

Chapter 11

Detect Deceptive Numbers

Be skeptical of any data you receive from others. Just because a chart looks good in a company's presentation doesn't mean it's conveying the information in a form you need for making investment decisions. Most importantly, start by assessing the biases of those providing the numbers; they will almost always have them. Even the press has an agenda—getting more viewers or readers, which is why they often inflate the importance of new information. Taking a line from the Watergate scandal, “follow the money” to see who is paying for this particular data series to be collected and distributed. If it's funded by anyone other than analysts similar to you, there's a good chance it has biases that must be understood before using it to make an investment decision.

Exhibit 11.1 has my top 10 most common factors to consider in order to avoid deception with numbers, followed by specific discussions of charts, ratios, and statistics.

Exhibit 11.1 Best Practice (Knowledge): Spotting the Top 10 Deceptions When Presented with Data

1. Complexity offers opportunity for deception. If it's too difficult to understand (or the other person to explain), ask for a breakdown of the components. Even something as complicated as landing a 747 jumbo jet can be broken down into simple-to-understand components.

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2. Be leery of sources that extrapolate future trends at the same rate as the past. If Microsoft had continued its 1980s growth rate into the 1990s and beyond, it would have become the entire U.S. GDP. "Trees don't grow to the sky" is a good adage to keep in mind when someone fails to have a slowdown in his or her future trends.
3. Don't let someone else choose the time period for your analysis. Companies are notorious for providing information back to when things troughed so that management can look fantastic at running the business. If a company says it has had five quarters of double-digit growth, it should beg the question, "What happened six quarters ago?" In general, companies focus on time periods that accentuate the positives and hide the negatives.
4. Be mindful of survivorship biases that are prevalent in the investment community. Struggling companies are often dropped from popular stock indexes even though the stock is still held in portfolios, which causes the pain to be felt twice (stock does poorly before it's dropped; then when it's removed from the index, the benchmark index is immune while the portfolio is not).
5. Be skeptical of survey data unless you're comfortable that the publisher has minimal biases. There are many tricks that can be played to get the desired answer, such as how the questions are asked or how the survey population is selected. For example, asking 30 high-school-aged adolescents, "Would you prefer to chew this brand of gum or increase your chances of getting cavities?" would likely yield results that could lead the company to say, "80 percent of respondents said they prefer to chew our gum." If survey data is critical to your analysis, do your best to see the questionnaire and identify how the population was selected.
6. When a company releases earnings, read its release but look at the numbers in *your* format. Companies have an incentive to spin the numbers in the most positive light possible. My general rule is to immediately compare the company's pretax income with my forecast and then work up the income statement to find the variance. For some industries, cash flow is the more transparent data point.
7. At a minimum, a company's revenue and earnings should grow from inflation each year. As such, be skeptical when a company says it "achieved record revenue" in the quarter or "has grown EPS for the past five years." What you really want to know is how much have earnings grown beyond general economic inflation or compared with the company's peers.
8. The fewer facts and numbers used by an expert, the more skeptical you should be. Try it yourself by watching a few guests respond to questions on

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