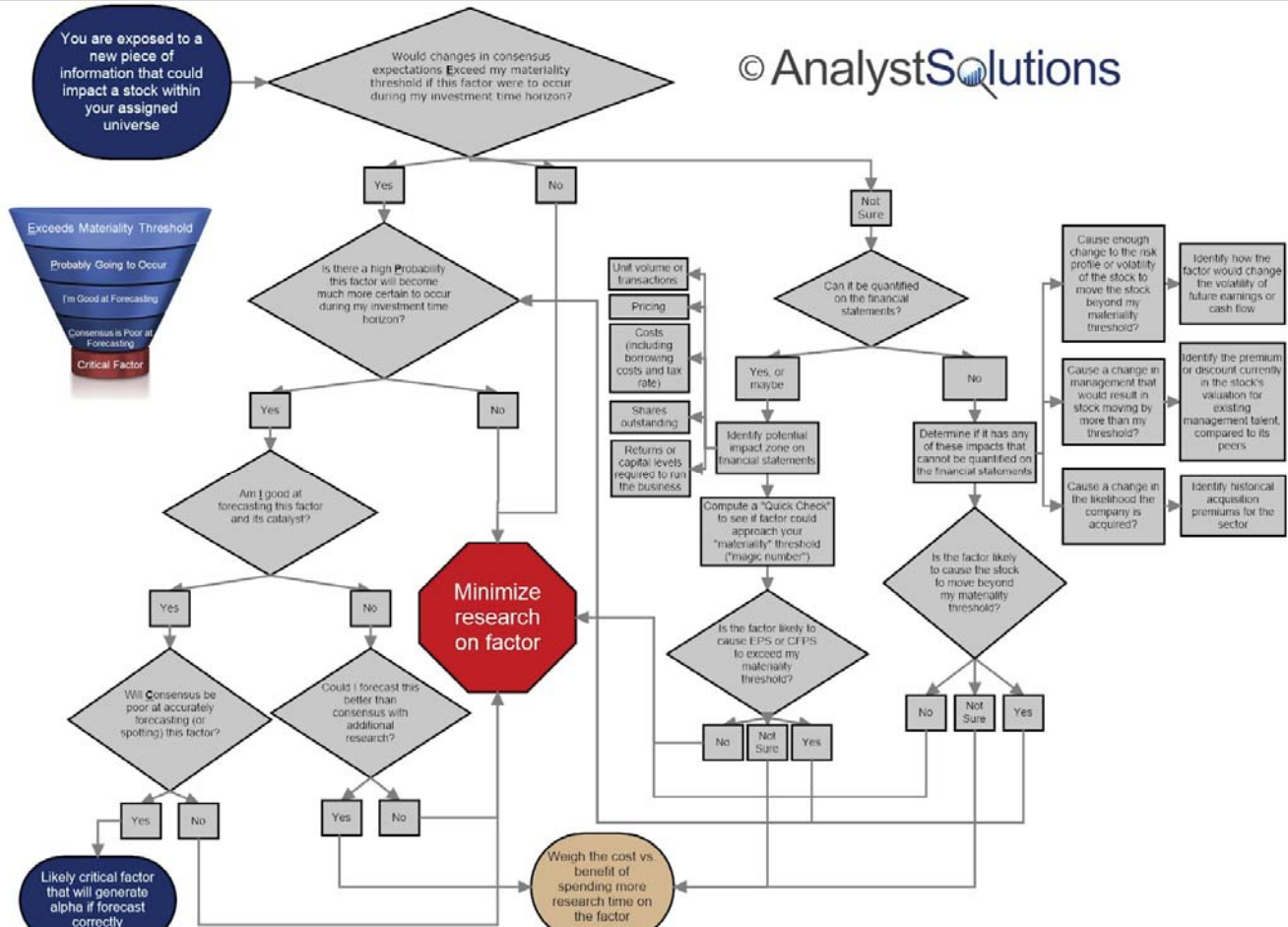
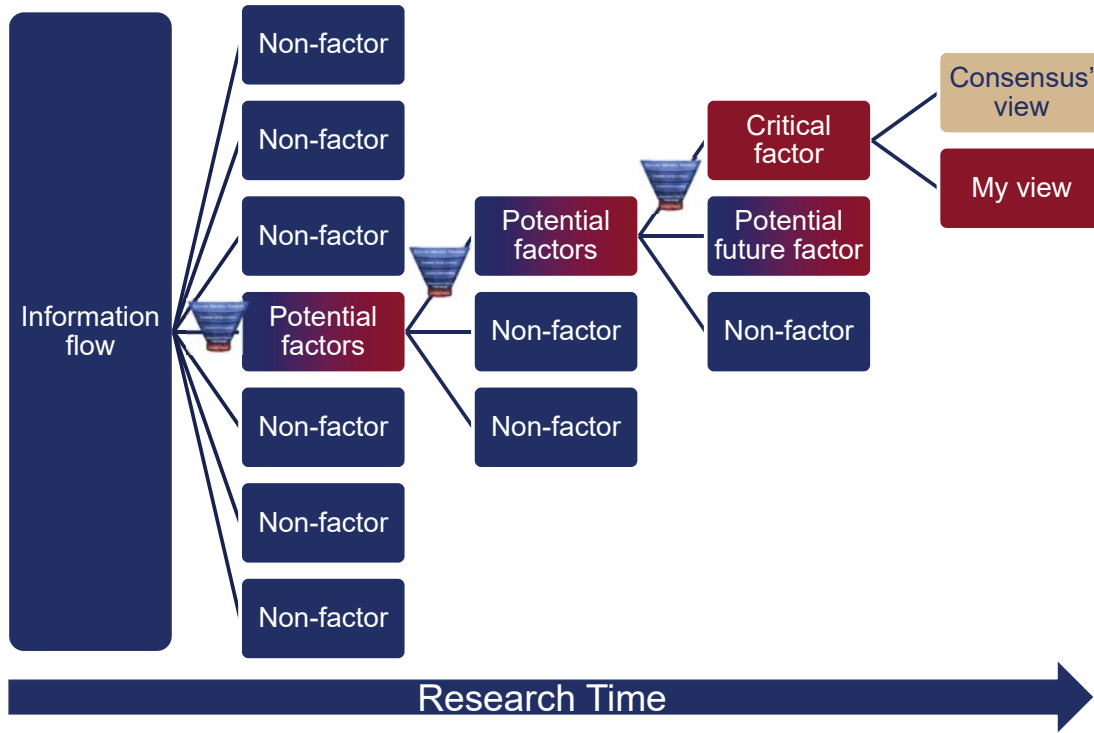
- Information flow never stops
- Take command with a process
- “He who processes information efficiently will be a happier analyst”

New Information Starts the Process



- You are exposed to a new piece of information that could impact a stock within your assigned universe
- What do you do next?

Identifying the Critical Factors



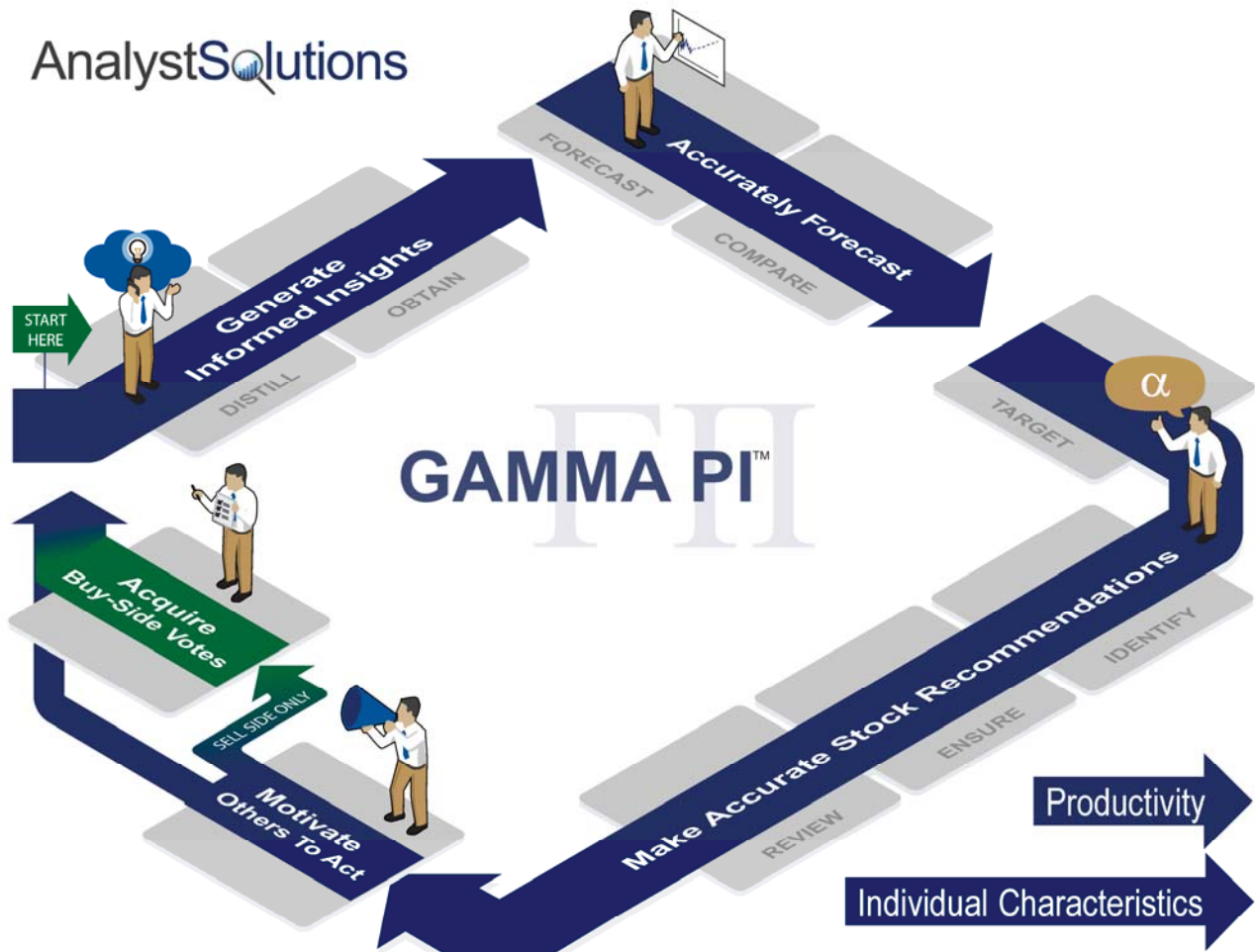
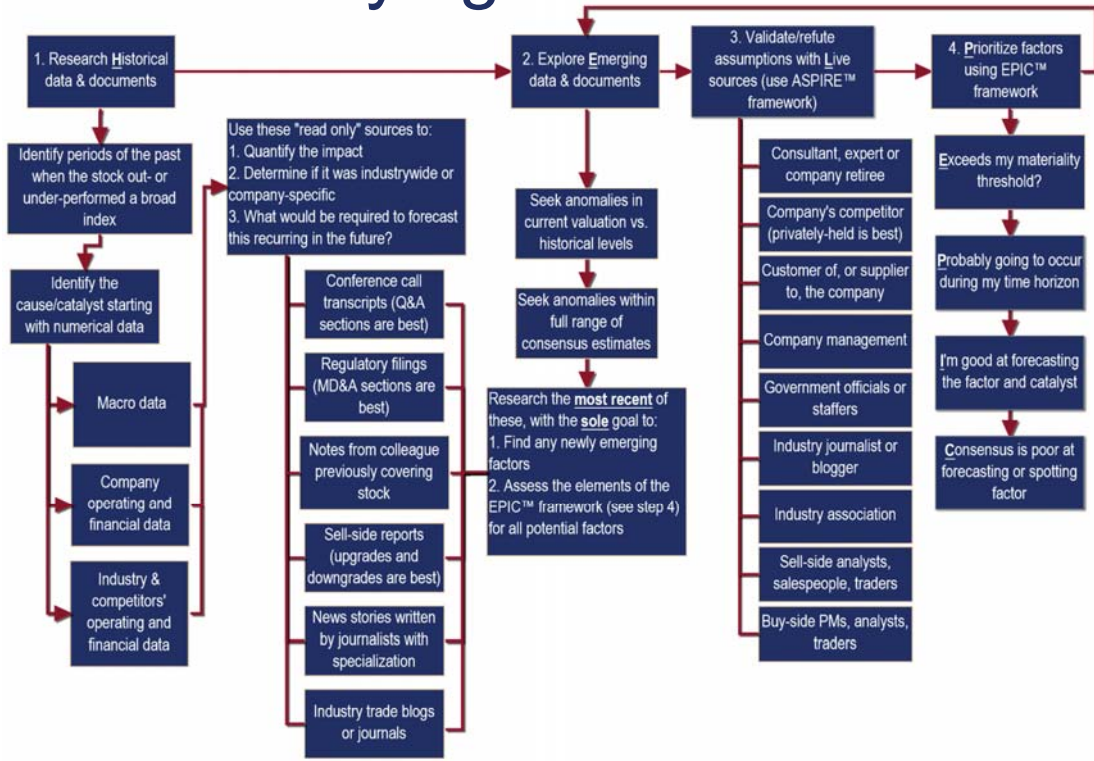
Benefits of Focusing on Critical Factors

- Reviewing information becomes more efficient because as much as 90% can be ignored
- Greater focus on seeking the **best** information sources with expertise around critical factors
- Financial modeling is focused on forecasting the areas that will most impact EPS and cash flows
- Stock calls are predicated on a change in the consensus thinking surrounding a factor that will move the stock
- Presentations and reports are easier to produce and more appreciated by recipients because they focus on the most important issue likely to move a stock
- Sell-side analysts are more impactful when helping clients because they're focused on important issues

EPIC™ Stock Calls Require Critical Factors Meet All Four Criteria

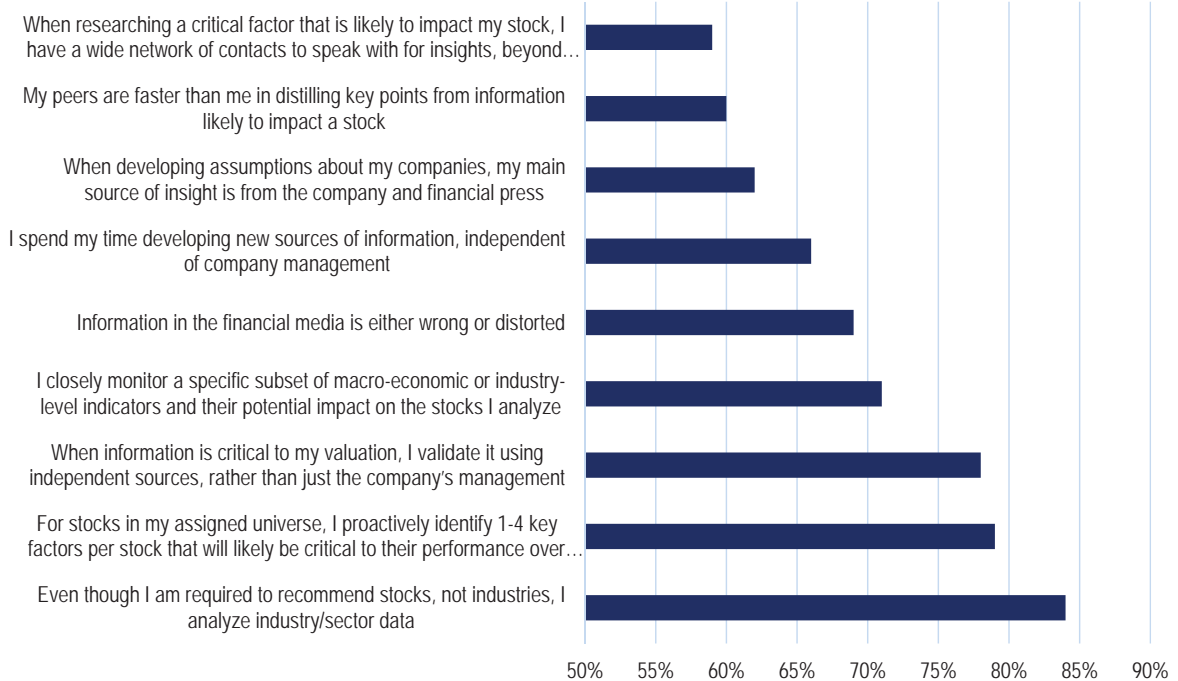


HELP™ Framework For Identifying Critical Factors



CASE: IS LUCAS GENERATING DIFFERENTIATED INSIGHTS?

Survey Responses: Generating Informed Insights





ASPIRE™ to Gain Insight

CRITICAL FACTORS

Assumptions for critical factors



Source(s) of insight



Prepare to approach and interview



Introduce and interview



Respond with follow-up



Evaluate benefit

Module 1: “A” of ASPIRE™

CRITICAL FACTORS

Assumptions for critical factors



Source(s) of insight



Prepare to approach and interview



Introduce and interview



Respond with follow-up



Evaluate benefit

Seeking Insights Before Defining Critical Factors...

Is akin to setting off on a journey without a destination



EXERCISE: QUALITY CONTROL INSPECTOR

Quality Control Inspector: Card Type #1

- **Undisputable fact:** one side of the card has a shape and the other side has a color
- **Rule:** *If a card has a circle on one side, then it must have the color yellow on the other side.*
- Based on these 4 cards alone, which do you need to turn over to see if the cards are defective?
- Identify the card(s) you need to turn over to confirm if this rule has been broken.



Quality Control Inspector: Card Type #2

- **Undisputable fact:** one side of the card has a letter and the other side has a number
- **Rule:** *If a card has the letter S on one side, then it has the number 3 on the other side.*
- Based on these 4 cards alone, which do you need to turn over to see if the cards are defective?
- Identify the card(s) you need to turn over to confirm if this rule has been broken.



Quality Control Inspector: Card Type #3

- **Undisputable fact:** one side of the card has the statement about a specific company's unique quality (green border) and the other side explains if the stock has outperformed or underperformed the market over the long-term (red border).
- **Rule:** *Companies with earnings growth rates faster than the market always outperform the market over the long term.*
- Based on these 4 cards alone, which do you need to turn over to see if the cards are defective?
- Identify the card(s) you need to turn over to confirm if this rule has been broken.



Amazon Search

The screenshot shows the Amazon website interface. At the top left is the Amazon Prime logo. Navigation links include 'Today's Deals', 'Gift Cards', 'Sell', and 'Help'. A search bar is set to 'Tools & Home Improvement'. Below the search bar are category links: 'Home Improvement', 'Best Sellers', 'Gift Ideas', 'Lighting & Ceiling Fans', 'Hardware', 'Kitchen & Bath Fixtures', 'Power & Hand Tools', and 'Woodwork'. The main content area features the title 'Customer Reviews' and a link to 'Kidde KN-COSM-B Battery-Operated Combination Carbon Monoxide and Smoke Alarm with Talking Alarm'. A star rating chart shows 683 reviews: 5 stars (440), 4 stars (132), 3 stars (36), 2 stars (18), and 1 star (57). The average rating is 4.5 stars. A 'Create your own review' button is visible.

Star Rating	Count
5 star	440
4 star	132
3 star	36
2 star	18
1 star	57

Definition: Confirmation Bias

Confirmation bias *noun*

: seeking out information that supports your view and rejecting, distorting, or ignoring information that conflicts with it

Best Practices for Equity Research Analysts

Confirmation Bias

Tell-tale signs of confirmation bias

- You under-react to unfavorable information in earnings reports
- You are closed-minded
- You show no interest in understanding the “other side of the trade”

Methods to avoid confirmation bias

- Conduct all of the necessary research before considering the rating
- Approach new information with an open mind
- Build upside, downside and base-case scenarios while doing research
- Make sure you know the opposing view of your recommendation

Complete Your TAP

Section 3

Transformation Action Plan (TAP)



Instructions for the Transformation Action Plan (TAP):

- Throughout this workshop complete the TAP below
 - Apply the key points after the workshop to help you improve your performance
 - This will not be collected and so write in a manner that will help you utilize the concepts being learned
-

Assumptions Are Required

Do not proceed to the next step unless you have created a list of critical factors, and the associated assumptions, for a stock

- It takes substantial time to find and interview live information sources
- These are wasted efforts if the information source doesn't have insights that help to forecast a critical factor



Review Opening Case for: Assumptions for Critical Factors

Lucas...

- Doesn't know the critical factors for his stocks or the key assumptions that drive those factors
- Goes to the conference with confirmation bias about trans-Pacific pricing is likely to increase

Module 2: “S” of ASPIRE™

**CRITICAL
FACTORS**

Assumptions for critical factors



Source(s) of insight



Prepare to approach and interview



Introduce and interview



Respond with follow-up



Evaluate benefit

Complete Your TAP

Section 4

Transformation Action Plan (TAP)



Instructions for the Transformation Action Plan (TAP):

- Throughout this workshop complete the TAP below
- Apply the key points after the workshop to help you improve your performance
- This will not be collected and so write in a manner that will help you utilize the concepts being learned

Sources of Insight

- Live
 - Roles outside financial markets
 - Roles within financial markets
- “Read-only”
 - Data (including surveys)
 - News feeds/blogs
 - Company documents



Looking at Data in a Unique Manner



Apple's off-balance sheet commitments [are] a bullish indicator for June quarter revenue...

...these off-balance sheet commitments to acquire components and capital assets (including product tooling and manufacturing process equipment), and related to advertising and R&D are a good indicator of revenue with correlation of 98% since 2007.

Where Do I Find Sources?



Scan Target-Rich Websites

Use online sites such as those below to find individuals formerly employed by the company, currently employed by a competitor (preferably a privately-held competitor) or an expert on the critical factor(s) you're researching:

- On-line networking groups such as LinkedIn, alumni networks, etc.
- On-line job boards such as Monster.com and Upwork



Scan Content Creators



- Research topical blogs, which can be found using www.google.com/blogsearch (to find names of the blogger and those who are mentioned or quoted)
- News stories (to find names of the journalist and those being quoted)
 - General press, when the story has a focus on your sector(s)
 - Trade journals focused on your sector(s)

Scan for High-Profile Authorities

- Conference speakers (even those you don't attend) focused on the critical factor(s)
- Authors of papers, books and presentations
 - Conduct a Google "Advanced Search" and ensure the "file type" is PDF or PowerPoint
 - For books use: <http://www.worldcat.org/>
 - For papers use: <http://www.ssrn.com/en/> or <http://www.ebscohost.com/> (subscription based)
 - You may want to research YouTube, but unless the topic pertains to companies only, you may get too many search results to quickly analyze
- Search the internet for names of consulting firms that specialize in the sector (if the search doesn't come up with a quick answer, ask company management for the consultants they use)

Scan Aggregator of Names



- Industry, association and professional society websites
- Industry award winner lists (e.g. “top performers of the year”)
- Databases or lists that contain the names of the largest privately-held companies in your sector (it can be an industry associate directory, or use a service such as Hoovers)

Consider Expert Networks

You may want to utilize expert networks (if allowed by your firm), but understand the best contacts are probably already speaking to others in the financial community and so they won't be entirely proprietary



Expert Networks

Examples:

- GLG
- AlphaSights
- Third Bridge
- Guidepoint Global
- ExpertView



AnalystSolutions does not endorse, or receive compensation from any firms listed above

Dedicated Research Firms

- You own the results
- Requires time and a sizeable budget
- Need to find the best firm for the project
- Integrity-research.com



AnalystSolutions does not endorse, or receive compensation from any firms recommended in its workshops
For registered AnalystSolutions participants -- not to be re-distributed

Dedicated Research Firm Examples

Dedicated Research Firm	Type	Product	Service
IMS Health	Scripts Data	Global Measures of Dispensing Activity	IMS Health captures elements of the prescription details recorded in retail pharmacies of all types—chain, independent, mail-order and specialty—in more than 15 countries around the world, on more than three billion prescription transactions a year.
Symphony Health Solutions	Scripts Data	Integrated Dataverse (IDV)	Symphony Health Solutions' Integrated Dataverse (IDV) [™] provides near-census point-of-sale prescription data with extensive prescription, medical, and hospital claims.
Guidepoint Global	Ongoing Survey	Tracker	Guidepoint Global is an expert network which includes over 225,000 professionals with particular strength in the technology and healthcare sectors. One way clients use GG's network is to conduct Surveys and Quick Polls.

Source: Integrity Research

Limitations of Relying on Company Management

- Can't be objective
 - Exaggerate upside
 - Downplay downside
- Can't be source of key information not already widely-disseminated
- Unaware of their blind spots



Live Roles Within Financial Markets

- Buy-side analysts should forge relationships with:
 - Other smart buy-side analysts
 - Three sell-side analysts per sector
- Sell-side analysts should be continually surveying the smartest
 - Clients
 - Salespeople
 - Traders



EXERCISE: “NETWORKING SELF-ASSESSMENT”

Introverts Have Networking Strengths

"I have a confession to make. I am an introvert. If you are, too, that's fine— in many ways, we have an advantage over our more assertive colleagues. You may feel that, despite all your knowledge of networking, you are too shy to network successfully. The idea that networking is only for people with outgoing personalities is really false. Introverts have strengths that they can use with strategies that blend well with their personalities. Here are some real advantages that introverts have for networking:

- Introverts are usually great listeners. They would rather let another person do the talking, and that shows respect toward their colleague
- They remember details about their contacts, which others might miss. Because they are listening, they can take in more information about their contact
- They focus on the person they are talking to, making that person feel significant
- They build sound relationships and care for them because they are often helpful individuals who watch out for others
- They find the right time to speak— never interrupting or asserting their opinions
- They are helpful, which often makes others want to be helpful in return
- They network very well in situations where they can use their skill to help others."

- Andrea R. Nierenberg, Essential Business Networking: Tips, Tactics, and Tools You Can Use

Cultivating Sources of Insight



Read Relevant Content Creators



- Proactively read *relevant* industry trade blogs and journals that answer questions about critical factors
- If possible, have these automatically sent to you or set time aside each week to read

Participate in Industry Events

- Examples:
 - Conferences
 - Trade shows
 - Annual award banquets
- Prescreen
- Get an advanced list
- Approach good speakers after presentations
- Attend social events
- Connect with the senior event coordinator



Sign Up

REGISTER



JOIN NOW



SIGN UP



SUBSCRIBE



- Join *relevant*:
 - On-line groups (LinkedIn, industry forums, user groups, etc.)
 - Industry trade groups
- Subscribe to relevant industry consulting firms' publications
- Participate at the industry-level

Don't Forget To...

- Ask contacts for:
 - Up-stream sources
 - Down-stream sources
- Periodically contact the information source to help them



Not Sure Where to Start?

Contact the Investor Relations managers of two to three of the companies that are major players in the sector(s) and ask the following questions:

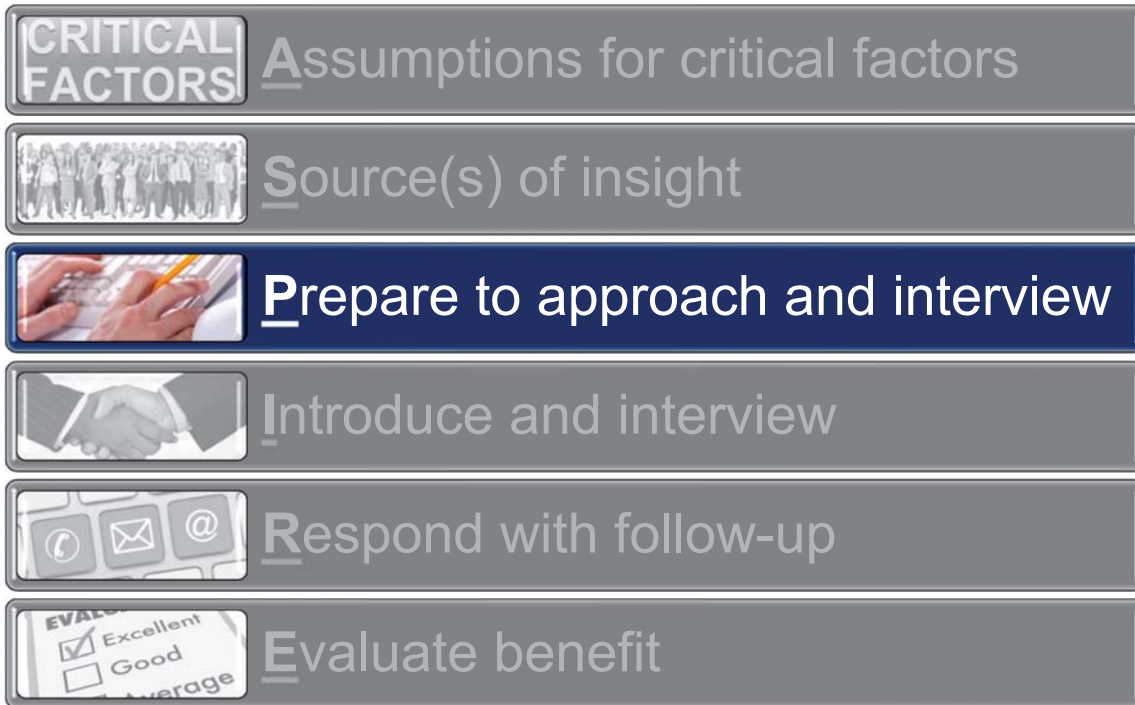
- Which trade journals do the company's managers subscribe to?
- Which trade associations does the company belong to, and which are the most powerful in lobbying for regulatory change?
- Which conferences are attended by company management and the financial community?
- Which industry task forces do company management belong to?
- Which industry consultants produce the most insightful reports?

Review Opening Case for: Sources of Insight

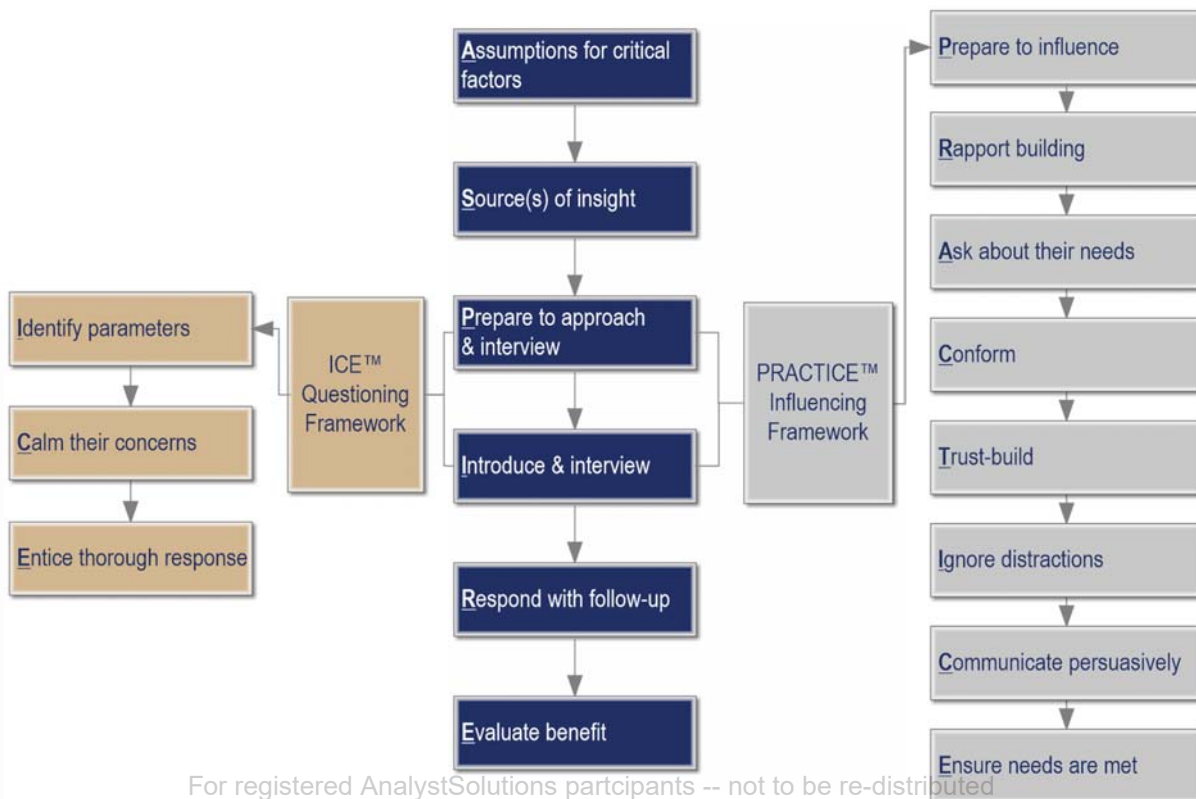
Lucas...

- **Doesn't have proprietary sources** of insight and instead relies too heavily on publically-available information (news stories, sell-side reports and regulatory filings)
- **Doesn't see the value in:**
 - **Going to conferences** because he feels it takes too much time
 - **Knowing the best industry events or groups** that host them
 - Arriving to the conference in time to **participate in the opening social event**
 - **Meeting with Sunil**, because he's not a "top executive" even though Sunil may have insights or other contacts he can provide Lucas
 - Watching the panel of industry journalists/bloggers, to learn insights, and possibly meet the panelists afterwards to make new industry contacts
- **Doesn't review the speaker list** until he's on the plane, which limits his ability to do more research on who will be the best potential contacts to approach
- **Doesn't ask the CEO or Sunil for names of other good industry contacts** to speak with at the conference or afterwards
- **Doesn't know there are consulting firms** that specialize in forecasting critical factors for his sector
- **Doesn't think to ask the conference organizers** for a list of attendees in advance
- **Doesn't ask his friend for names** of individuals in ExpBitz that could help better understand airline pricing
- **Incorrectly asserts Sunil is a valuable source** of insight for trans-Pacific pricing

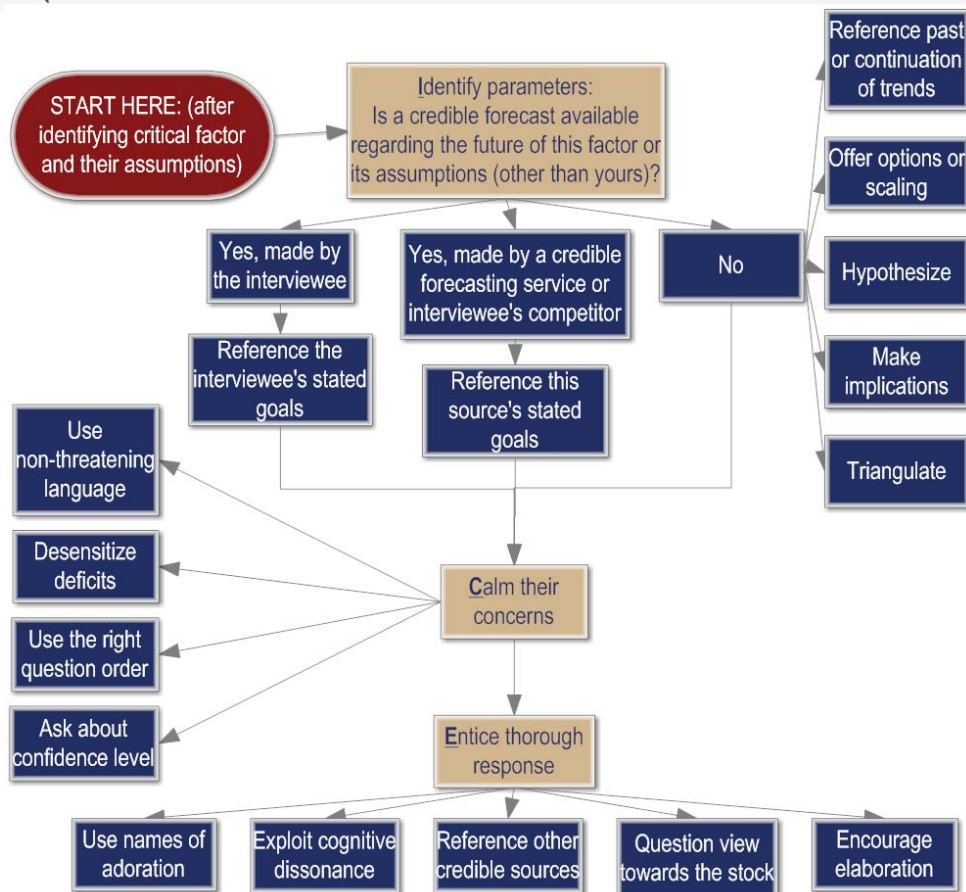
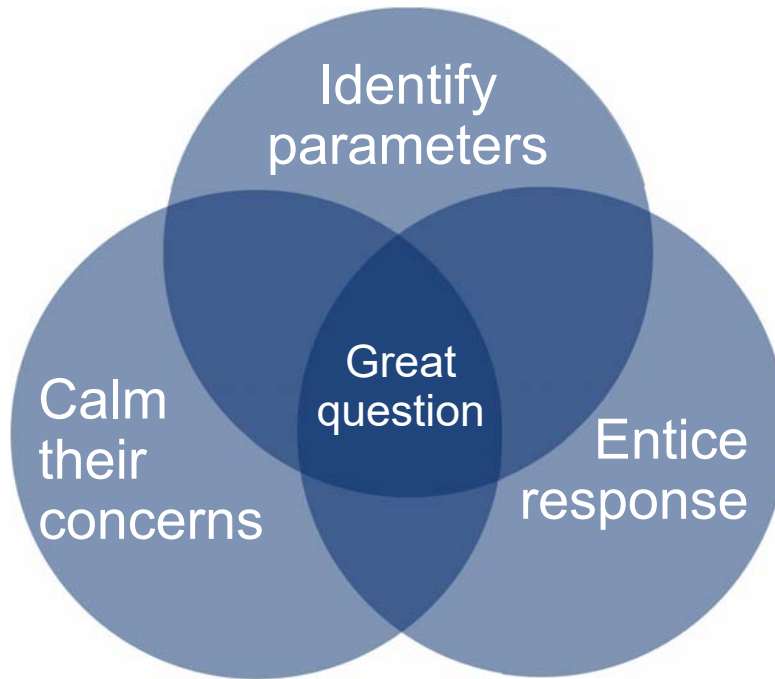
Module 3: "P" of ASPIRE™



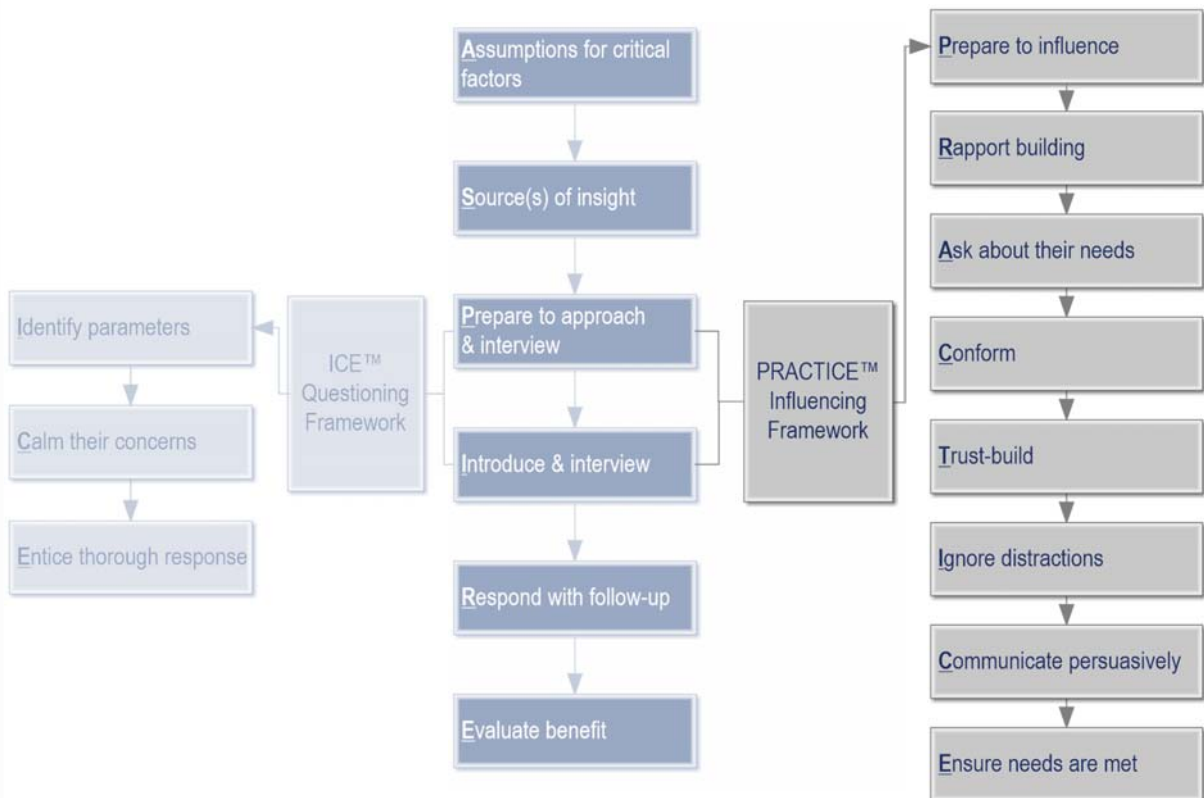
Key Frameworks



ICE™ Framework



Key Frameworks



“P” of PRACTICE™ Framework

- Prepare to influence by answering “What’s In it for Them?”
 - Search for the person on Google, LinkedIn, Bloomberg, Facebook, Twitter, etc. to help identify potential needs (notoriety, knowledge, friendship, etc.)
 - If you’ve been provided the contact’s name via a colleague, ask about the contact’s motivations
- Research their background to better conform when meeting



Typical “WIIFT”

- Access to insights from senior management of companies within the industry
- Understanding of their company and its stock price
- Understanding of the industry trends or their company’s competitors
- Access to other experts
- To be recognized as an industry thought leader
- Ego boost
- Desire to honor request from colleague or friend who referred you to the information source
- Develop more friendships within the industry

“P” of PRACTICE™ Framework for Influencing Others

- Prepare to influence includes self-assessment
- Honestly answering these questions (resolve deficits where possible):
 - Will you be credible to this person? (Ensure you know the critical factors for a stock)
 - Do you have strong communication skills?
 - Are you a good listener?
 - Are you empathetic?
 - Do you adapt well?
 - Do you have a large network of contacts to potentially share as “currency” with this contact?

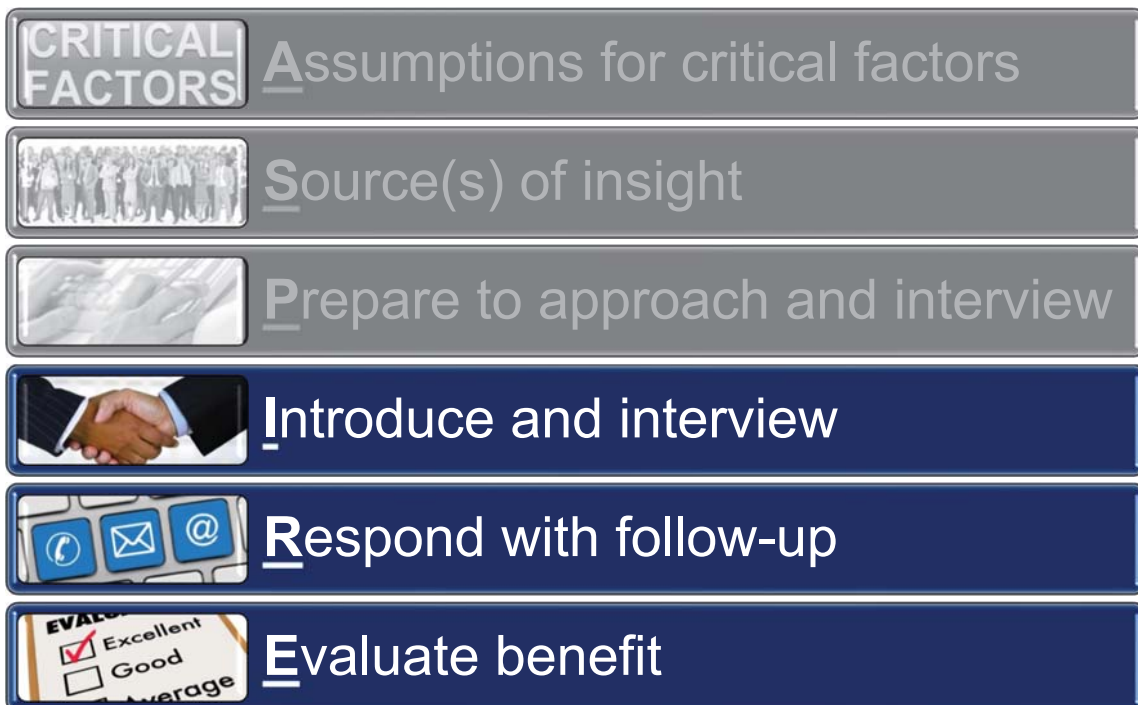


Review Opening Case for Prepare to Approach & Interview

Lucas...

- **Doesn't stay at the conference hotel** which creates more logistical challenges for him to participate, and suggests to attendees he **isn't conforming** to their ways (which hurts his ability to influence)
- In preparing his questions, he asks them:
 - With **too much jargon** that may intimidate the interviewee
 - In a manner that likely put the **interviewees on the defensive** (does not "calm their concerns")
 - That **cannot be legally answered** and thus puts the interviewee on the defensive (does not "calm their concerns")
 - **With no parameters** that can be answered with minimal research
 - About a topic where the **interviewee is not qualified** to provide an accurate answer
- Does not **conform with Sunil's disinterest for alcohol** (which hurts his ability to influence by violating the "conform" principle)
- Fails to "entice thorough response" by **suggesting the CEO's company is too small**
- **Hasn't conducted research on the CEO** he approaches, even though he has been listed as they keynote speaker for over six months
- Plans for the interview to take place in a **noisy bar** (difficult to hear) where there is no place to sit (difficult to take notes)
- **Wastes valuable time in his hotel room** before meeting Sunil that could have been spent researching Sunil and his company in order to develop good questions that had parameters

Remaining Elements of ASPIRE™



CONCLUSION

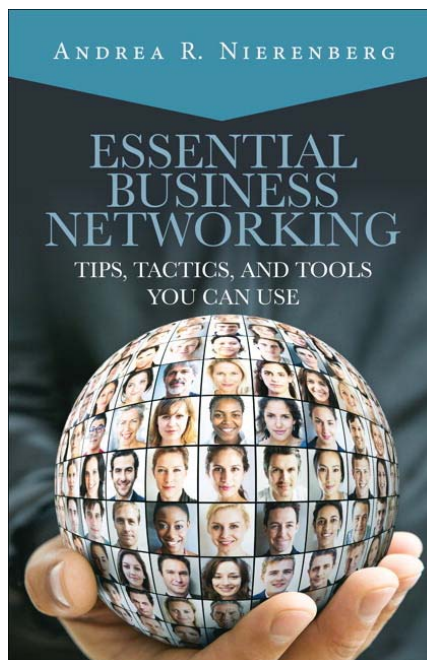
Summary of ASPIRE™ Best Practices (1 of 2)

- Identify the **A**ssumptions that need answering for the 1-4 critical factors per stock
- Seek **S**ources of insight such as:
 - Reviewing industry trade journal, website, or blog
 - Interviewing:
 - Consultant, expert, or company retiree who is not in an expert network
 - Management from customer of, or supplier to, or competitor of the stock being researched (can be publically-traded or privately-held company)
 - Government official, staffer, lobbyist or association executive
 - Journalist, blogger or noted book author
 - Industry award-winners (e.g. best salesperson)
 - Consultant, expert, or company retiree who is part of an expert network
 - Analyzing information from private forecasting service in a manner other than for which it was intended
 - Conducting survey, formal or informal
- **P**repare to approach and interview
 - Prepare questions, ensuring they have these elements (from our ICE™ framework):
 - Identifiable parameters
 - Calm their concerns
 - Entice a response
 - Identify “What’s in it for them?” (WIIFT)

Summary of ASPIRE™ Best Practices (2 of 2)

- **I**ntroduce and interview
 - Use good influencing skill techniques (explained in our PRACTICE™ framework):
 - Build rapport by showing interest in them
 - Ask about their needs
 - Conform to their style and do not openly reject their view (even if you disagree with it)
 - Use “linking & building” to get from their view to your question
 - Use the rule of reciprocity, social proof, scarcity and authority figure to motivate them to help
 - Explain you won’t quote or attribute their thoughts
 - Start by asking easiest questions first
 - Don’t allow interviewee to take control or use their influencing skills to derail the interview
 - Convey and read body language to be effective
 - End with purpose by asking for commitment to follow-up and referrals to other information sources
- **R**espond quickly with follow-up to build trust and improve ability to influence
- **E**valuate the benefits of spending time cultivating each contact

Networking Resource

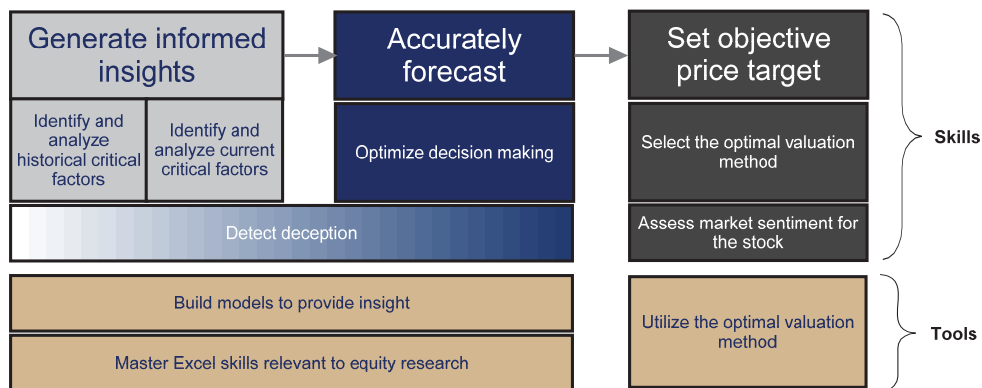


ABC's of Networking*

- A. Take action with a positive attitude
- B. Belong to groups. Build your brand
- C. Connect with your contacts consistently and cultivate a relationship
- D. Deliver above expectations
- E. Engage, evolve, and empathize
- F. Take a friendly approach
- G. Set goals. "Go for it." Show gratitude. Be giving
- H. Humor and help go hand in hand
- I. Be interested and have integrity
- J. Join and get involved
- K. Keep in touch and be kind
- L. Listen and learn
- M. Motivate yourself
- N. Niceness pays
- O. Ask open-ended questions. Take opportunities
- P. Professionalism pays. Practice it
- Q. Set your own quota
- R. Be a resource and do your research
- S. Be strategic and wear a smile
- T. Timing is everything. Trust is key
- U. Understand others
- V. Be versatile
- W. Write letters and cards
- X. Do it with love, XOXO (or at least like)
- Y. Focus on "you"— meaning the other person you are connecting with
- Z. Have a zeal for the possibilities of new and nurtured relationships

* Source: Andrea R. Nierenberg, *Essential Business Networking*

Skills vs. Tools



Model Components

Historical Revenues

Forecast Revenues

Historical Expenses
(may appear as only a margin)

Forecast Expenses
(or margins)

Historical Below-the-Line Items

Forecast Below-the-Line Items

Example Revenue Drivers Video

	2016E			2017E			2013	2014	2015	2016E	2017E	2018E	2019E	2020E	2021E
Europe advertising revenue	1,270.0	1,548.0	1,883.0	1,927.3	1,838.2	1,913.8	2,082.3	2,636.6	1,958.0	3,151.0	4,298.0	6,365.3	8,270.9	10,014.3	11,849.0
% change Y/Y	48.5%	56.5%	55.1%	36.4%	28.0%	23.9%	32.2%	38.6%	38.3%	59.9%	37.2%	48.9%	31.2%	21.1%	18.2%
DRIVEN: Net adds	333.0	338.0	342.2	348.2	354.2	359.2	364.2	371.7	282.0	301.0	323.0	348.2	371.7	392.9	411.4
DRIVER: CPM, % change Y/Y	10.0	5.0	4.2	6.0	6.0	5.0	5.0	7.5	21.0	19.0	22.0	25.2	23.5	21.2	18.6
Advertising ARPU per DAU - annualized	\$15.48	\$18.42	\$19.38	\$22.33	\$19.66	\$21.46	\$23.03	\$28.80	\$7.21	\$10.74	\$13.77	\$18.70	\$22.98	\$26.20	\$27.47
% change Y/Y	3.2%	7.0%	1.1%	7.0%	11.0%	12.0%	18.0%	20.0%	37.0%	38.0%	14.4%	2.8%	11.0%	8.0%	8.0%
% of North America monetization levels	28.3%	28.0%	28.6%	24.6%	19.7%	21.4%	22.3%	29.3%	32.0%	38.9%	26.8%	24.9%	23.2%	21.2%	20.0%
Asia advertising revenue	848.0	1,008.0	1,137.0	1,283.7	1,224.7	1,440.7	1,516.1	1,616.2	874.0	1,241.0	2,050.0	4,284.7	5,797.7	7,641.4	9,014.0
% change Y/Y	59.0%	64.5%	62.6%	54.1%	44.0%	42.2%	32.9%	25.0%	75.7%	72.2%	48.7%	59.7%	34.9%	31.5%	24.3%
DRIVEN: Net adds	596.0	592.0	629.2	654.2	662.2	708.7	733.7	756.7	368.0	449.0	540.0	654.2	750.7	849.2	936.7
DRIVER: CPM, % change Y/Y	26.0	28.0	37.2	25.0	28.0	26.5	25.0	23.0	70.0	81.0	91.0	114.2	102.5	92.5	87.5
Advertising ARPU per DAU - annualized	\$6.14	\$6.97	\$7.45	\$8.04	\$7.33	\$8.20	\$8.41	\$8.68	\$2.92	\$4.28	\$5.37	\$7.18	\$8.22	\$9.52	\$10.85
% change Y/Y	2.4%	7.3%	9.4%	8.0%	13.0%	15.0%	20.0%	21.0%	55.2%	171.9%	118.3%	7.6%	13.1%	12.0%	11.1%

AEIOU of Modeling

	A	B	C
1	A	=	Accurate
2	E	=	Efficient
3	I	=	Illuminating
4	O	=	Organized
5	U	=	Useful

Accurate

- Is it technically sound?
- Do the columns add up to the annual result?
- Are the financial statements properly integrated?
- Are differences from company filings explained?



Efficient



- Does the format allow for quick data entry after a company reports results?
- Is it easy to add columns and rows when necessary?
- Does it avoid complicated macros and circular references so that it's quick to make changes?

Illuminating

- Is it easy to see trends and anomalies in critical factors that differ from consensus?
- Does it show changes in key financial metrics, such as margins, earnings per share (EPS) growth rate, return on invested capital (ROIC)?
- Does it help in spotting accounting yellow flags?



Financial Modeling Considerations

- What drives the long-term movement of stock prices?
- What do typical investors want from every investment?
 - Remember: The primary purpose in analyzing financial statements is to identify the growth rate of a company's long-term free cash flows
 - The markets focus on EPS as a proxy for free cash flows
- GAAP vs. adjusted

Organized



- Is it well documented so that others can follow along?
- Are the assumptions for the critical factors easy to find?
- Do the 3 financial statements flow in the natural progression?

Useful

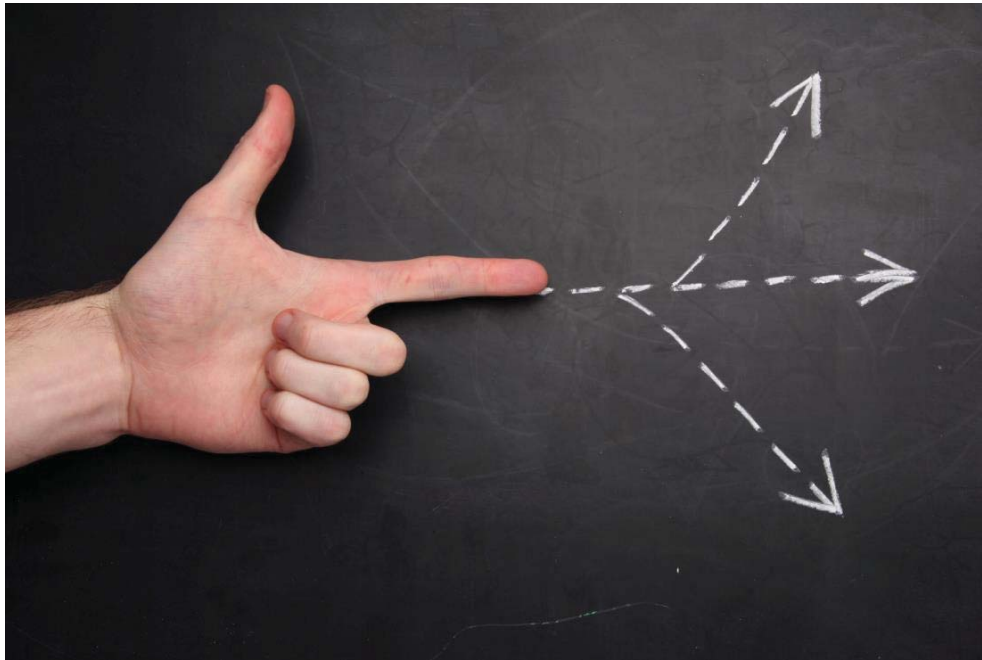
Is it sophisticated enough to consistently create forecasts more accurate than consensus without causing undue burden that wastes the analyst's time?



Models Are Tools, Not Portraits

- A financial model is NOT simply a way to present data (it's not simply about getting the numbers to look correct)
- It's about getting the model to synthesize all of your assumptions into an EPS estimate
- “Hard-coding” a cell does not help you forecast...it makes it even more difficult

Create Financial Forecast Scenarios



Scenarios Force You To Think About What You Don't Know

EPS Impact from Changes to Critical Factor Assumptions	Downside	Base	Upside
Critical Factor #1. Impact from slowing international growth	Non-U.S. growth of -1%	Non-U.S. growth of 2%	Non-U.S. growth of 5%
EPS Impact vs. Base-case	-\$0.25	\$0.00	\$0.25
Probability (must equal 100%)	20%	60%	20%
EPS Impact, Weighted for Probability	-\$0.05	\$0.00	\$0.05
Critical Factor #2. Operating margins stop improving	O.M. decline 200 bps	O.M. decline 100 bps	O.M. rise 50 bps
EPS Impact vs. Base-case	-\$0.18	\$0.00	\$0.27
Probability (must equal 100%)	35%	50%	15%
Weighted probability	-\$0.06	\$0.00	\$0.04
Critical Factor #3. Food inflation (not passed along to customer)	6% inflation	3.5% inflation	1% inflation
EPS Impact vs. Base-case	-\$0.10	\$0.00	\$0.10
Probability (must equal 100%)	15%	75%	10%
Weighted probability	-\$0.02	\$0.00	\$0.01

From workshops: *Apply Practical Valuation Techniques for More Accurate Price Targets; and Master the Stock Call Techniques of Highly Experienced Analysts*

Exercise: Valuation in Its Most Basic Terms

- What's \$1,000/year for the next 10 years worth? (assuming no inflation and no default risk)
- Now assume inflation of 3%, and no default risk
 $=NPV(.03,10,-1000) = \$8,530$
- Everyone starts trading similar contracts and all bids/asks are at \$8,350
- The following Monday, some contracts go to \$8,000 while others go to \$9,000
 1. What is the justification for these moves, assuming the inflation and default risk constraints are removed?
 2. Compared to these fictitious contracts, what are the *similarities* in movements of stock prices?

Valuation Accuracy



Get In the “Mind of the Market”



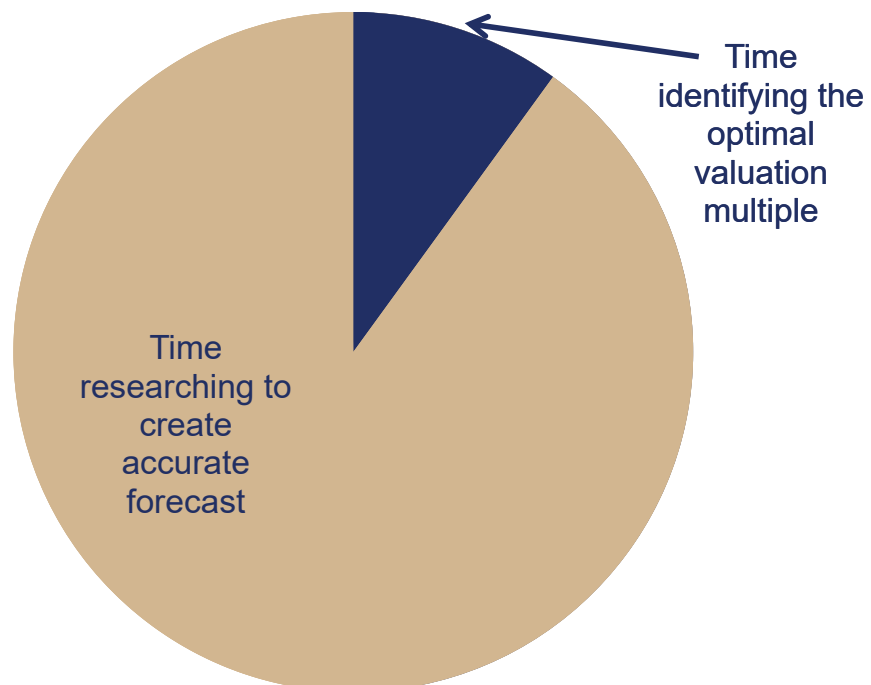
Price Target in Its Simplest Terms



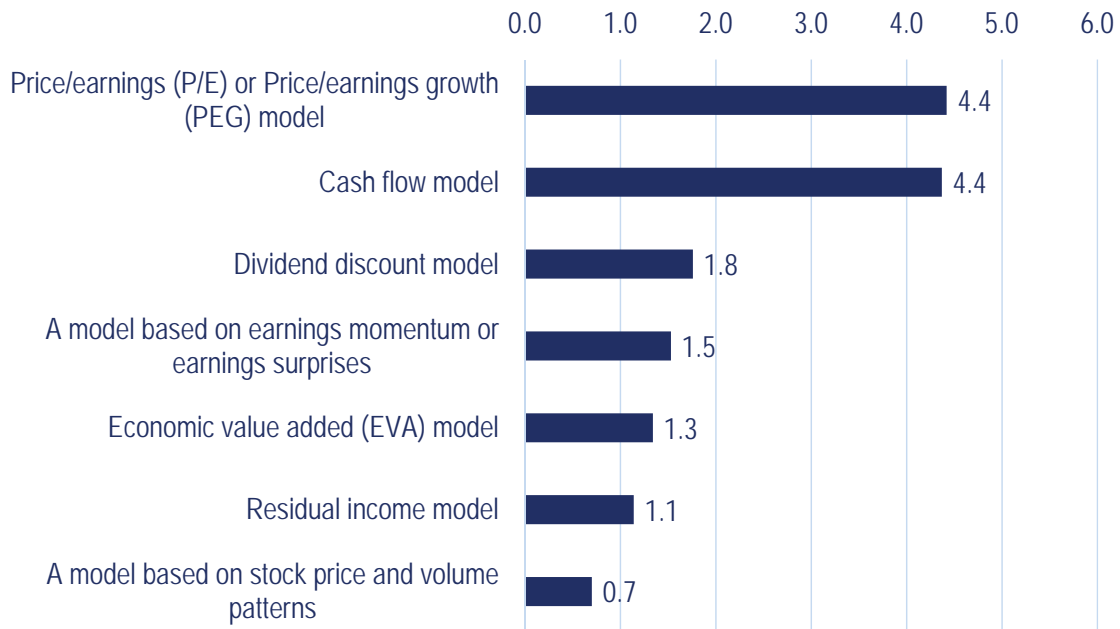
P/E Is Usually Influenced by Growth



Time Developing Price Target



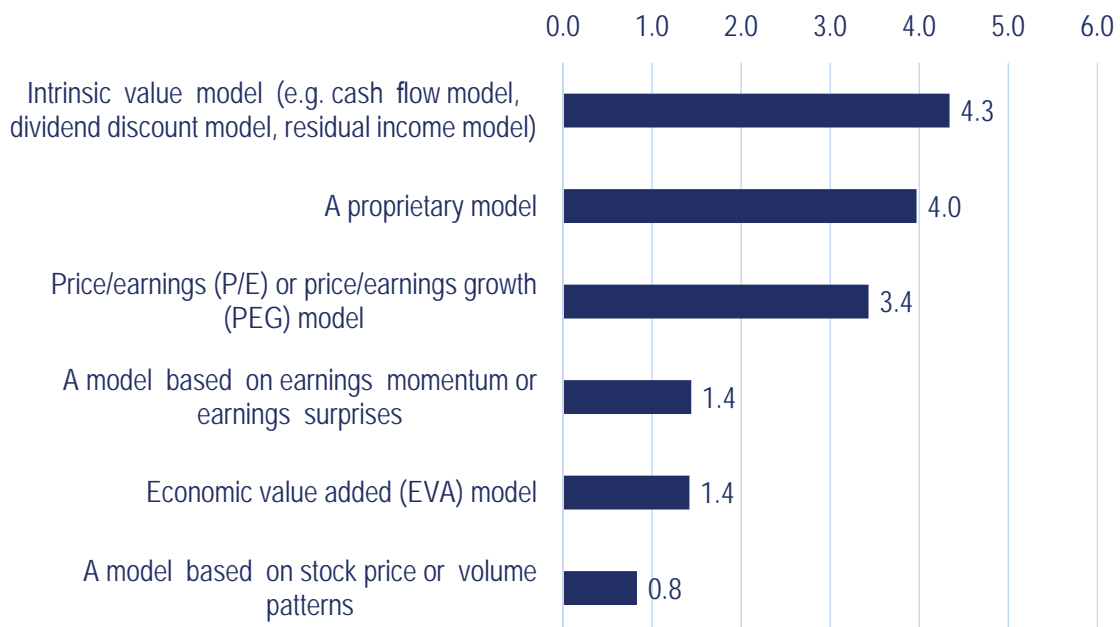
U.S. Sell-side Valuation Models to Support Their Stock Recommendations



6=greatest frequency

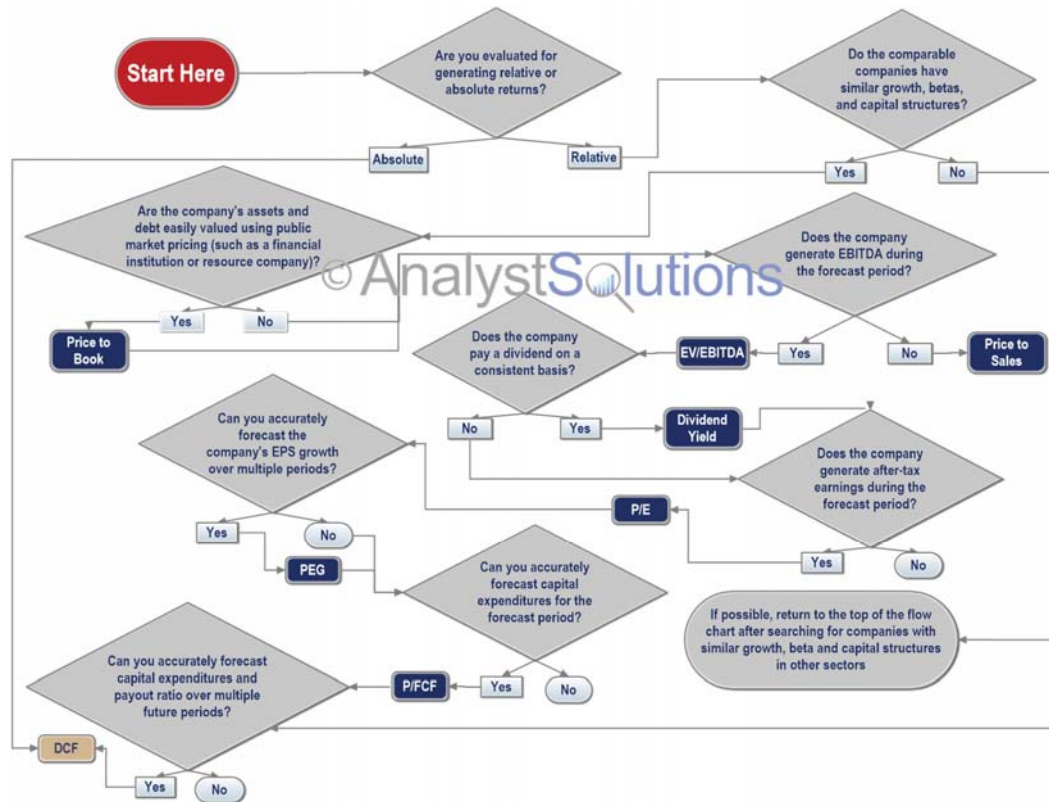
Brown, Lawrence D., Andrew C. Call, Michael B. Clement, and Nathan Y. Sharp. 2015. "Inside the 'Black Box' of Sell-Side Financial Analysts." *Journal of Accounting Research* 53 (1):1-47. <https://doi.org/10.1111/1475-679X.12067>. (Table 2)

U.S. Buy-side Valuation Models to Support Their Stock Recommendations



6=greatest frequency

Brown, Lawrence D., Andrew C. Call, Michael B. Clement, and Nathan Y. Sharp. 2016. "The Activities of Buy-Side Analysts and the Determinants of Their Stock Recommendations." *Journal of Accounting and Economics* 62 (1):139-56. <https://doi.org/10.1016/j.jacc.2016.06.002>. (Table 5)



K.I.S.S. Principle

- Occam's razor:
 - Among competing hypotheses, the one with the fewest assumptions should be selected
- Solomonoff's theory of inductive inference:
 - Shorter computable theories have more weight when calculating the probability of the next observation
- Attributed to Albert Einstein:
 - Everything Should Be Made as Simple as Possible, But Not Simpler

Source: Wikipedia

Complexity is Not Our Friend

Rev Account Stud (2016) 21:596–632
DOI 10.1007/s11142-016-9352-4



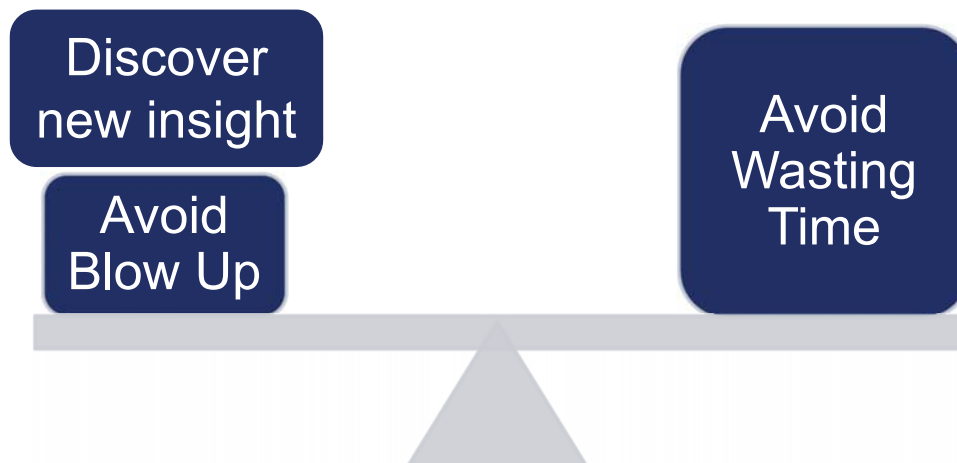
Errors and questionable judgments in analysts' DCF models

Jeremiah Green¹ · John R. M. Hand² ·
X. Frank Zhang³

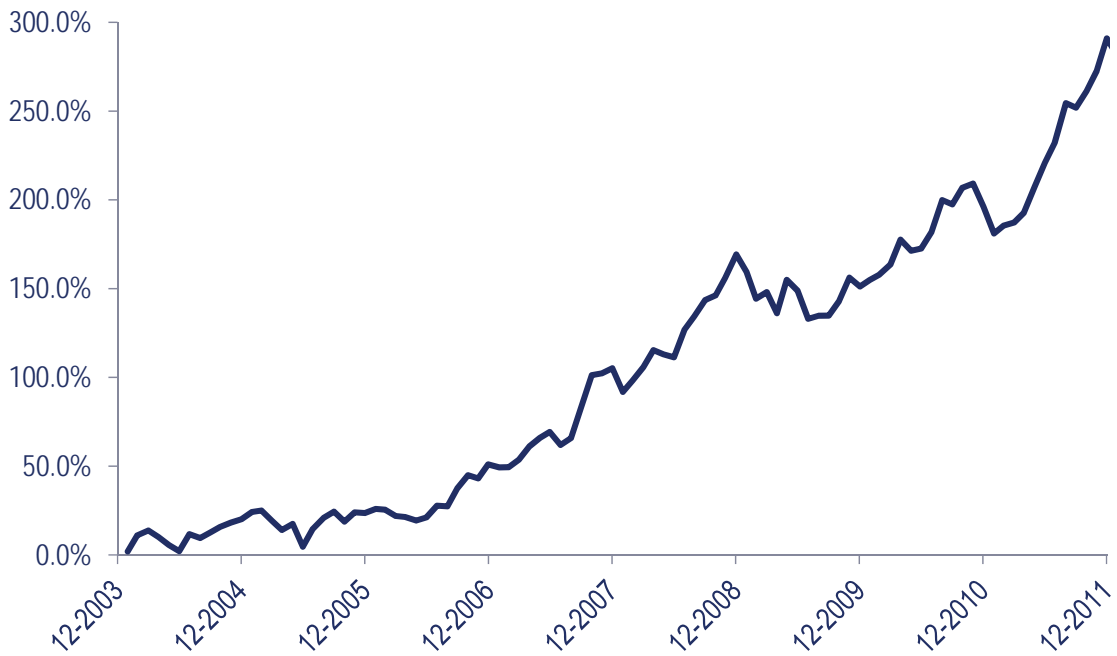
Published online: 24 February 2016
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- For a sample of 120 DCF models detailed in reports issued by U.S. brokers in 2012 and 2013, we estimate that analysts make a median of **three** theory-related and/or execution errors and **four** questionable economic judgments **per DCF**
- Recalculating analysts' DCFs after correcting for major errors changes analysts' mean valuations and target prices by between -2 and 14% per error

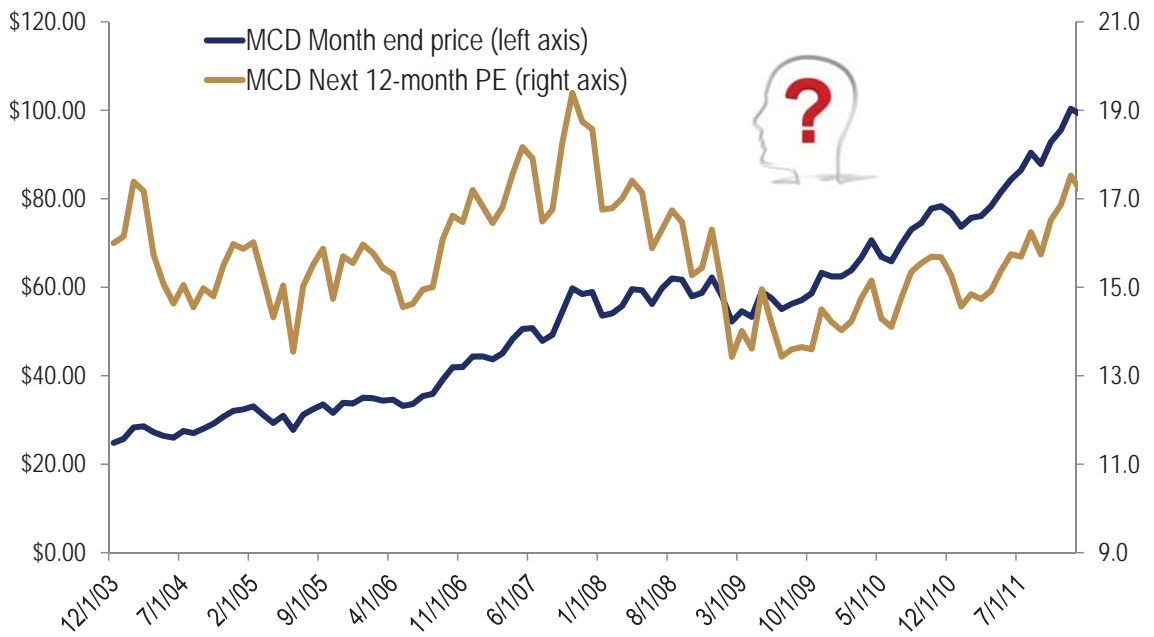
Consider a Second Valuation Method If It Adds Value



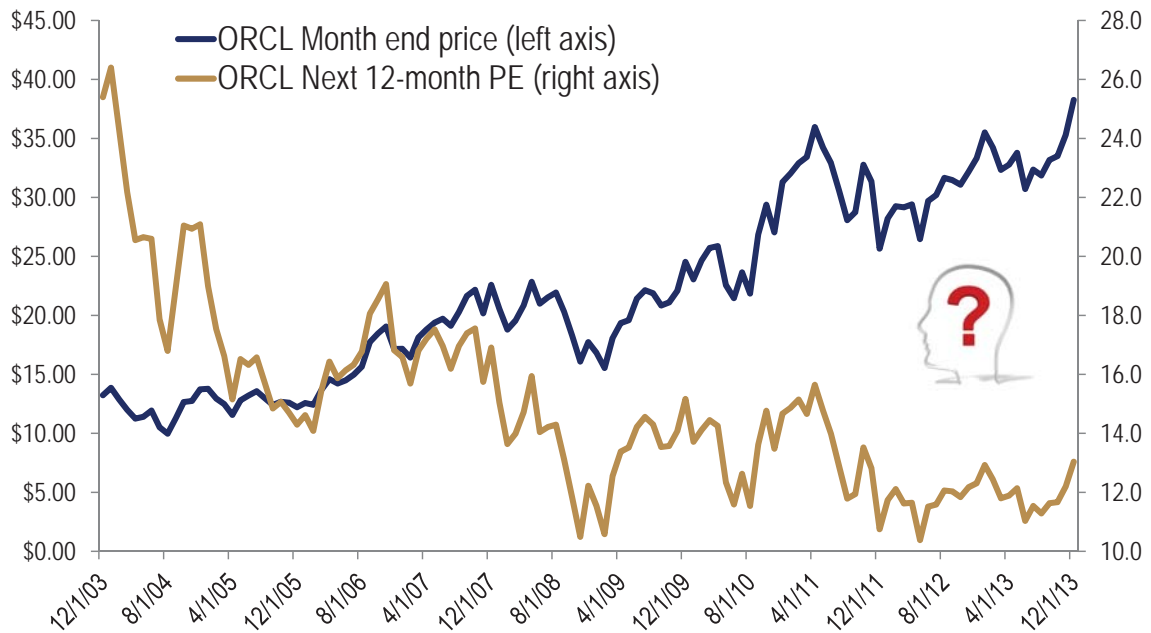
MCD Relative Performance



MCD's P/E Ratio

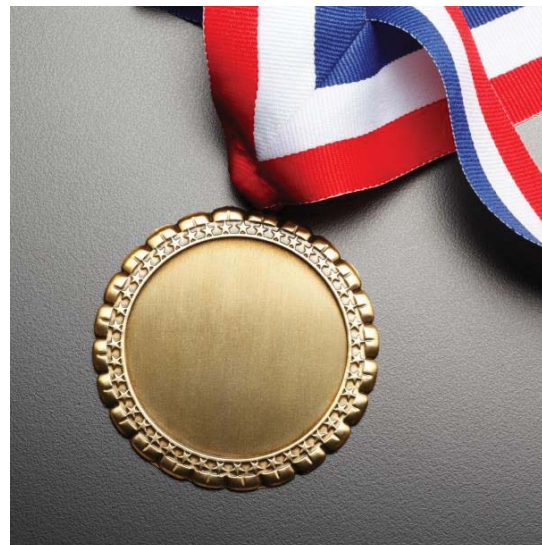


ORCL's P/E Ratio

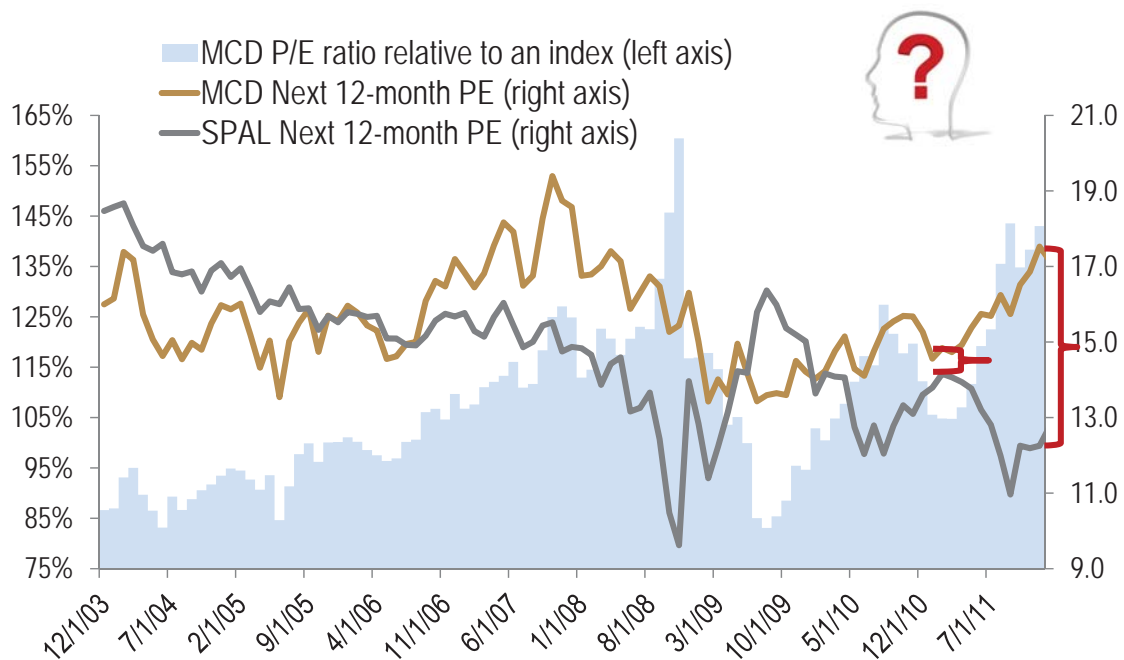


What's In the Stock?

- Is 6th place good?
- Is a restaurant rating of "4" good?
- Should you be pleased that the stock you're about to recommend is trading at a market multiple?



MCD's Absolute and Relative P/E Ratio



Relative Valuation Has More Information than Absolute

- Relative P/E ratio looks at stock's P/E ratio relative to market's (or sector's) P/E ratio
- A stock's P/E ratio helps to understand how the market values a stock, but it includes noise/misinformation brought about by systematic risk, at the sector or market level

Is It Helpful to Analyze the Sector's Valuation Levels?

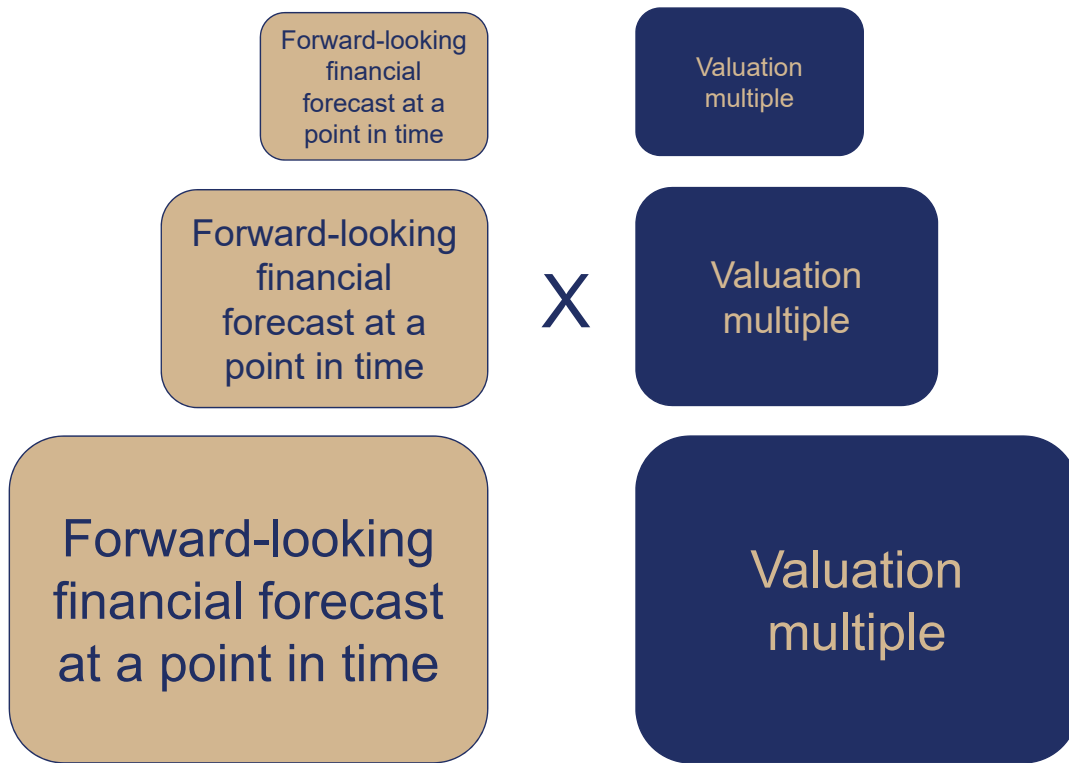
- Yes, if there is a strong correlation with sector (>0.5)
- Bloomberg:
 - Use “PC” function for simple analysis; or
 - Add sector index to “PC function; or
 - Create correlation matrix using “CORR” function and pull in universe of stocks and specific sectors

Security	MCD↓	SPX	S5COND
1) MCD	1.000	0.322	0.348
2) SSREST	0.781	0.497	0.588
3) YUM	0.399	0.499	0.499
4) QSR	0.295	0.385	0.399
5) WEN	0.286	0.486	0.505
6) SONC	0.268	0.286	0.336
7) JACK	0.198	0.139	0.259

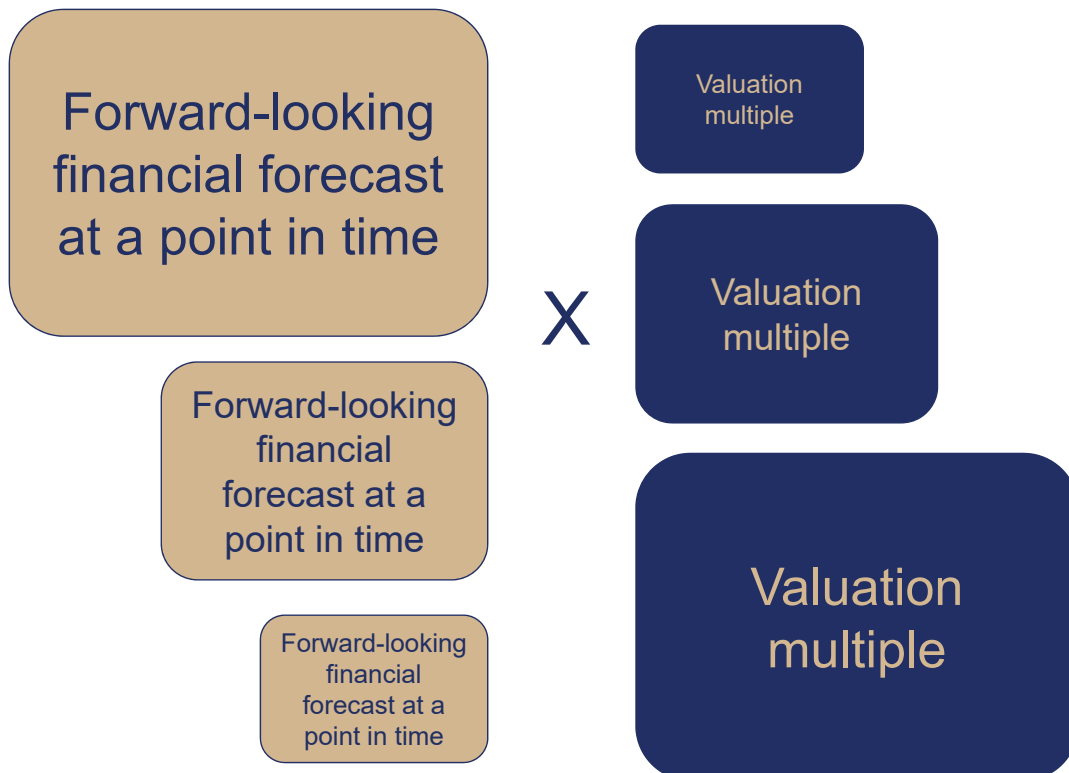
Regress P/E Ratios for Stock vs. Sector or Market



Price Target in Its Simplest Terms



Peak on Peak or Peak on Trough?



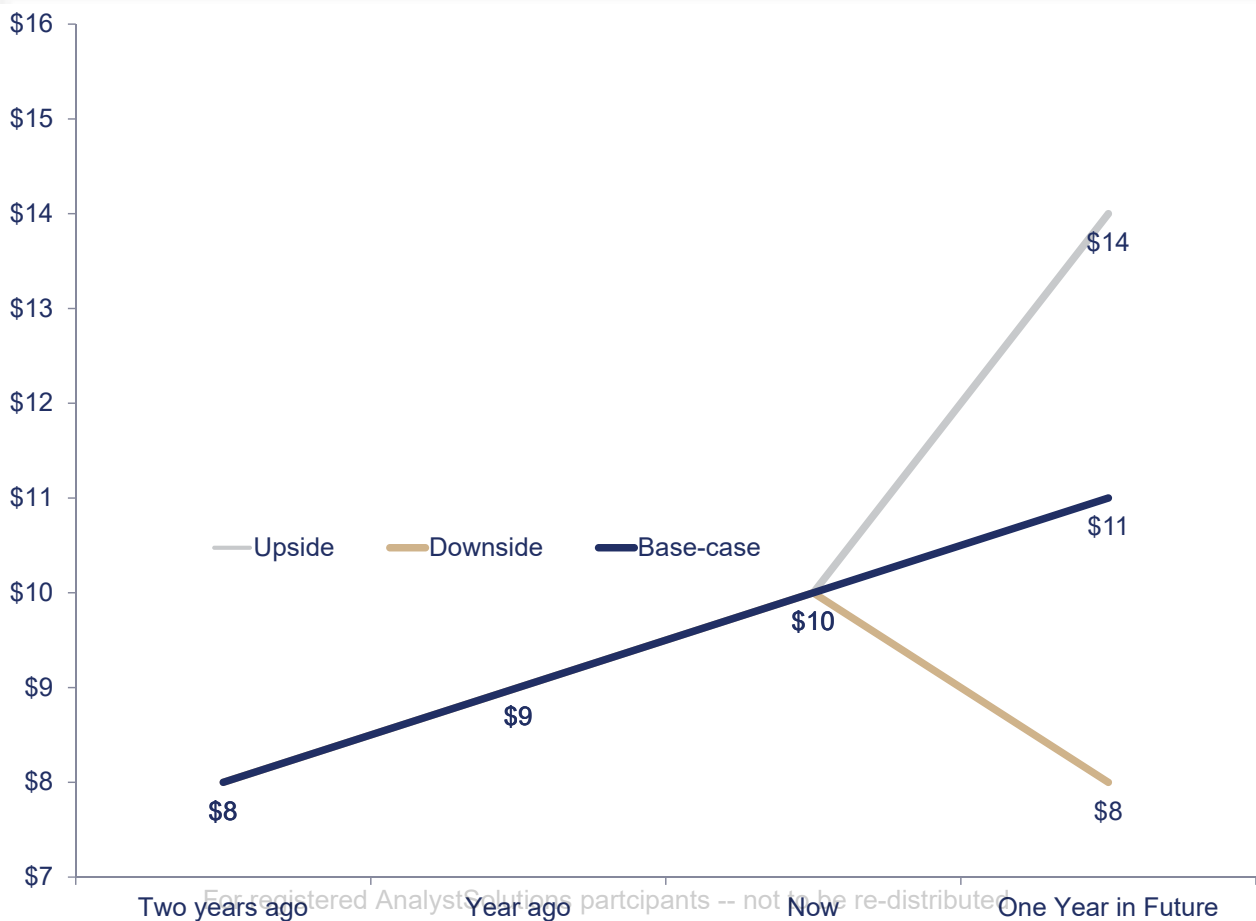
Develop a Range of Multiples

- Valuation isn't about one precise multiple
 - Understand market psychology
 - Understand range of future realistic outcomes
- A best practice is to have:
 - Base case multiple
 - Upside case multiple
 - Downside case multiple

Valuation
multiple

Valuation
multiple

Valuation
multiple



Shortcomings with Price Targets

- Static: only change when analyst updates
- Usually look only 6-18 months out
- Single-point
 - No measure of conviction or risk



CASE: DAVID PLANS SBUX UPGRADE

Key Elements of Great Stock Pickers

- Dispassionate -- Namely, they don't allow non-relevant factors to cloud their judgment
- Stick to their discipline and strategy over the long-term
- Self-aware of where they have expertise and where they don't

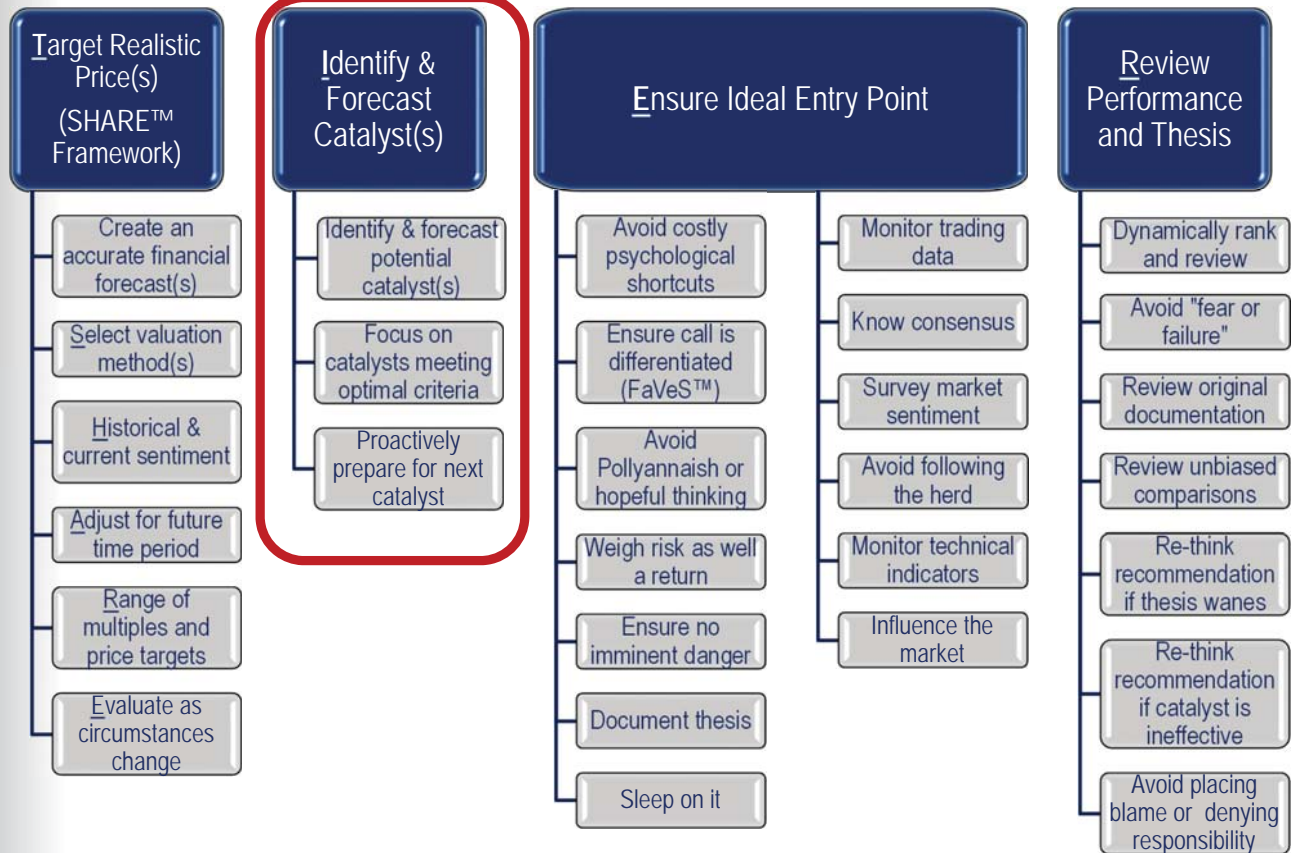


Greatest Challenges to Stock Picking

1. All of the information needed to make a perfect stock call is rarely available
2. Analysts need to balance relative urgency with the need for thorough research that produces unique insights
3. There isn't always a great stock-picking opportunity in an analyst's space
4. Some factors that move stocks can't be forecast
5. Many analysts are so overworked that they don't have time to find unique insight
6. Emotions cloud clear thinking, often causing an analyst to make the wrong decision



Module 2



Identify & Forecast Catalysts

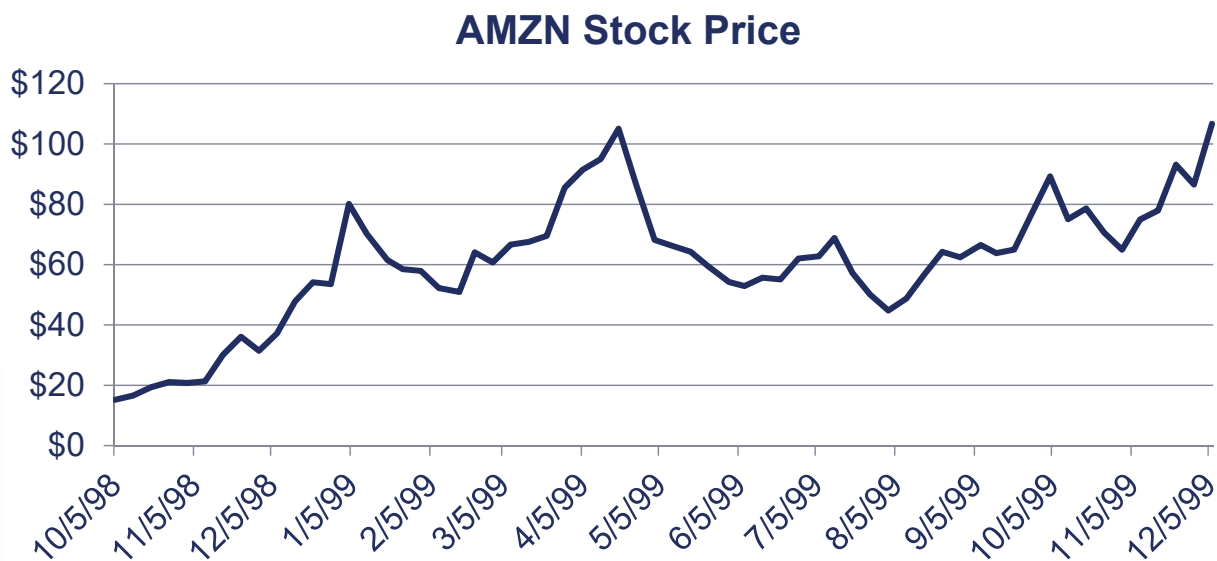
Markets can remain irrational a lot longer than you and I can remain solvent

– John Maynard Keynes

Among the most noted 20th century economists

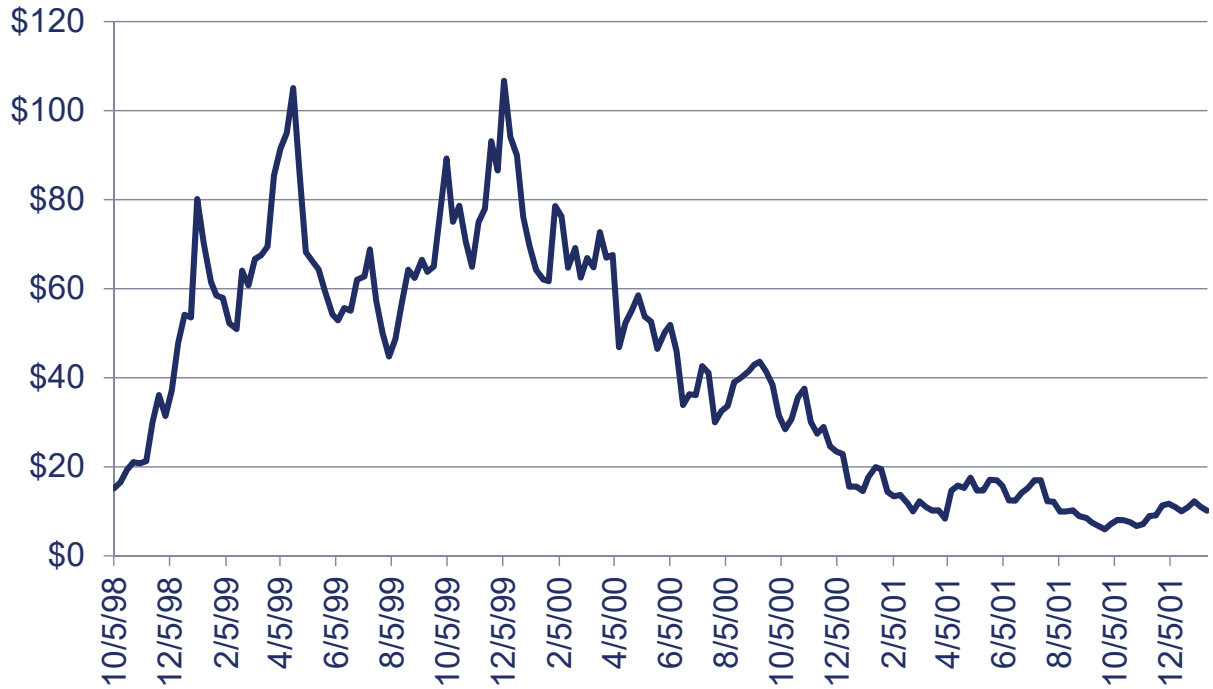
Disagreement over AMZN

- In late 1998, Jonathan Cohen, then Merrill Lynch's head Internet analyst, publicly disagreed with Henry Blodget, then CIBC Oppenheimer analyst, about Amazon's valuation:
 - Cohen's price target: \$8 (\$50 pre-splits)
 - Blodget's price target: \$66 (\$400 pre-splits)
- Who was right?



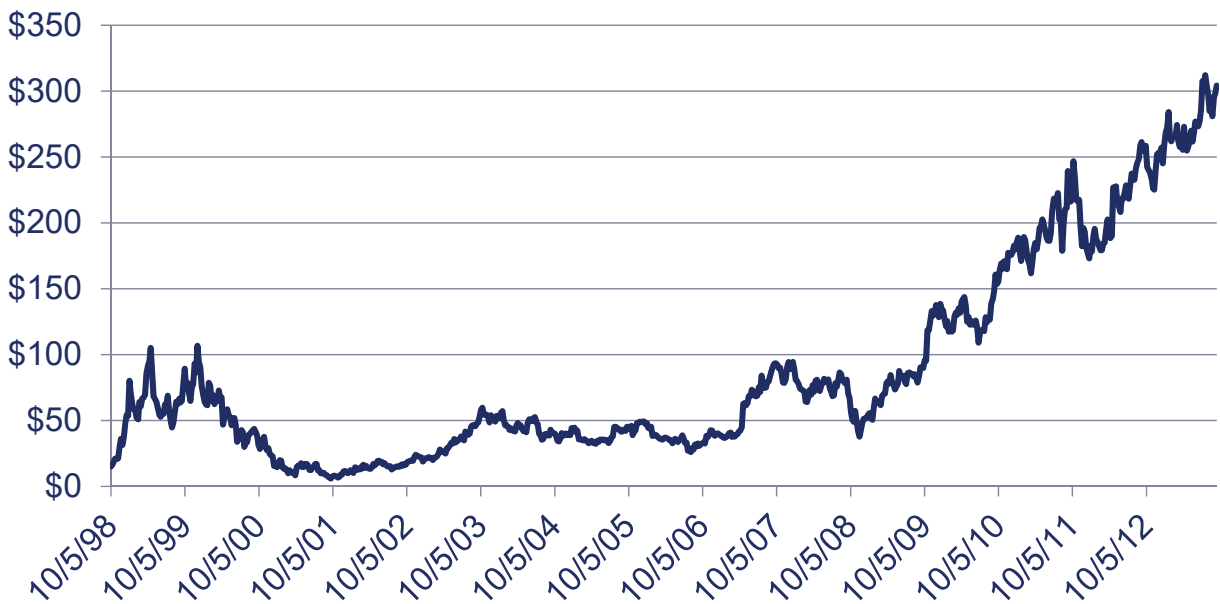
Cohen's price target: \$8 (\$50 pre-splits)
Blodget's price target: \$66 (\$400 pre-splits)

AMZN Stock Price



Cohen's price target: \$8 (\$50 pre-splits)
Blodget's price target: \$66 (\$400 pre-splits)

AMZN Stock Price



Cohen's price target: \$8 (\$50 pre-splits)
Blodget's price target: \$66 (\$400 pre-splits)

Elements of a Catalyst

- Be more specific than simply the company is going to “beat” or “fall short” of the market’s expectations
- Specify how future consensus earnings or cash flow will be impacted, specifically changes to these areas:
 - Pricing
 - Volume
 - Costs
 - Margins
 - Free cash flow
 - Returns
 - EPS growth rate







Examples of Catalysts

The company’s...

- Volume/pricing/new orders for a specific product or region will be better/worse than expected
- Market share will accelerate or decelerate more than expected
- Costs for a specific line item are going to be higher/lower than expected



Identifying & Forecasting Catalyst(s)

		Catalyst	
		Doesn't Occur (or occurs late)	Occurs on time
Stock Movement	Stock call generates alpha	 Right for the wrong reasons (aka Lucky)	 Great call! You're following best practices
	Stock call doesn't generate alpha	 Poor analysis or thesis failed to play out	 Poor assessment of catalyst's impact

What Makes a Catalyst High Quality?



- 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

Proactively Prepare (for yourself and those who rely on you)

- When an event is target-rich for catalysts and has a level of predictability, analysts should put the date in their calendars
- Predict a view about the event especially if it's likely to include a catalyst that impacts a stock recommendation
- Be mindful that a company can be impacted by announcements that come from events held by its competitors



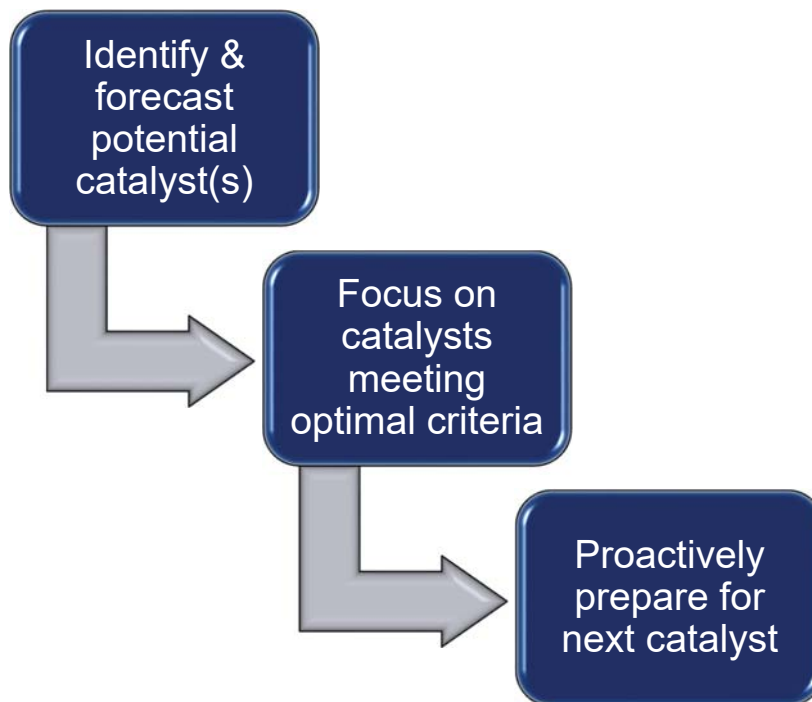
Target-Rich Catalyst Events

Some of the more common places to expect catalysts include:

- Company-sponsored analyst meetings and calls
- Earnings releases
- The company's annual pricing, volume, or earnings guidance or projection
- Deadlines for new legislation, regulations, or court case outcomes
- Prescheduled announcements by the company's customers, competitors, or suppliers
- New product releases or significant product extensions
- Interim sales data, for the company or the sector
- Non-deal investor roadshows



Step 2: Identify & Forecast Catalysts Summary



Identify & Forecast Catalyst(s) DRCs

Detailed Reference Card (DRC)

Best Practices for Making Accurate Stock Recommendations

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



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 future earnings or cash flow impact in areas such as:

- Pricing
- Volume
- Costs
- Margins
- Free cash flow
- Return

Detailed Reference Card (DRC)

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

Opening Case Examples We Covered in this Module

- Best Practices by Pablo and David:
 - Pablo is trying to ascertain the catalyst that will move the stock (i.e. the date of the new products being released)
 - Pablo wants to explore what could go wrong (negative catalyst)
- Bad Practices by David:
 - Doesn't know when the new products will be released, which is the catalyst for his stock call
 - Doesn't seem to be concerned by the company's potential for falling short of the current quarterly consensus estimates (negative catalyst)

Test Your TIER™ Knowledge



_____ r _____ price(s)



_____ & forecast c _____(s)

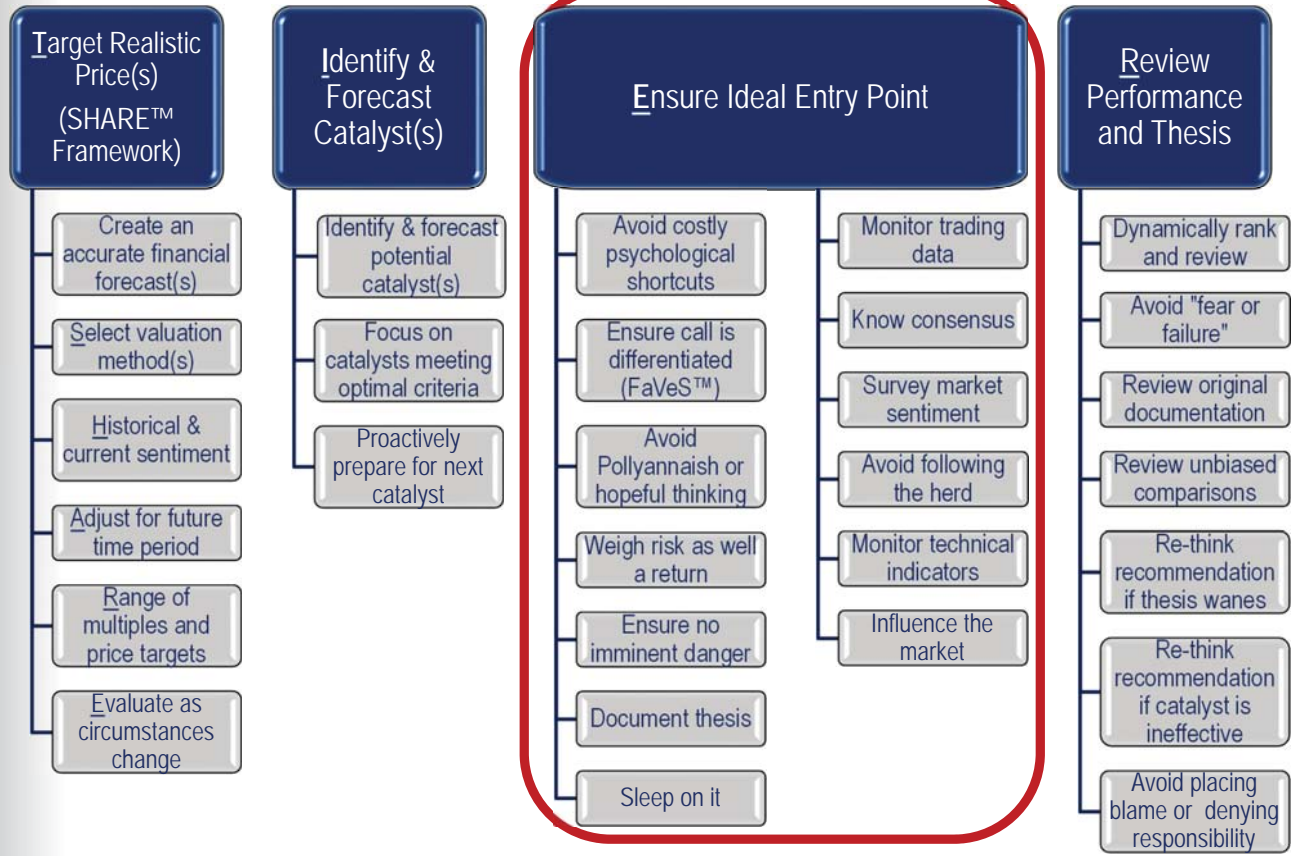


Ensure ideal entry point



Review performance and thesis

Module 3



Step 3A of TIER™: Ensure Ideal Entry Point

Part A: Validate Your View

Part B: Assess and Influence the Market's View



Poll Everywhere

- You do not need to sign up for an account
- Connect to Poll Everywhere
 - Polleverywhere.com/POSP
 - Poll Everyone app
 - POSP

FIND THE F's EXERCISE

Avoid Mind Traps



Heuristics Mind Trap

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



Avoid Heuristics Mind Trap

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



LIST OF NAMES EXERCISE

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Familiarity Bias Mind Trap

- Problem: preferring stocks you're familiar with over those you're less familiar with
- Manifestation:
 - You spend more time researching companies that are easy to follow than those more difficult to follow
 - When asked for a stock recommendation, you offer the one you know the best rather than the one with the best risk/return potential



Avoid Familiarity Bias Mind Trap

- Don't make a suboptimal recommendation just because you know the stock better than the proposed alternatives
- Ensure there are no "forgotten" stocks in your assigned universe by setting aside time to ensure you are well-versed on all them (even the more complicated ones)

Avoid Recency Bias

- Avoid making recommendations where the stimulus is primarily based on a recent meeting or call with company management, especially if it's initiated by the company
- Don't ignore (or fail to research) a stock's critical factors of the past as they often come back and become the critical factors that move the stock in the future



HOW DO YOU DIFFER?

Ensure a Differentiated Stock Call with a Superior FaVeS™ Insight

Forecast

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

Valuation

- Valuation methodology or valuation multiple superior to the market

Sentiment

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

Ensure a Differentiated Stock Call with a Superior FaVeS™ Insight

Forecast

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

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- Valuation methodology or valuation multiple superior to the market

Sentiment

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

Use “Change in Valuation” Sparingly

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

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



Ensure a Differentiated Stock Call with a Superior FaVeS™ Insight

Forecast

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

Valuation

- Valuation methodology or valuation multiple superior to the market

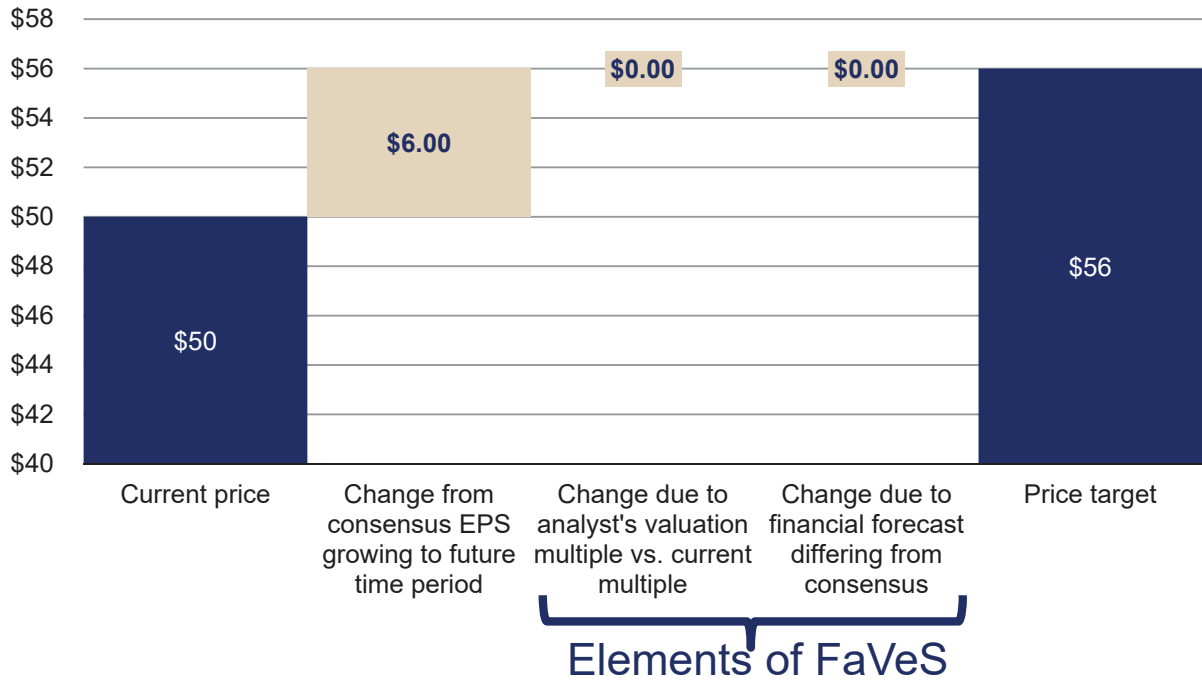
Sentiment

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

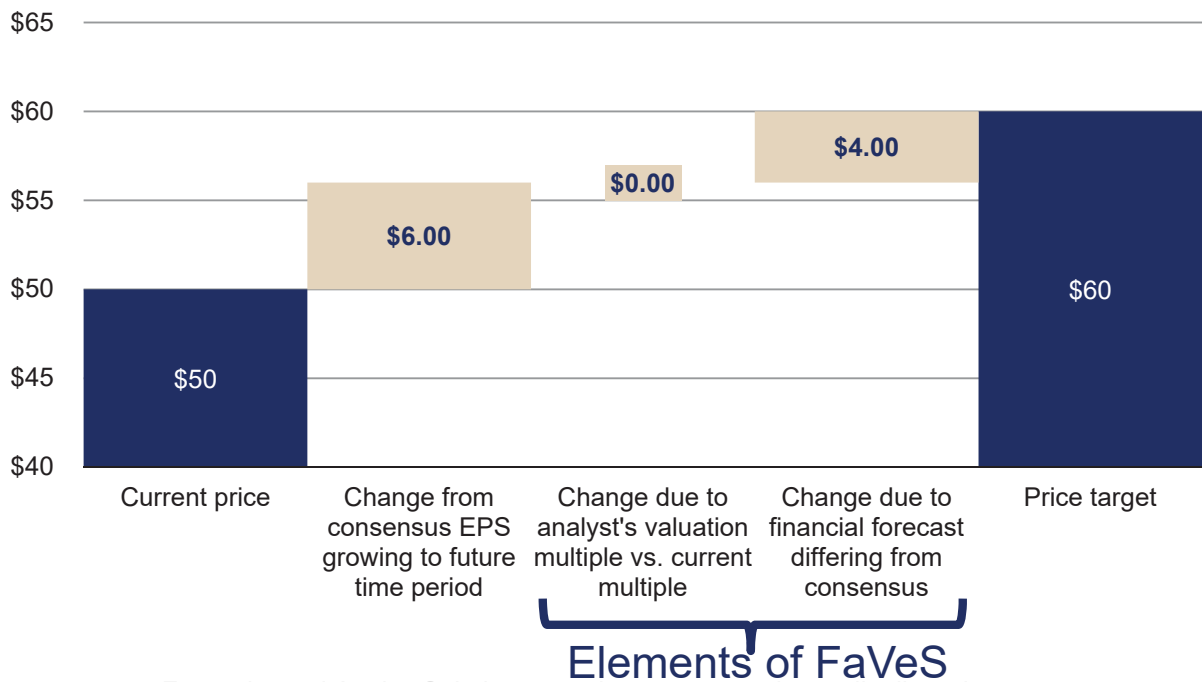
Quantify “How Do You Differ?”

	Scenario			
	A	B	C	D
1. Current data				
Current stock price	\$50.00	\$50.00	\$50.00	\$50.00
Next 12-month (“NTM”) consensus EPS forecast at present (we call this “Year 1”)	\$5.00	\$5.00	\$5.00	\$5.00
Stock’s current valuation multiple based on Year 1 EPS	10.0	10.0	10.0	10.0
Current market multiple	15.0	15.0	15.0	15.0
Stock’s current premium or discount to the market multiple	-33%	-33%	-33%	-33%
2. Change from consensus EPS between Year 1 and Year 2				
NTM consensus in Year 2 (i.e. forecast at beginning of Year 2 for Year 2)	\$5.60	\$5.60	\$5.60	\$5.60
Difference between Year 2 and Year 1 consensus forecasts	12%	12%	12%	12%
Item #2 above is due to passage of time while #3 and #4 below are influenced by the analyst				
3. Change due to analyst’s financial forecast differing from consensus				
Analyst’s NTM EPS forecast in one year (i.e. forecast for Year 2)	\$5.60	\$6.00	\$6.00	\$6.60
Premium or discount of analyst’s EPS estimate in Year 2 compared to consensus’	0%	7%	7%	18%
4. Change due to analyst’s future valuation multiple differing from current multiple				
Analyst’s estimate of market multiple at beginning of Year 2 (typically keep same as present)	15.0	15.0	15.0	15.0
Analyst’s estimate of stock’s premium or discount to market multiple at beginning of Year 2	-33%	-33%	-27%	-20%
Valuation multiple used for price target at beginning of Year 2	10.0	10.0	11.0	12.0
Difference between analyst’s future multiple and stock’s current multiple				
5. Price target	\$56.00	\$60.00	\$65.70	\$79.20
Change from current price	12%	20%	31%	58%

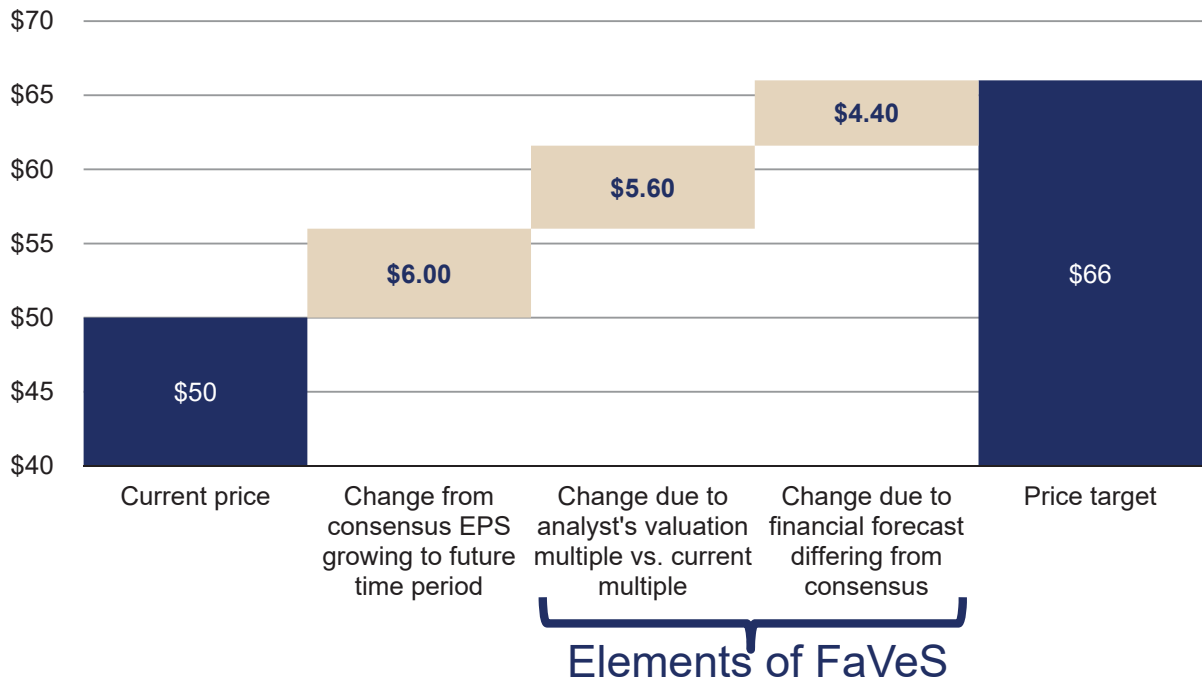
Dissect How You Differ (A)



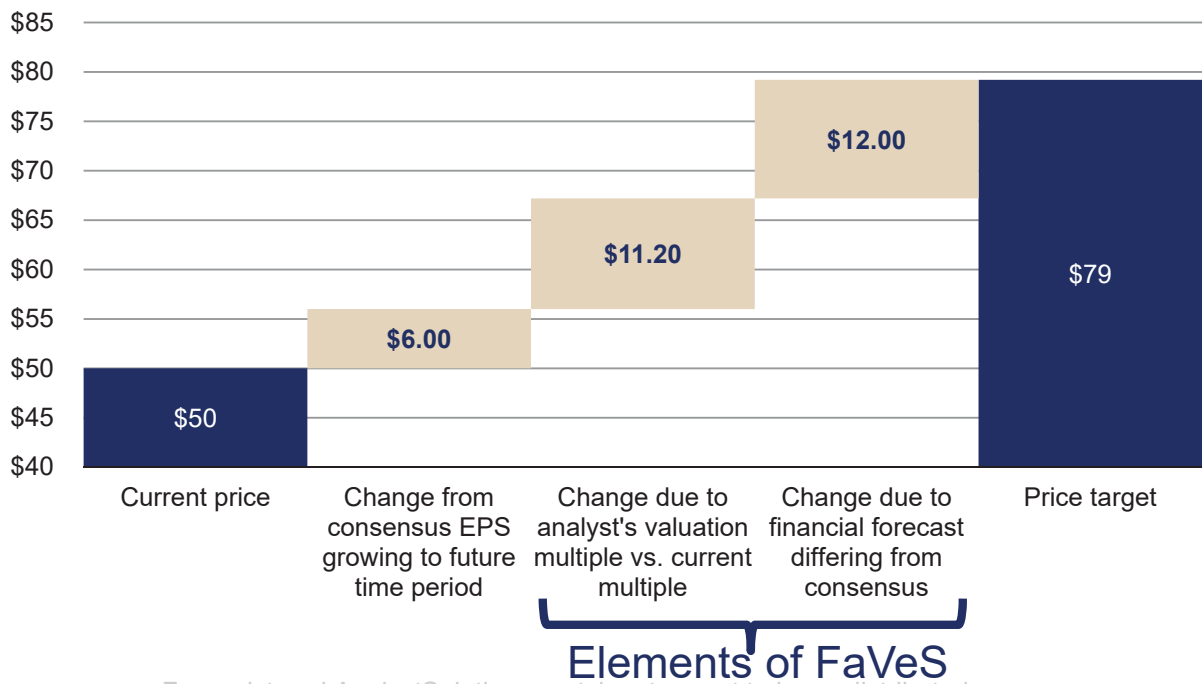
Dissect How You Differ (B)



Dissect How You Differ (C)



Dissect How You Differ (D)



“HOW DO YOU DIFFER?” EXERCISE

Forecasting Financial Results that Differ from Consensus

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



“RANK YOUR ABILITY” EXERCISE

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Overconfidence Mind Trap

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



Avoid Overconfidence Mind Trap

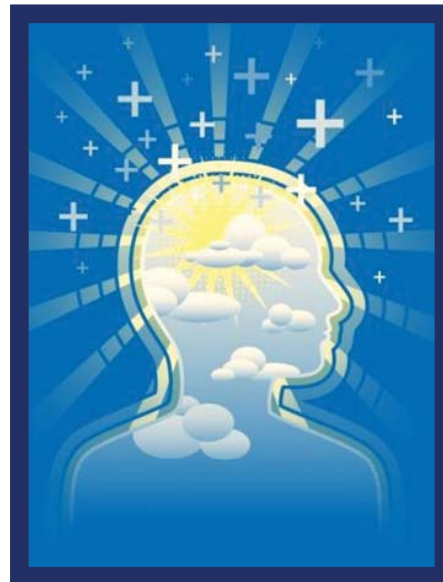
- Remind yourself that no professional investor is right 100% of the time
- Require yourself to fully understand the other side of the trade before making a recommendation
- Ask a trusted colleague or investment committee to scrutinize your thesis
- Any time you think “I can't lose”, think through the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

“HOW DOES YOUR FUTURE LOOK?” EXERCISE

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Optimism Bias Mind Trap

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



Avoid Optimism Bias Mind Trap

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

Avoid Self-Attribution Bias

- After a big win, review documents you wrote when you recommended the stock to see if your thesis played out or another factor was involved
- When you have a stock loss, ask yourself two questions before blaming others or saying “That couldn’t have been foreseen”:
 - Did anyone else see it coming?
 - What might have been done to detect the surprise earlier?
- Examine constructive criticism or negative feedback to the same degree you internalize positive feedback and praise

Resist Predetermining the Rating

Will reduce:
CONFIRMATION BIAS,
which, if unchecked, can
lead to:

- Seeking only information to confirm your thesis
- Summarily rejecting information that refutes your thesis



Conviction Should Equate to Probability



- When you differ materially from consensus, focus on developing greater conviction
- Conviction usually increases when you dig deeper into the assumptions by conducting more thorough research

Weigh Risk as Well as Return

Ensure the risk-adjusted return to the price target is better than alternative investments in the assigned universe

		Returns	
		Low	High
Risk	High	Often the result of poor research -- not identifying the true risks	Exciting, but most PMs don't like to be here
	Low	Tough to add value	Best stock calls -- usually require thorough research

Ensure No Imminent Danger

Don't get hit by these freight trains:

- Current quarter'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 end
- A large management lock-up is about to expire...



Twitter shares tumble 14% as lock-up period expires

3 Hours Ago



Document Your Thesis

Can help reduce these types of mind traps:

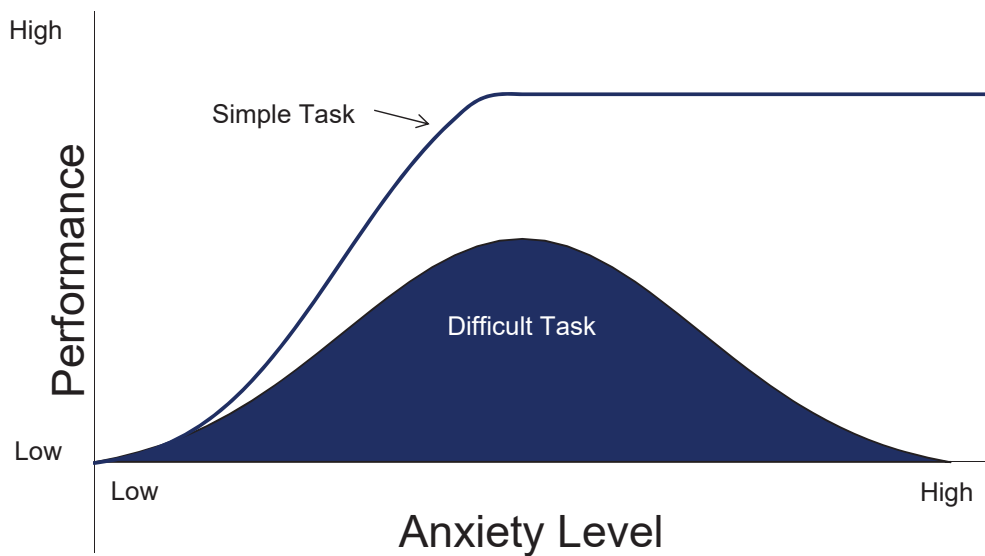
- Loss aversion
- Sunk cost
- Momentum
- Self-attribution



Sleep On It



Yerkes-Dodson Law



Opening Case Examples Covered in 3A of this Module

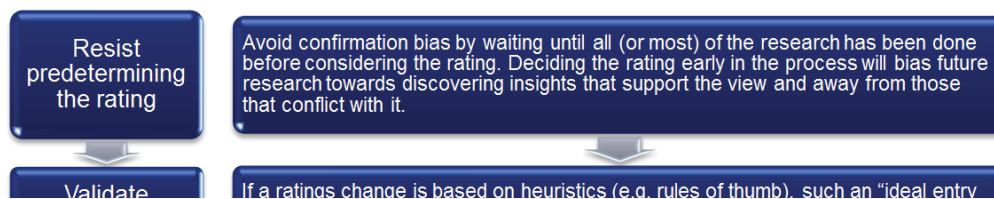
- **Best Practices by Pablo and David:**
 - David is aware of how his estimate compares to consensus
 - Pablo is looking for imminent risks such as a potential disappointment in the current quarter
 - Pablo is questioning if David has selective memory, where he revises history to meet his needs
- **Bad Practices by David:**
 - Says he's been wanting to "upgrade SBUX for years" suggesting he has a pre-existing bias that could be clouding his view (aka "Confirmation Bias")
 - Is relying on a basic rule of thumb (heuristic) in terms of buying the stock late in the year to get upside by February, which he doesn't appear to have validated
 - Hasn't considered what could go wrong with his call
 - Doesn't seem to be concerned by the company's potential for falling short of the current quarterly consensus estimates
 - Dismisses prior bad calls to things that were a surprise to everyone even though a sell-side firm had correctly made an accurate call on one of the stocks

Ensure Ideal Entry Point DRC

Detailed Reference Card (DRC)

Best Practices for Making Accurate Stock Recommendations

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



Step 3B of TIER™: Ensure Ideal Entry Point

Part A: Validate Your View

Part B: Assess and Influence
the Market's View



Monitor Trading Data

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

- Short interest
- Company insider buying and selling
- Changes in the types of investors who own the stock (e.g. value, GARP, growth, momentum)
- Movement of stock compared to company's debt yield or CDS spreads

Investment Style of SBUX Largest Institutional Holders (late 2013)

Holder Name	Investment Style	Market Value (\$)	Position Change (\$)
Fidelity Contrafund	Aggressive Growth	1,195,304,286	521,800
Vanguard Total Stock Market Index Fund	Index	784,760,310	153,094
T Rowe Price Growth Stock Fund	Aggressive Growth	673,005,746	535,800
PowerShares QQQ Trust	Index	603,466,492	275,927

Insider Buying and Selling of SBUX

Trade Date	Participants	Net (\$)
11/15/13	SCHULTZ HOWARD D. ALST	-10
11/14/13	SCHULTZ HOWARD D. ALST	-5
9/30/13	ALSTEAD TROY M. CULVER	
9/30/13	ALSTEAD TROY M. CULVER	
8/19/13	HOBSON MELLODY	
8/2/13	SCHULTZ HOWARD D. ALST	
6/28/13	ALSTEAD TROY M. CULVER	
6/28/13	ALSTEAD TROY M. CULVER	
6/17/13	HANSBERRY JEFFERY	

Short Interest as Percentage

Ticker	Short Interest % of Float
DRI.N	10.1%
DNKN.O	8.5%
NDLS.O	8.1%
BJRI.O	6.1%
RRGB.O	5.6%
SONC.O	5.5%
PNRA.O	5.4%
BLMN.O	5.3%
CAKE.O	4.8%
WEN.O	4.6%
TXRH.O	4.0%
EAT.N	2.5%
BWLD.O	2.3%
MCD.N	2.2%
DPZ.N	2.2%
YUM.N	2.2%
JACK.O	2.0%
CMG.N	1.8%
THL.TO	1.0%
SBUX.O	0.6%

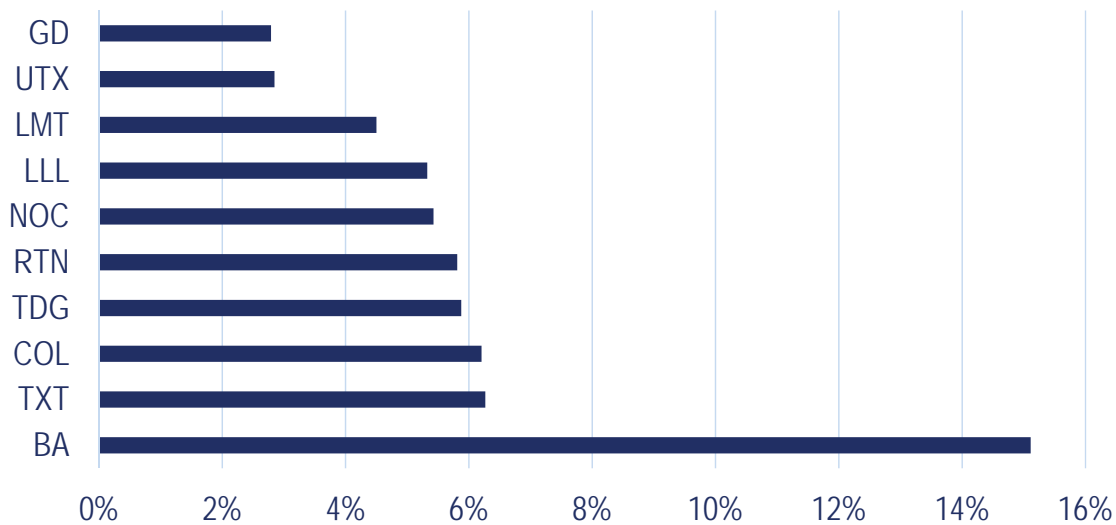
Know “Consensus” For the Stock

- How many analysts comprise the consensus?
- Where is the “informed consensus”?
- How do their views differ from the broader consensus?
- Are the estimates stale?
- Are there any disagreements about what’s in the number?



Investigate “Consensus”

Standard Deviation of Consensus Estimates
(Aerospace & Defense)

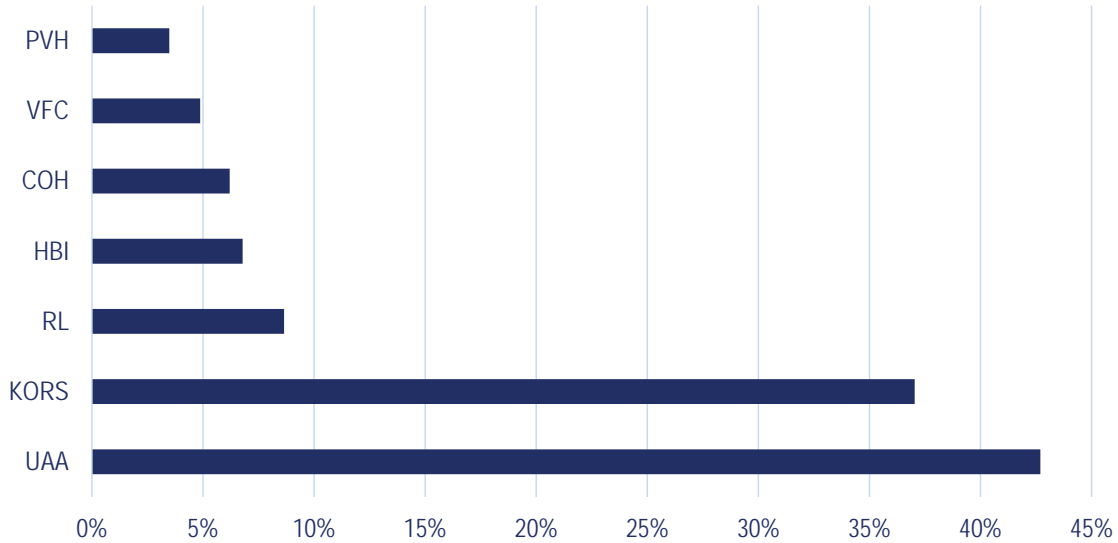


Source: Bloomberg 9-March 2017

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

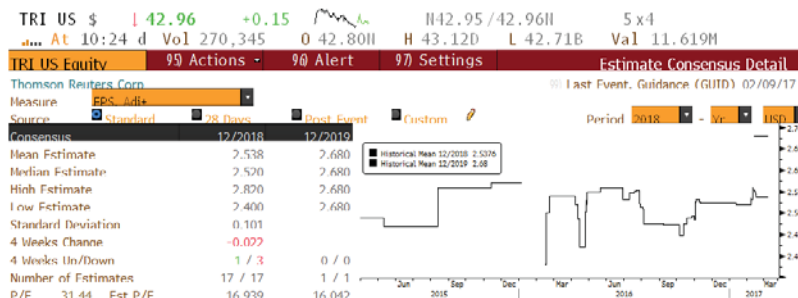
Investigate “Consensus”

Standard Deviation of Consensus Estimates
(Apparel, Accessories & Luxury)



Source: Bloomberg 9-March 2017

Investigate “Consensus”



Source: Bloomberg 9-March 2017

Survey Market Sentiment

Speak with market participants:

- Experienced buy-side analysts or PMs who currently own or have owned the stock in the fund
- Sell-side salespeople who have interest in the stock
- Sell-side traders who trade the stock
- The company's investor relations contact
- Sell-side analysts (if you're a buy-side analyst)



Ask About...

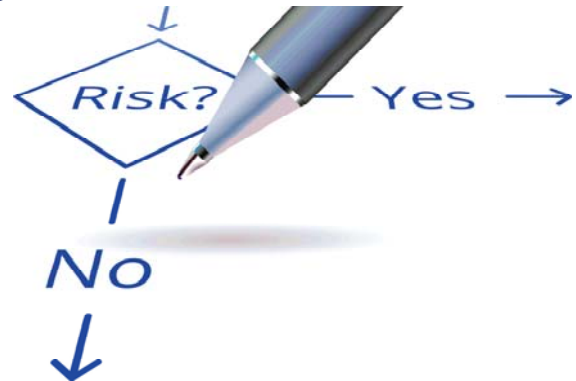
- Biggest investor concerns (may or may not be critical factors)
- Expectations that are above or below the published consensus
- The names and types of stocks receiving the most/least attention (where is everyone spending their time and what's being ignored?)
- General view toward the market (bullish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



Assessing the Market's Risk Appetite

The market's relative appetite for risk can be gauged by monitoring:

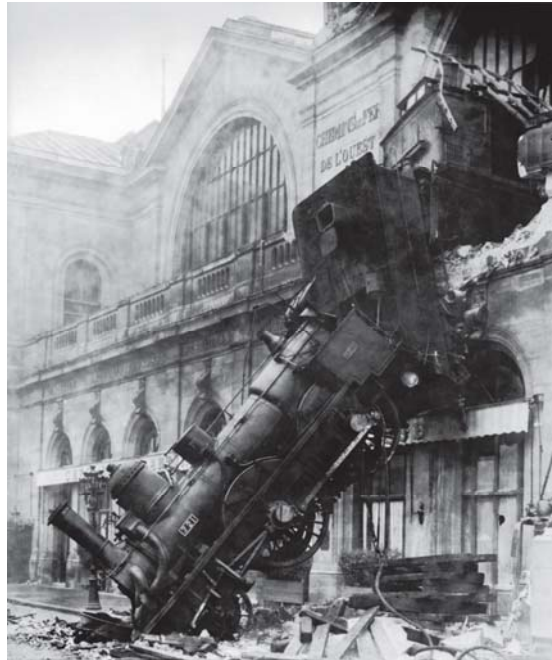
- Treasury yields
- Size of the deal calendar
- VIX
- Recent stock performance of:
 - Weak companies versus stable companies
 - Emerging markets versus developed markets
 - Small cap versus large cap



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Momentum Bias Mind Trap

- Problem: assuming recent trends will continue, even if historical evidence and metrics suggest they are unsustainable
- Manifestation:
 - You assume growth will continue just because a large number of investors are drawing the same conclusion
 - You chase stocks that have already rallied
 - You ignore historical valuation parameters to “make the call work”



Avoid Momentum Bias Mind Trap

- If you've missed a substantial move in a stock, be hesitant to chase it such as jumping on the bandwagon. If you're in the same trade as everyone else, ask "Who's going to take the other side of the trade when I want to get out?"
- Research history for your companies and industries, specifically, the growth rates and valuation multiples. If your price target relies on one or both being well outside historical trends, make sure you have a sound reason for doing so.
- When making a change to your thesis, ask where you are in the "greed vs. fear" spectrum compared with consensus. If you're in the same place, you may be following the herd.
- When markets appear to be moving too far too fast for irrational reasons (not based on fundamentals), consider the contrarian view

Monitor Technical Indicators

Monitor technical indicators

- Assesses the collective wisdom (including emotions) towards a stock based on:
 - Price
 - Volume
- Seeking trends (technical indicators will not predict inflection points)
 - Uptrend
 - Downtrend
 - Support
 - Resistance
- Don't let technicals bias your fundamental work



Influence the Market

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

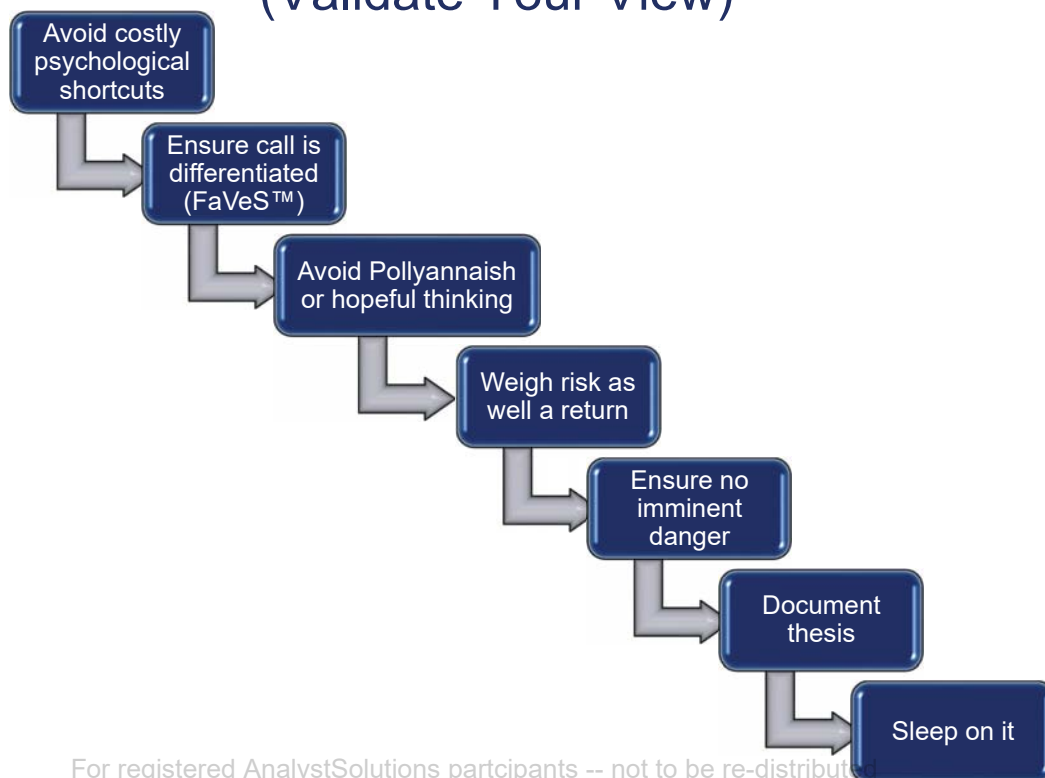


- If allowed by their firm, buy-side analysts should inform the most influential sell-side analysts of their thesis, but only after the buy-side analyst's firm has built a position in the stock
- Sell-side analysts publish their view and influence key market participants

Opening Case Examples We Covered in 3B of this Module

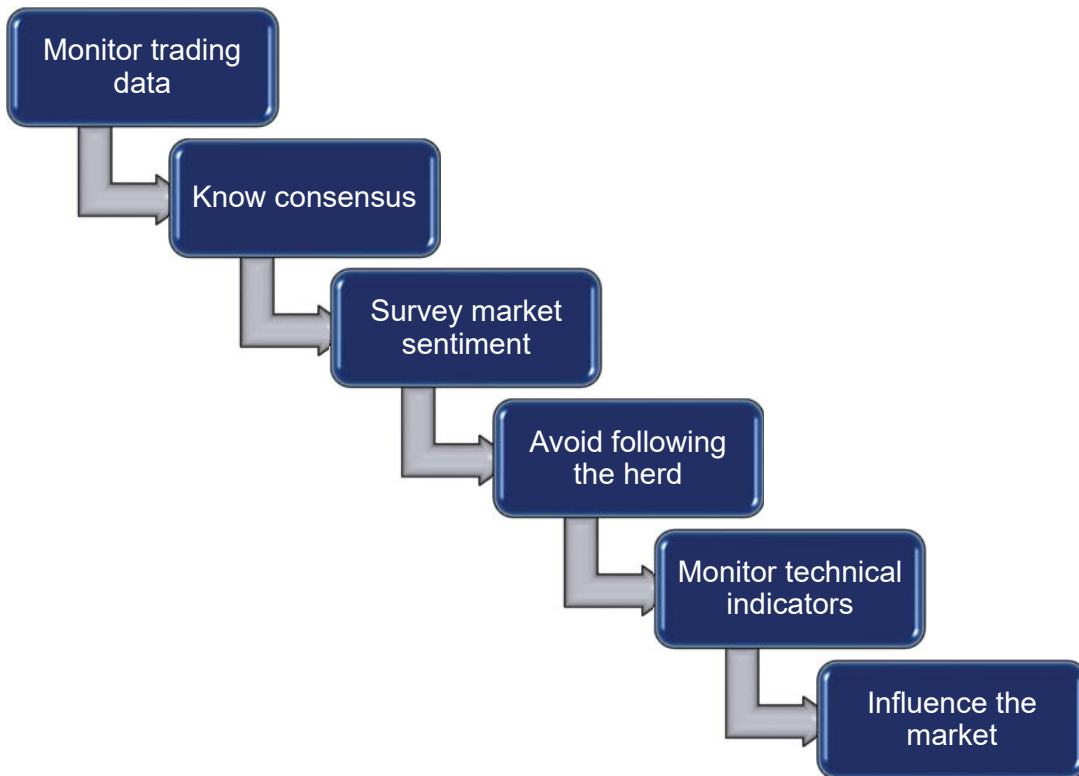
- **Best Practices by Pablo and David:**
 - David is aware of how his estimate compares to consensus
- **Bad Practices by David:**
 - Doesn't know why some analysts value the stock with a PEG ratio while others use P/E ratio
 - Doesn't seem to be concerned with the amount of stock owned by management

Step 3A: Ensure Ideal Entry Point (Validate Your View)



Step 3B: Ensure Ideal Entry Point

(Assess and Influence the Market's View)

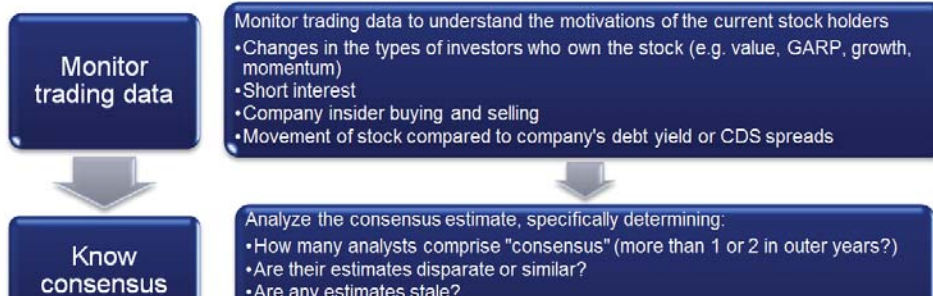


Ensure Ideal Entry Point DRCs

Detailed Reference Card (DRC)

Best Practices for Making Accurate Stock Recommendations

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




Test Your TIER™ Knowledge

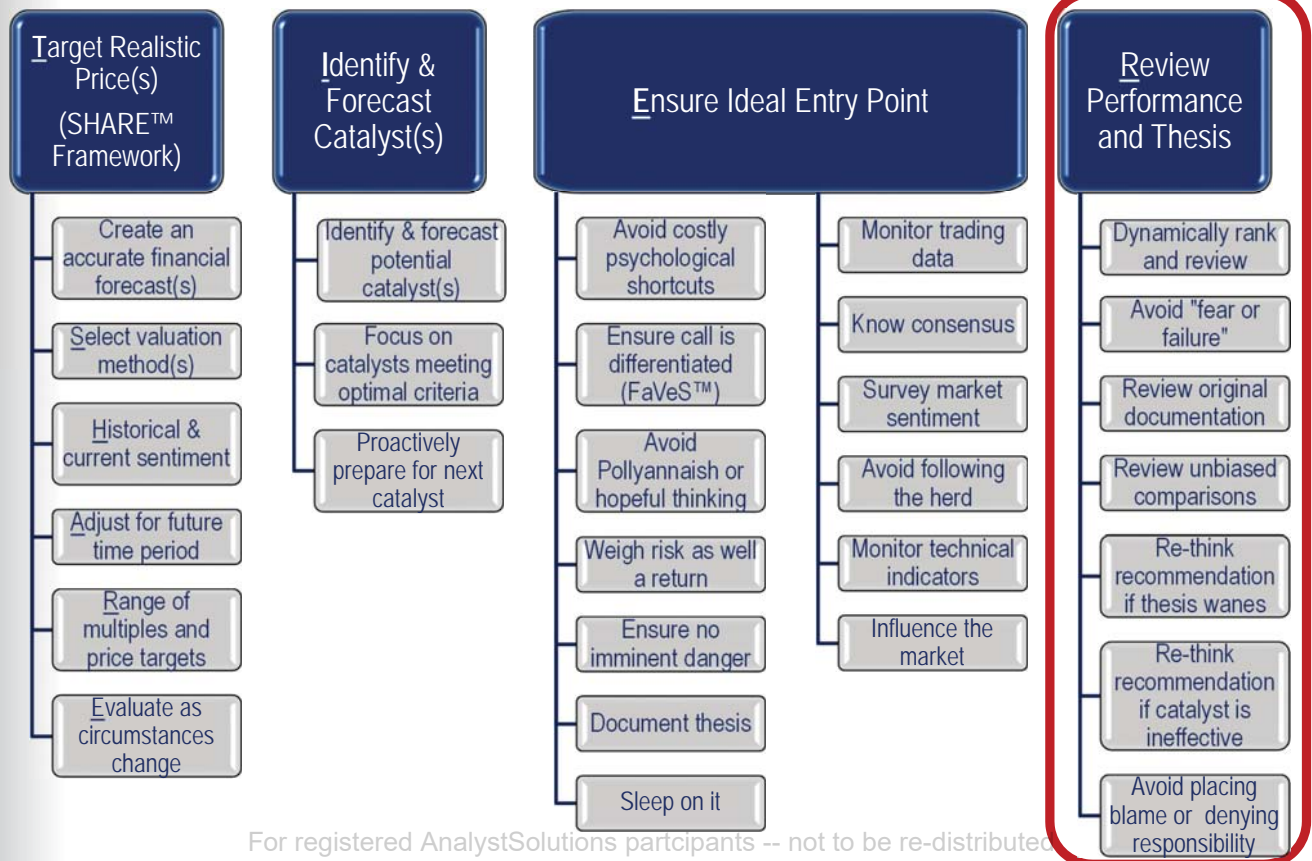
 _____ r _____ p _____ (s)

 _____ & f _____ c _____ (s)

 E _____ ideal _____ point

 R _____ eview performance and thesis

Module 4





Dynamically Rank and Review

All analysts have comp tables, but does yours:

- Updates stock prices automatically (via a feed to third-party service)
- Updates your forecast estimates (e.g. EPS, CFPS, BV, etc.) automatically from your models
- Includes consensus estimates which are automatically updated (via a feed to third-party service)
- Highlights when your financial forecasts differ materially from consensus
- For stocks you're recommending, shows how much future valuation multiple differs from the current multiple
- For stocks you're recommending, includes upside/downside returns to your target prices
- For stocks you're recommending, includes a column for you to adjust upside/downside for risk/probability
- Includes ranges of historical forward relative valuation (e.g. relative P/E)
- Includes current relative valuation to the market (e.g. relative P/E)
- Include relative valuation metrics (e.g. P/E) for stocks in other sectors with similar prospects
- Includes how your recommendations have performed since the last rating change relative to your universe of stocks and the overall market

Review Valuations Regularly

Look at the valuation levels of your stocks regularly, preferably on a daily basis, but no less frequent than weekly.

- It can be the catalyst for a ratings change and ensures that current recommendations are consistent with the magnitude of risk-adjusted upside or downside potential
- It helps to prioritize time, namely, to put more effort into places where the most potential alpha exists
- It helps to internalize when stocks are approaching desired price targets, and are thus worthy of a potential ratings change.
- It helps to understand the psychology about stocks, in terms of when certain stocks or subsectors move based on changes in the marketplace or in critical factors

Sunk Cost Mind Trap

- Problem: investing considerable time or capital into a given stock prevents you from looking at it objectively
- Manifestation:
 - You lose objectivity on a stock after making a recommendation
 - You hold on to a stock simply because you have sunk in considerable time or capital



Avoid the Sunk Cost Mind Trap

- When conducting extensive research on a topic, periodically ask, “What will I do if I discover nothing new?”
- Resist the temptation to make changes to your financial forecasts or valuation multiples to “make it work,” in an effort to show more upside/downside than you previously expected
- Be willing to reverse your recommendation when you’ve made a mistake, or your thesis failed to play out
- Set aside time (once a month or quarter), and ask yourself, “If I switched firms tomorrow, would my initial stock recommendations at the new firm match my current ones?” If not, understand why

Loss Aversion Mind Trap

- Problem: avoiding selling a stock at a loss
- Manifestation:
 - You are unwilling to admit mistakes
 - For non-performing stocks, you resist reversing your rating or look for new reasons to continue recommending



Avoid the Loss Aversion Mind Trap

- Ask yourself, “If I switched firms tomorrow, would my initial stock recommendations match my current ones?” If not, understand why
- After beating yourself up over a mistake, embrace it as a valuable lesson learned that will make you a better analyst
- Document thesis and review to keep honest to your original call



Eliminate Psychological Biases from Your Stock Calls

- 1 Complete thorough research (including valuation analysis) before making a stock recommendation
- 2 Document your thought process (including changes to financial forecast, valuation multiple or method) and review it periodically
- 3 Ask trusted colleagues (or investment committee) to alert you to blind spots in your investment thesis
- 4 Create automatic stop-loss triggers and mechanical sell disciplines
- 5 Accept mistakes as valuable opportunities to learn

Review Original Documentation

Can be as simple as a few lines found in:

- Spreadsheet
- Report
- Presentation

Helps avoid these biases:

- Loss aversion
- Sunk cost
- Momentum
- Self-attribution



Review Unbiased Comparisons

Avoid many typical destructive biases, by periodically:

- Conducting blind test
- Asking “If I switched firms tomorrow...”



Re-think Recommendation If...

Thesis Wanes



Catalyst Is Ineffective



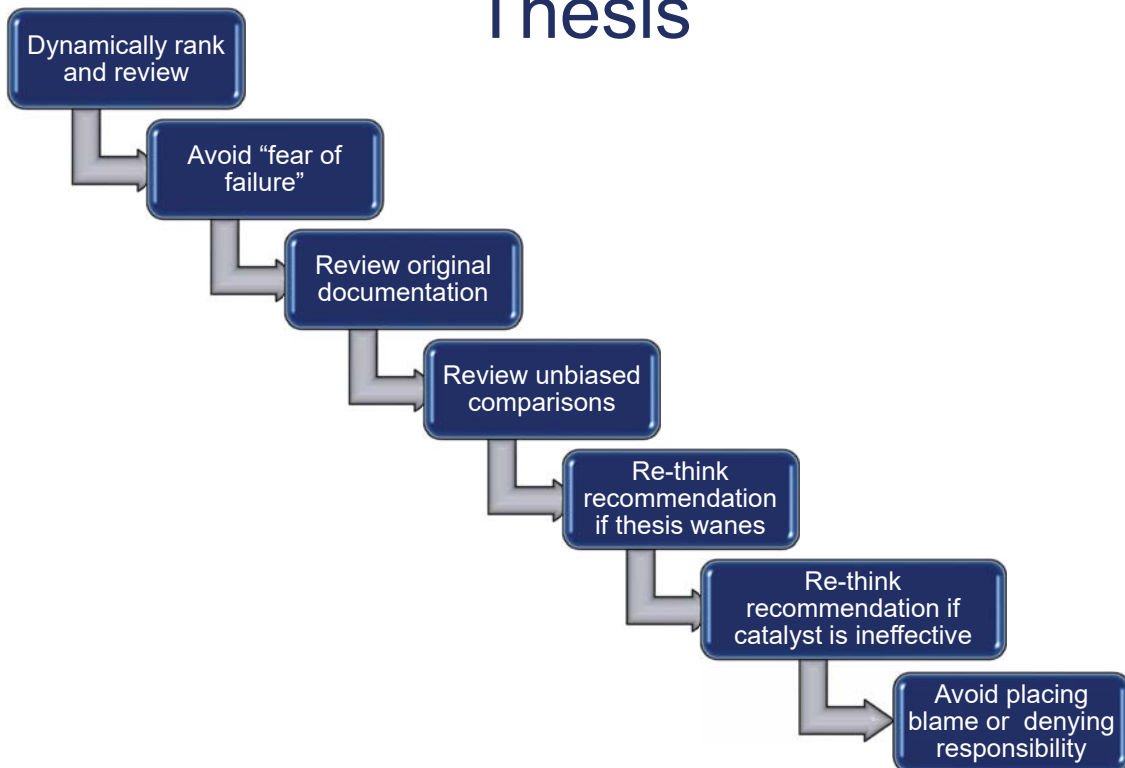
Avoid Placing Blame or Denying Responsibility

Coping Strategies:

- Accepting responsibility
- Distancing
- Plan-full problem solving
- Positive reappraisal

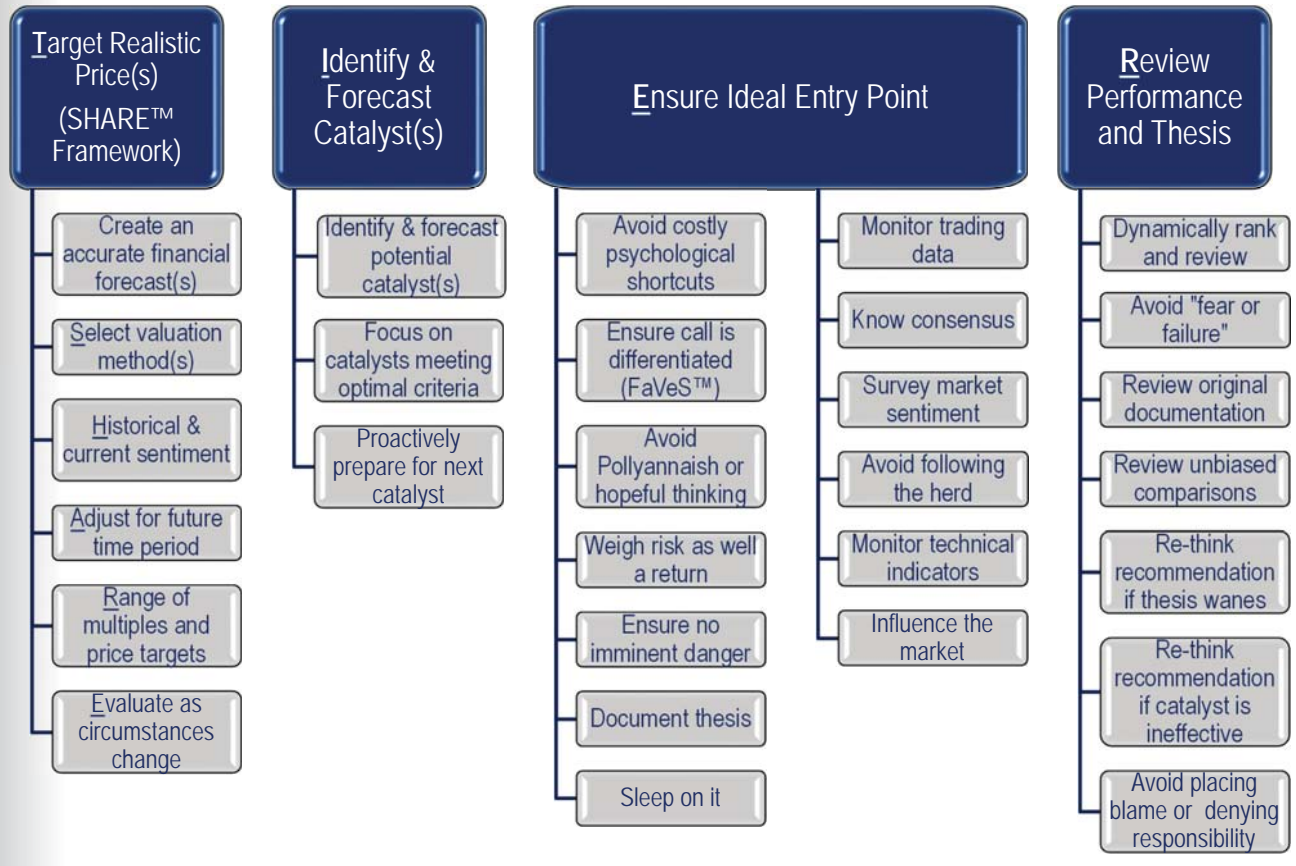


Step 4: Review Performance & Thesis



Opening Case Examples Covered in this Module


- **Best Practices by Pablo and David:**
 - Pablo correctly notes that most of the upside in the stock this year has been in line with the market's move
- **Bad Practices by David:**
 - Is impressed the stock has moved 18% this year even though this is likely due to the overall market move
 - Dismisses prior bad calls to things that were a surprise to everyone even though a sell-side firm had correctly made an accurate call on one of the stocks



Test Your TIER™ Knowledge

 T _____ r _____ p _____ (s)

 I _____ & f _____ c _____ (s)

 E _____ ideal _____ point

 R _____ p _____ and t _____

Portfolio Manager's Frustrations

- Over 80% of research is worthless
 - Not unique
 - Few to no insights
 - Backward looking
 - Lacks substance
 - Lacks conviction
- Research should focus on:
 - What's unique about the analyst's work?
 - What's the market missing?
 - Where do the supporting details come from?
 - What's new from the last update?

Tell me something that will generate alpha



Split Your Screen if Using Electronic Version

Opening Case

Lucas Gallo is an equity research analyst at Nickel Mine Asset Management (NMAM), having graduated with an MBA from a prestigious university before joining the firm five months ago. Lucas covers the transportation, chemical, and auto sectors. He has not made any changes to the ratings of the stocks since being given the group because he is still conducting initial research to develop his own unique view.

For their first year at NMAM, each new analyst is assigned to a senior portfolio manager (PM) to be his or her mentor. Lucas has been assigned to David Torres, an experienced PM and chair of NMAM's 5-member investment committee.

The investment committee of four portfolio managers and two senior analysts has just come together in the firm's conference room to hear Lucas' presentation. Nadia is a portfolio manager and member of the firm's investment committee.

David: Lucas, please share your thoughts with the committee.

Exhibit 1: ENTER™ Quality Checklist

ENTER™ Quality Checklist	Yes/No/Not Clear
Expectational	
Does the analyst have a <u>forward-looking</u> view in terms of the stock and the critical factor(s) likely to move the stock?	
Has the analyst identified the catalyst(s) likely to move his stock and important dates when the catalyst is most likely to cause the stock to move to his price target?	
Has the analyst framed company management's forecast in terms of his <u>independent</u> financial forecast (rather than just repeat management)?	

CASE: LUCAS' FIRST ATTEMPT AT COMMUNICATING HIS STOCK CALL

Module 1: Step 1



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

- Expectational
- Novel
- Thorough
- Examinable
- Revealing



STEP 2: UTILIZE THE OPTIMAL CHANNEL

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



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

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



Have you done enough research to **ENTER™** the investment debate?



The First “E” in **ENTER™** represents being Expectational



- Forward-looking view for the critical factors and their catalysts
- Identify important future dates
- If researching the past, it should be to help forecast the future

EXERCISE: BE EXPECTATIONAL IN YOUR APPROACH

The “N” in ENTER™ represents a Novel perspective

Novel research includes:



- Insights not already known by the broader market...
- Or explaining how widely-known information is being misinterpreted
- Providing new or unique insights to explain your out-of-consensus view...
 - Use the FaVeS™ framework

Ensure a Differentiated Stock Call with a Superior FaVeS™ Insight

Forecast

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

Valuation

- Valuation methodology or valuation multiple superior to the market

Sentiment

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

Utilized in workshop: *Master the Stock Call Techniques of Highly Experienced Analysts*

EXERCISE: IS THE ANALYST'S RESEARCH EXPECTATIONAL AND NOVEL?

CASE: LUCAS TRIES AGAIN

Module 2: Step 2



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

- Expectational
- Novel
- Thorough
- Examinable
- Revealing



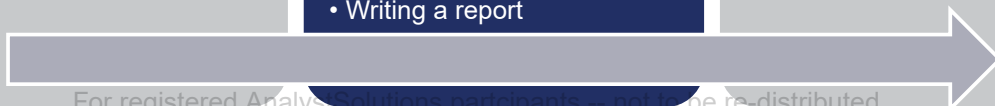
STEP 2: UTILIZE THE OPTIMAL CHANNEL

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- Writing a report



STEP 3: ENSURE MESSAGE HAS VALUE (ADViCE™ framework)

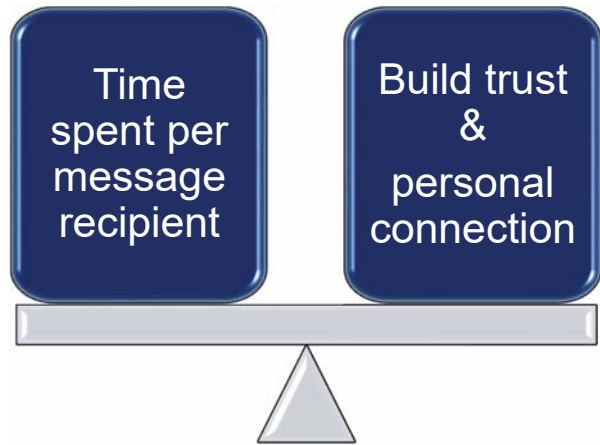
- Aware
- Differentiated
- Validated
- Conclusion-oriented
- Easy-to-consume



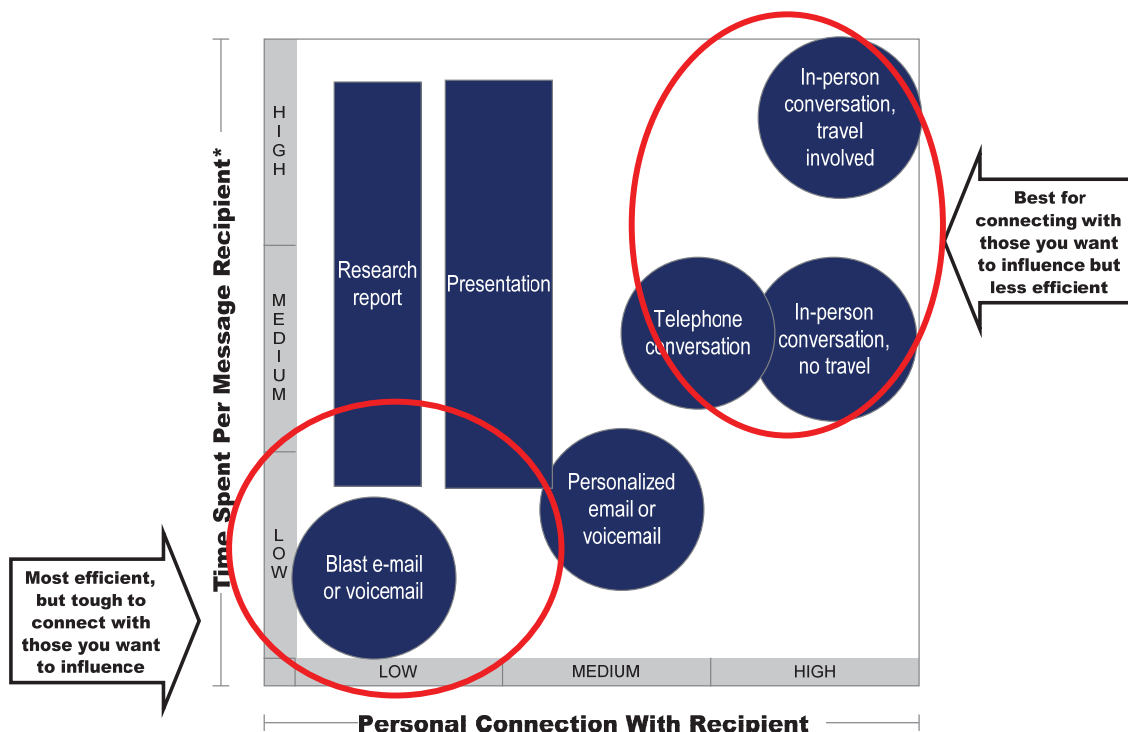
Every Communications Channel Has Pros & Cons

There are trade-offs to every option:

- In-person conversation
- Telephone conversation
- Leaving voicemail
- Presenting
 - Brief
 - In-depth
- Sending an email or text message
- Writing a report



Trade-Offs for Every Channel



* Time spent includes preparation of the communication not to be re-distributed

Key Influencing Skills Required for Successful Equity Research

- Network Building
- Understanding Others' Needs
- Adaptability
- Self-awareness
- Credibility
- Communications Skills



Module 3: Step 3



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

- Expectational
- Novel
- Thorough
- Examinable
- Revealing



STEP 2: UTILIZE THE OPTIMAL CHANNEL

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

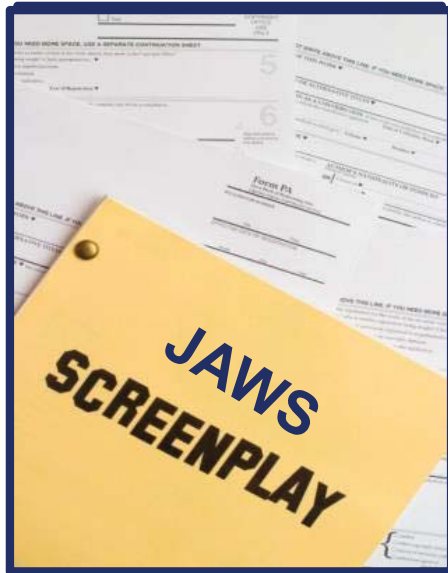


STEP 3: ENSURE MESSAGE HAS VALUE (ADViCE™ framework)

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

Content vs. Message Example

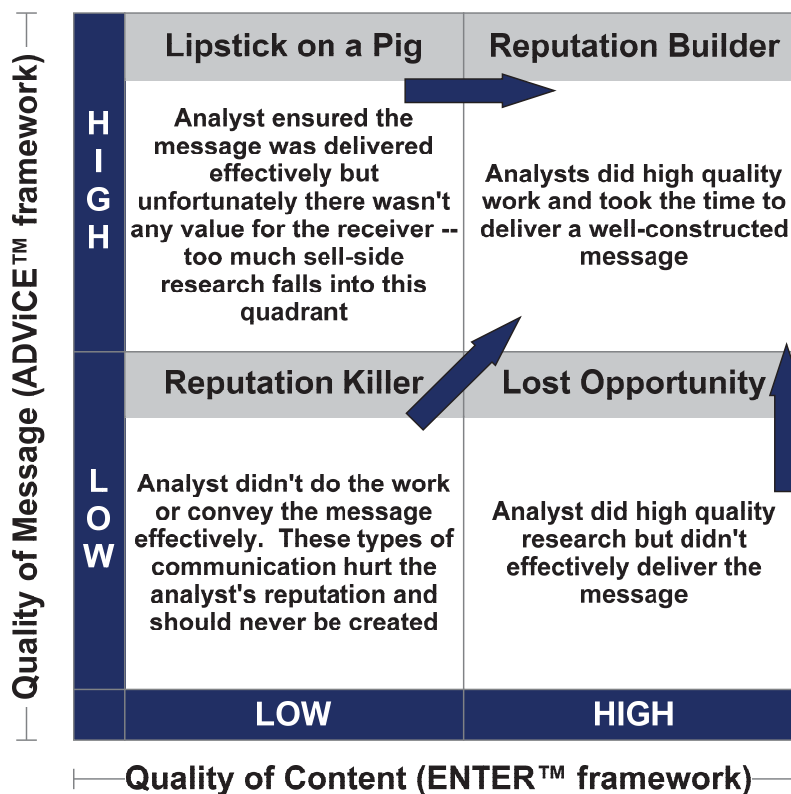
**Screenplay/Script =
Content / Research**



**Movie on Screen =
Message / Delivery**



Both content and message matter



ADViCE™ Framework



Aware



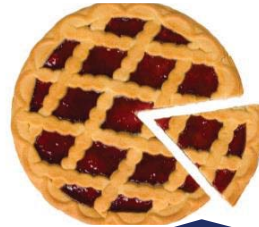
Differentiated



Validated



Conclusion-oriented

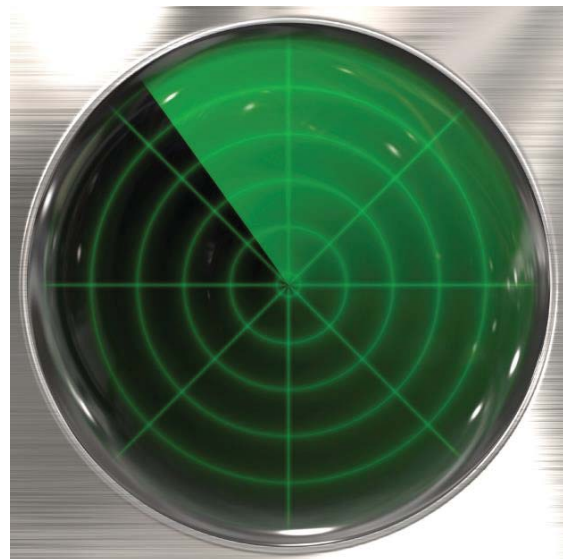


Easy-to-consume

“A” in ADViCE™ Represents Being “Aware”

This is about exposing elements that might not be easy or comfortable:

- Provide alternative scenarios in the form of base-case, upside- and down-side scenarios to show where you could be wrong
- Demonstrate you're not oblivious to the other side of your recommendation by addressing why there are alternative views
- Disclose when you make adjustments to your thesis
- Convey your conviction level, even if it's not high



“D” in ADViCE™ Represents Being “Differentiated”



- Minimize communicating when the message is not differentiated from consensus
- Using the FaVeS™ framework, quantify how you materially differ from the consensus thinking. To have a valid stock call, you must have a superior and materially-different view to the market in one of these areas:
 - Financial forecast
 - Valuation method/multiple
 - Short-term Sentiment of the market
- Explain how your view of the catalyst(s) that will drive your thesis differs from the consensus thinking

“V” in ADViCE™ Represents Having a “Validated View”



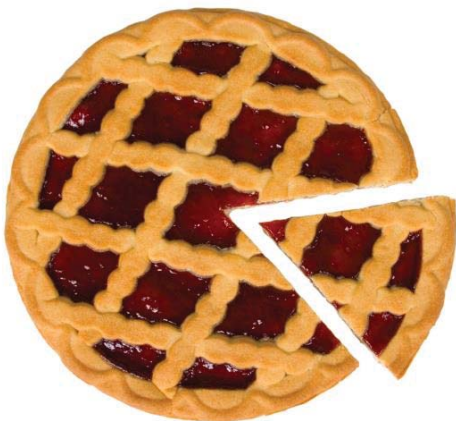
- Without divulging proprietary sources, provide information/data from at least one informed, independent, and reliable source (preferably two or more if it's critical to your call) to validate your out-of-consensus thesis
- Quantify as much as possible, including the materiality of your out-of-consensus view
- Rely sparingly on company management for insights

“C” in ADViCE™ represents “Conclusion-oriented”



- Start your stock communications with conclusions about:
 - At least one stock (are you upgrading, downgrading, or just becoming more/less positive)
 - The catalyst(s) likely to move consensus to your way of thinking
- A stock should be mentioned no later than the second sentence of your communication
- Mention a stock and its rating in the headline for reports and subject lines for emails
- Provide a price target and upside/downside vs. the prior day's close

“E” in ADViCE™ represents “Easy to Consume”



- Quickly convey all of the key elements of the ADViCE™ framework
- Include supportive anecdotes and stories
- Be concise
- Quantify insights whenever possible, but don't overwhelm with too much raw data
- Avoid too much jargon and acronyms

ADViCE™ Framework



Aware



Differentiated



Validated



Conclusion-oriented



Easy-to-consume

ADViCE™ Framework



A _____



D _____



V _____

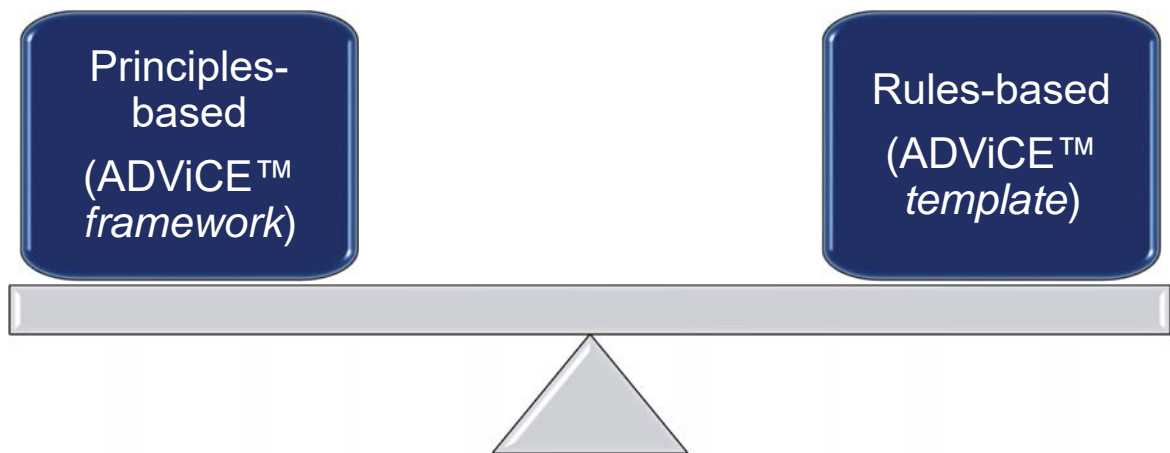


C _____ - _____



E _____ - _____

Two Options to Master the ADViCE™ Framework



7 Stages of ADViCE™ Template

1. Brief Conclusion
2. FaVeS™ element that is being changed (be brief)
3. Price target math
4. Research to support unique FaVeS™ element
5. Quantify unique FaVeS™ element
6. When and why will consensus adopt your view?
7. What could go wrong?

ADViCE™ Framework: Element #1

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

ADViCE™ Framework: Element #2

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

ADViCE™ Framework: Element #3

Element	Wording	Why important	Portion of ADViCE™ framework
Level 1 (email, page 1 of report, slides for brief presentation or voicemail script)			
Price target math	Applying a X [valuation multiple] multiple on our/my XX.00 [EPS, CFPS, BV] estimate for 20XX [time period], results in a year-end/six-month/one-year price target of XX, which is XX% above yesterday's close.	Provides the elements of your price target and return	Conclusion-oriented

ADViCE™ Framework: Element #4

Element	Wording	Why important	Portion of ADViCE™ framework
Level 1 (email, page 1 of report, slides for brief presentation or voicemail script)			
Research to support unique FaVeS™ element	<p>[If there is more than one critical factor driving the story, you may want to communicate this element and the one directly below for each critical factor at a time]</p> <p>Our/my conclusion/above/below-consensus estimate is based on...</p> <p>our/my analysis of...</p> <p>discussions with...</p> <p>data we/I collected from...</p> <p>our/my unique modeling of...</p>	Validates view based on fundamental research and not just a hunch or guesstimate	<p><u>D</u>ifferentiated</p> <p><u>V</u>alidated</p>

ADViCE™ Framework: Element #5

Element	Wording	Why important	Portion of ADViCE™ framework
Level 1 (email, page 1 of report, slides for brief presentation or voicemail script)			
Quantify unique FaVeS™ element	<p>Specifically, we/I believe this results in \$XX/XX%...</p> <ul style="list-style-type: none"> • higher/lower EPS/CF/BV... • faster/slower EPS/CF growth rate... <p>...for 20XX [time period] than...</p> <ul style="list-style-type: none"> ○ current consensus expectations** ○ our/my prior estimate <p>AND/OR</p> <ul style="list-style-type: none"> • expansion/contraction of the stock's relative/absolute valuation multiple from X to Y 	Answers "materiality" question by quantifying how your view differs from consensus	Differentiated Conclusion-oriented


ADViCE™ Framework: Element #6

Element	Wording	Why important	Portion of ADViCE™ framework
Level 1 (email, page 1 of report, slides for brief presentation or voicemail script)			
When and why will consensus adopt your view?	<p>We/I...</p> <ul style="list-style-type: none"> • differ from consensus because... • believe consensus does not understand/appreciate... <p>[reason why consensus hasn't come around to your way of thinking yet].</p> <p>[AND]</p> <p>We/I believe consensus will adopt/understand our/my view by [specific quarter or time of year] due to [catalyst that will drive the market to your way of thinking].</p>	Explains how view of the catalyst(s) differs from the consensus thinking and when it will become clear to the market	Differentiated Conclusion-oriented

ADViCE™ Framework: Element #7

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

3 Steps For Communicating Stock Recommendations




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

- Expectational
- Novel
- Thorough
- Examinable
- Revealing



STEP 2: UTILIZE THE OPTIMAL CHANNEL

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



STEP 3: ENSURE MESSAGE HAS VALUE (ADViCE™ framework)

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

EXAMPLE: PAGE 1 OF REPORT

Follow through by continually practicing these three steps...



Train to Retain



Employ an Action Plan



Reinforce Knowledge



Our Tools



Workshops



One-on-one coaching



Assessments



Consulting



Keynote/offsite presentations

Workshops that Address Universal Analyst Needs



Identify & Monitor a Stock's Critical Factors



Generate Differentiated Insights Through Better Discovery, Questioning and Influencing



Apply Practical Valuation Techniques For More Accurate Price Targets



Master the Stock Call Techniques of Highly Experienced Analysts



Communicate Unique Stock Calls Successfully So Others Take Action



Maximize Your Time for Alpha Generation

Best Practices Bulletins

10 Steps for Equity Research Analysts to Perform Better



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

Portfolio Managers' #1 Frustration With Equity Research Analysts



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

[Read the Entire Bulletin >](#)

Questions and Feedback



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