Master the Stock Call Techniques of Highly Experienced Analysts

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CE Qualified Activity — CFA Institute
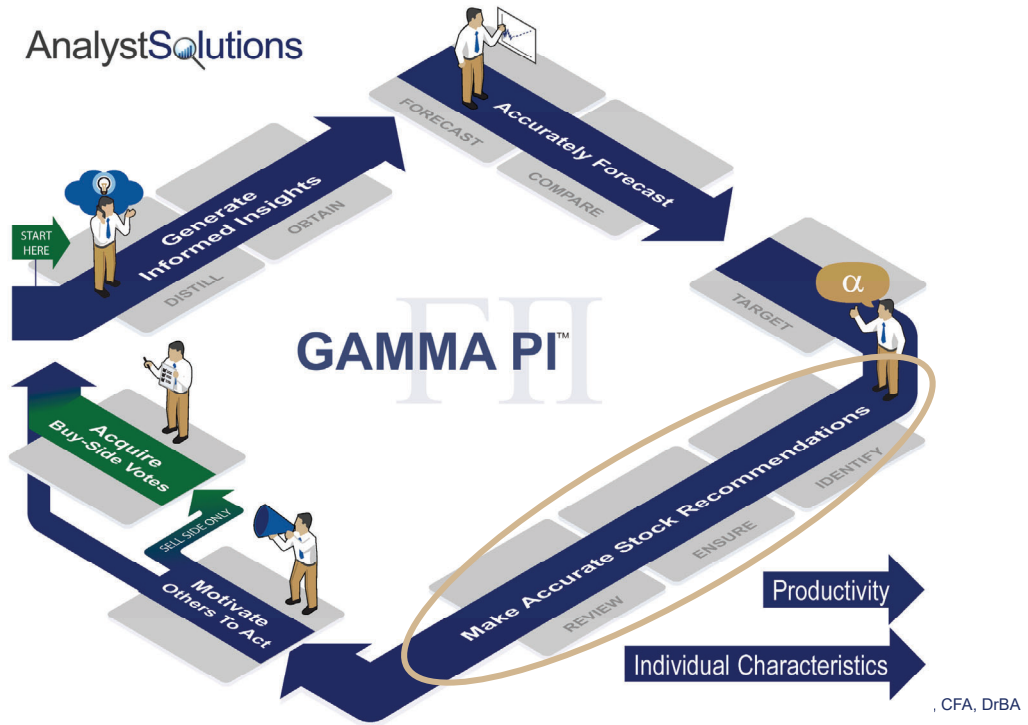
1500

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PRE-WORK EXERCISES

https://www.analystsolutions.com/msctheapw/
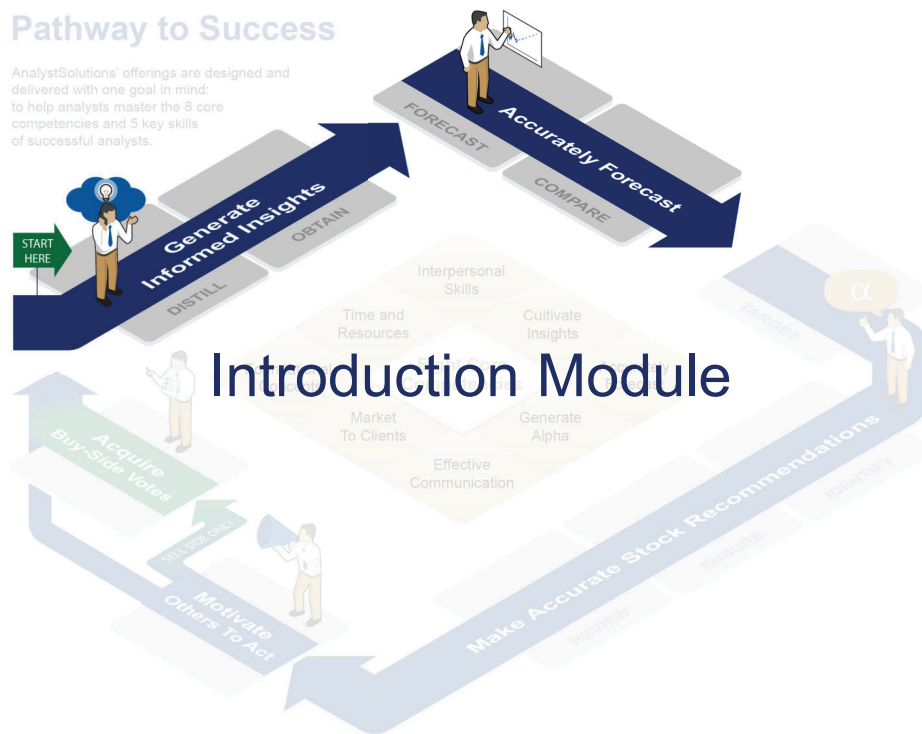
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Opening Case

First section of your Learner Workbook

1503

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Pathway to Success

AnalystSolutions' offerings are designed and delivered with one goal in mind: to help analysts master the 8 core competencies and 5 key skills of successful analysts.

START HERE

Generate Informed Insights

DISTILL · OBTAIN

FORECAST · Accurately Forecast · COMPARE

Interpersonal Skills

Time and Resources · Cultivate Insights

Market To Clients · Generate Alpha

Effective Communication

Acquire Buy-Side Votes

Motivate Others To Act

Make Accurate Stock Recommendations

Introduction Module

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
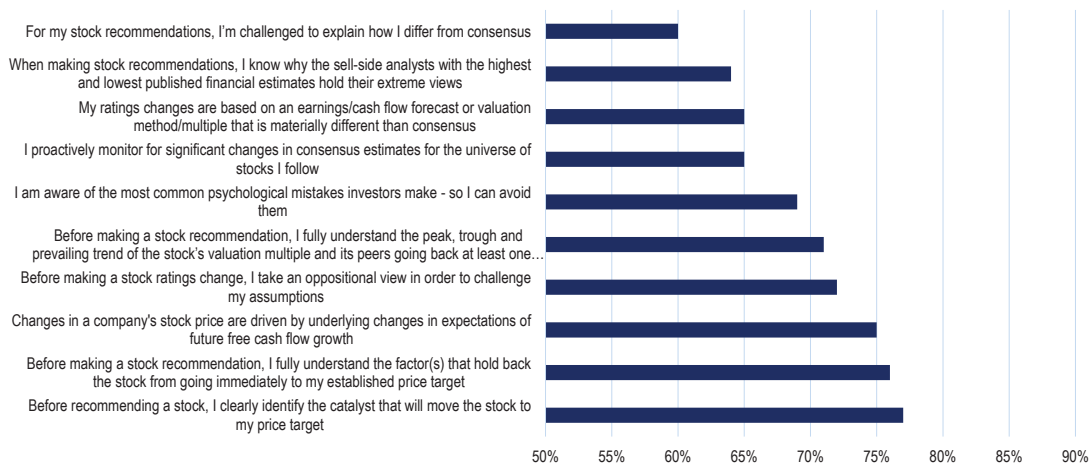
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Greatest Challenges to Stock Picking

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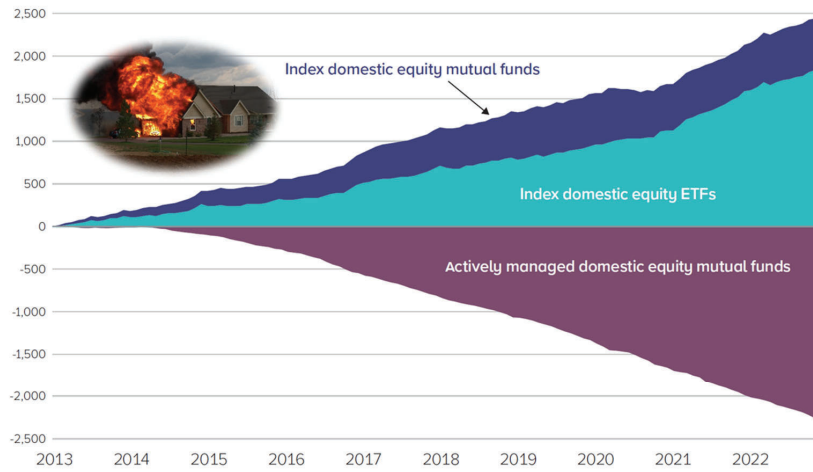- Emotions cloud clear thinking, often causing an analyst to make the wrong decision

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Survey Responses:
Make Accurate Stock Recommendations

For my stock recommendations, I'm challenged to explain how I differ from consensus

When making stock recommendations, I know why the sell-side analysts with the highest and lowest published financial estimates hold their extreme views

My ratings changes are based on an earnings/cash flow forecast or valuation method/multiple that is materially different than consensus

I proactively monitor for significant changes in consensus estimates for the universe of stocks I follow

I am aware of the most common psychological mistakes investors make - so I can avoid them

Before making a stock recommendation, I fully understand the peak, trough and prevailing trend of the stock's valuation multiple and its peers going back at least one…

Before making a stock ratings change, I take an oppositional view in order to challenge my assumptions

Changes in a company's stock price are driven by underlying changes in expectations of future free cash flow growth

Before making a stock recommendation, I fully understand the factor(s) that hold back the stock from going immediately to my established price target

Before recommending a stock, I clearly identify the catalyst that will move the stock to my price target

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Worthy of Analysis

Cumulative flows to domestic equity mutual funds and net share issuance of index domestic equity ETFs, billions of dollars, monthly
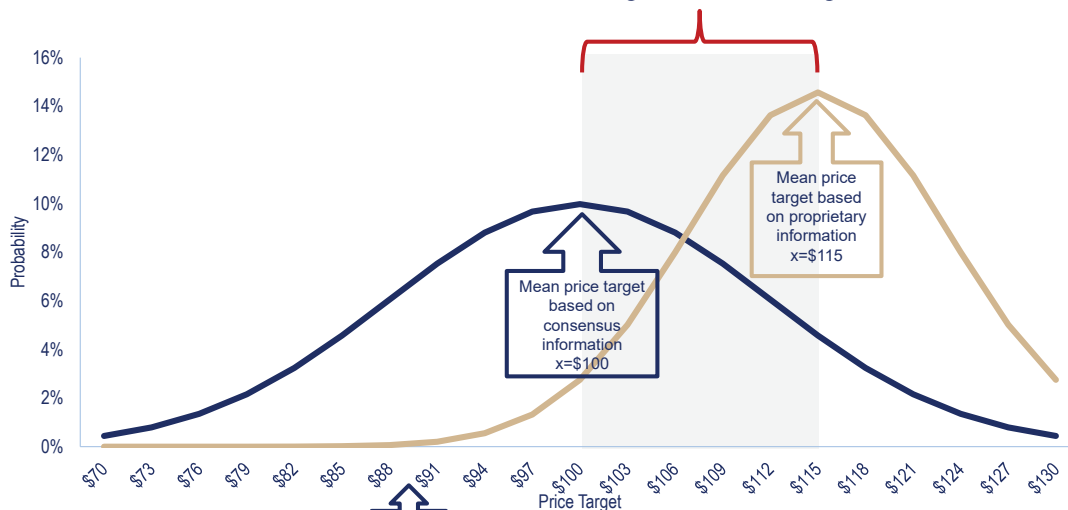

- Index domestic equity mutual funds
- Index domestic equity ETFs
- Actively managed domestic equity mutual funds

Source: Investment Company Institute

2017

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Information Asymmetry

Probability

Mean price target based on proprietary information x=$115

Mean price target based on consensus information x=$100

Current price

Price Target

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Information Asymmetry = Alpha

Fund Collects Fees	Fund Generates Alpha

Identify proprietary information

Speak with company management → Speak with company management

Consume public information → Consume public information
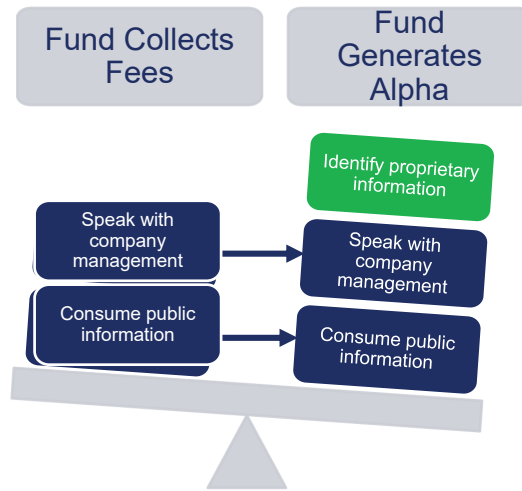
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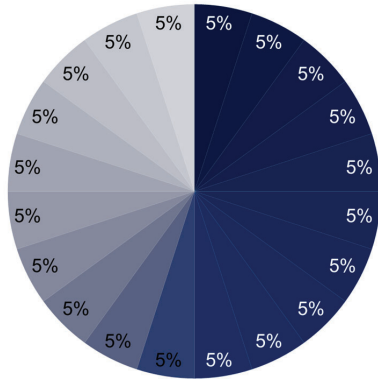# EPIC™ Stock Calls Require Critical Factors Meet All Four Criteria

Exceeds Materiality Threshold

Probably Going to Occur

I'm Good at Forecasting

Consensus is Poor at Forecasting

Critical Factor

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What Will Your Day Look Like?

Critical Factors Not Defined

5% 5% 5% 5% 5% 5% 5% 5% 5% 5% 5% 5% 5% 5% 5% 5% 5% 5% 5% 5%

Critical Factors Defined

5%
15%
40%
40%

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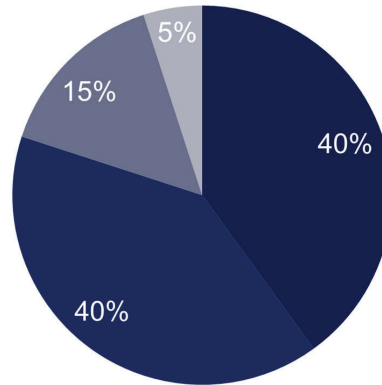
HELP™ Framework for
Identifying Critical Factors

Research History data & documents

Explore Emerging data & documents

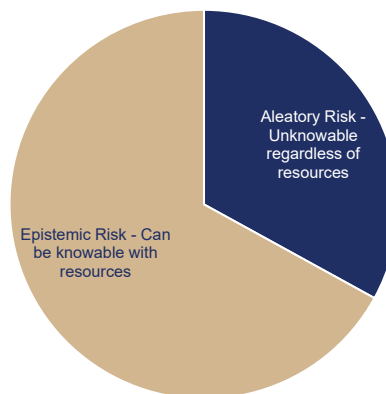**Validate/refute assumptions with Live sources**

Prioritize factors using EPIC™ framework

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Example Critical Factors

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

Factor	Exceeds my materiality threshold of 10%	Probably going to occur during my time horizon	I'm good at forecasting the factor and catalyst	Consensus is poor at forecasting or spotting factor	Total
Improved network efficiency	4	4	4	5	17
Change in ability to collect fuel surcharge	4	4	4	4	16
Change in ground package growth	3	4	4	4	15
Acquisitions	5	3	2	5	15
Growth in Asia-Pacific	2	2	4	3	11
Purchase of new aircraft	1	4	4	2	11
Change in purchased transportation cost trends	1	2	2	4	9
Change in depreciation rate	1	2	2	4	9
Major weather disruptions	2	3	2	2	9

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Improving Return vs. Risk

Pie chart segments: "Aleatory Risk - Unknowable regardless of resources" and "Epistemic Risk - Can be knowable with resources"
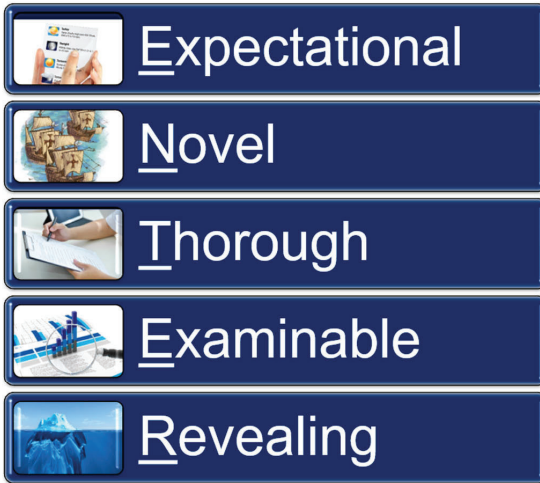
Integrity Research

Gerson Lehrman Doubles Down On Quantitative Insights Group

Posted: 31 Jul 2018 05:55 AM PDT

Leading expert network GLG (Gerson Lehrman Group) is aggressively expanding its Quantitative Insights group. After examining LinkedIn registrations and new hires advertised on the company website, we estimate that the group is more than doubling in size during 2018, projected to grow to approximately 60 staff by year end. GLG has offered custom surveys which …

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Key elements to ensure you are prepared to ENTER™ the investment debate…

- **E**xpectational
- **N**ovel
- **T**horough
- **E**xaminable
- **R**evealing

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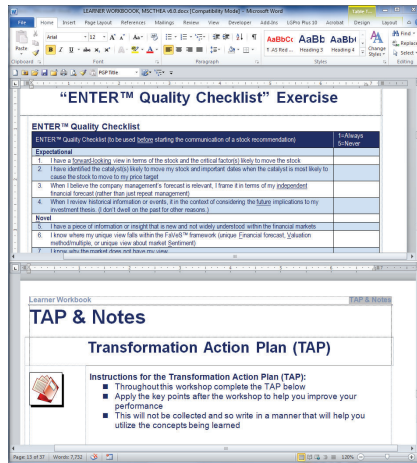
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EXERCISE: "ENTER™ QUALITY CHECKLIST"

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Split Your Screen if Using Digital Version
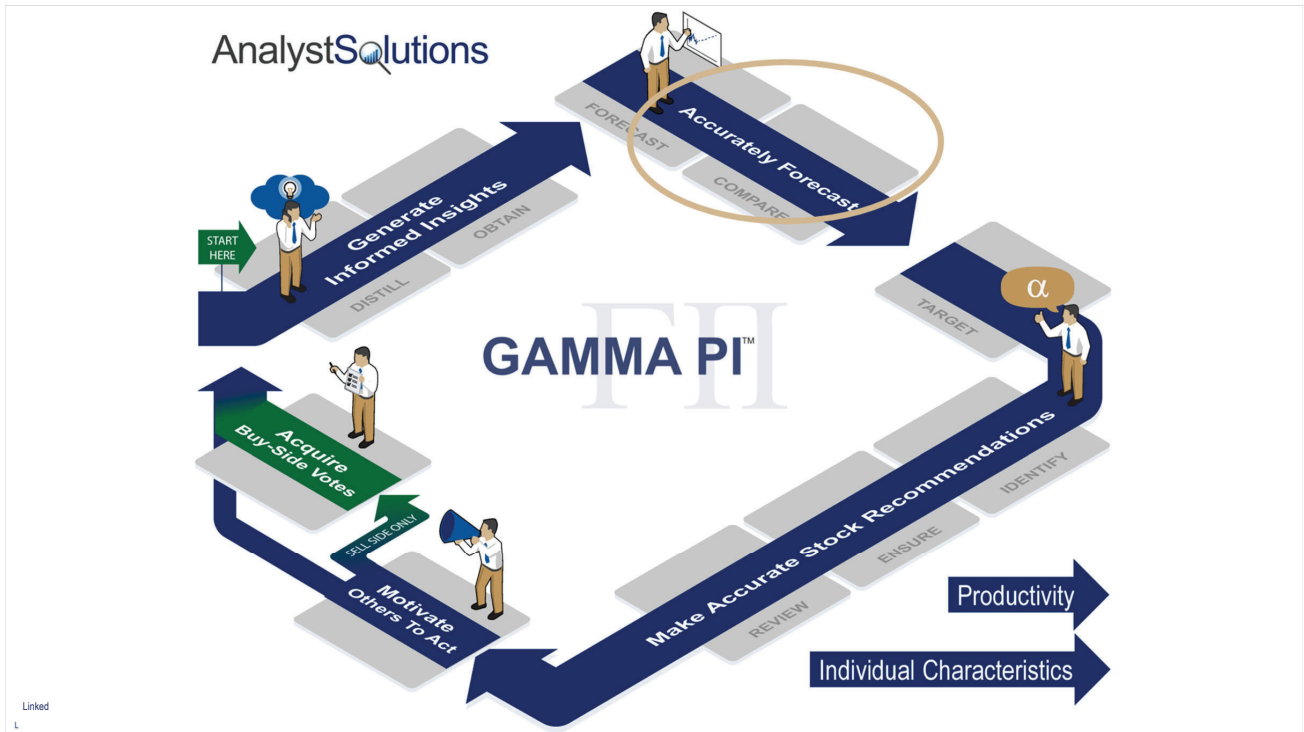
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Complete Your TAP

Section 1

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Price Target in Its Simplest Terms

Forward-looking financial forecast at a point in time → **Influences** → Valuation multiple

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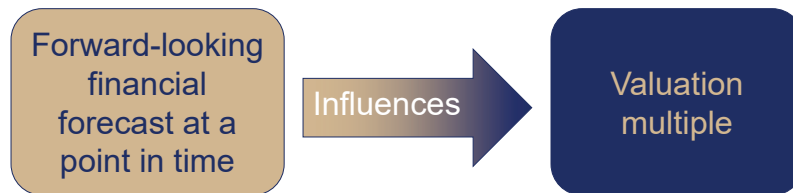
Exploit Anomalies

If your financial forecast is more accurate than consensus, you will have the ability to:

- Anticipate the multiple expansion; or

- Avoid double-counting if the multiple is already anticipating this change

Time identifying the optimal valuation multiple

Time researching to create accurate forecast

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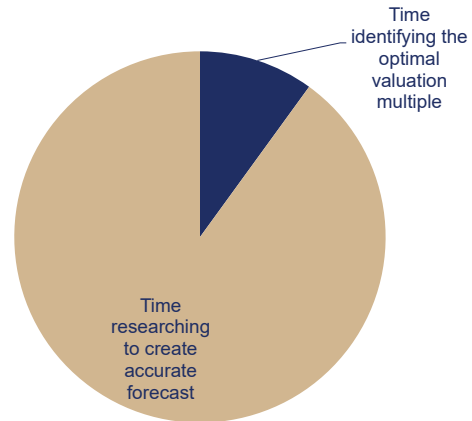
Stress Test Your Forecast

- Develop base-case, upside and downside scenarios for the 1-4 critical factors most likely to move your stocks

- Assign quantitative metrics for each

- Assign probabilities

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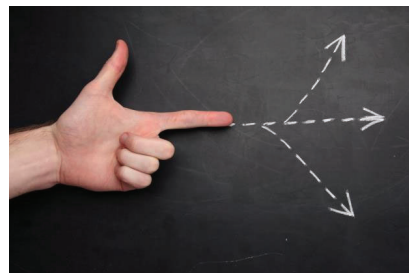
EXERCISE: STRESS TEST YOUR FORECAST

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Module 1:
TIER™ Framework For Making Accurate Stock Recommendations

Pathway to Success

AnalystSolutions' offerings are designed and delivered with one goal in mind:

| Target Realistic Price(s) (SHARE™ Framework) | Identify & Forecast Catalyst(s) | Ensure Ideal Entry Point | Review Performance and Thesis |

Interpersonal

Market To Clients

Generate Alpha

Effective Communication

Make Accurate Stock Recommendations

α

TARGET

IDENTIFY

ENSURE

REVIEW

Target Realistic Price(s) (SHARE™ Framework)

- Create an accurate financial forecast(s)
- Select valuation method(s)
- Historical & current sentiment
- Adjust for future time period
- Range of multiples and price targets
- Evaluate as circumstances change

Identify & Forecast Catalyst(s)

- Identify & forecast potential catalyst(s)
- Focus on catalysts meeting optimal criteria
- Proactively prepare for next catalyst

Ensure Ideal Entry Point

- Avoid costly psychological shortcuts
- Ensure call is differentiated (FaVeS™)
- Avoid Pollyannaish or hopeful thinking
- Weigh risk as well a return
- Ensure no imminent danger
- Document thesis
- Sleep on it

- Monitor trading data
- Know consensus
- Survey market sentiment
- Avoid following the herd
- Monitor technical indicators
- Influence the market

Review Performance and Thesis

- Dynamically rank and review
- Avoid "fear or failure"
- Review original documentation
- Review unbiased comparisons
- Re-think recommendation if thesis wanes
- Re-think recommendation if catalyst is ineffective
- Avoid placing blame or denying responsibility

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Get In the "Mind of the Market"

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Valuation Accuracy

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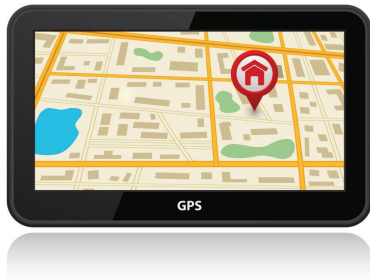
Who Gets the Cash?

$$P_0 = \frac{Div_1}{r_E - g}$$

Firm's
Cash Flow

Debt
Holders

Equity
Holders

Firm or
Enterprise
Value*

$$\frac{Price}{Earnings} = \frac{Price\ Per\ Share}{Earnings\ Per\ Share} = \frac{P}{E}$$
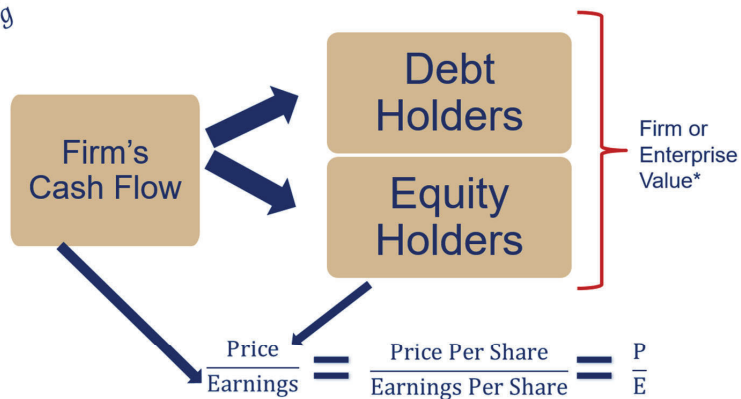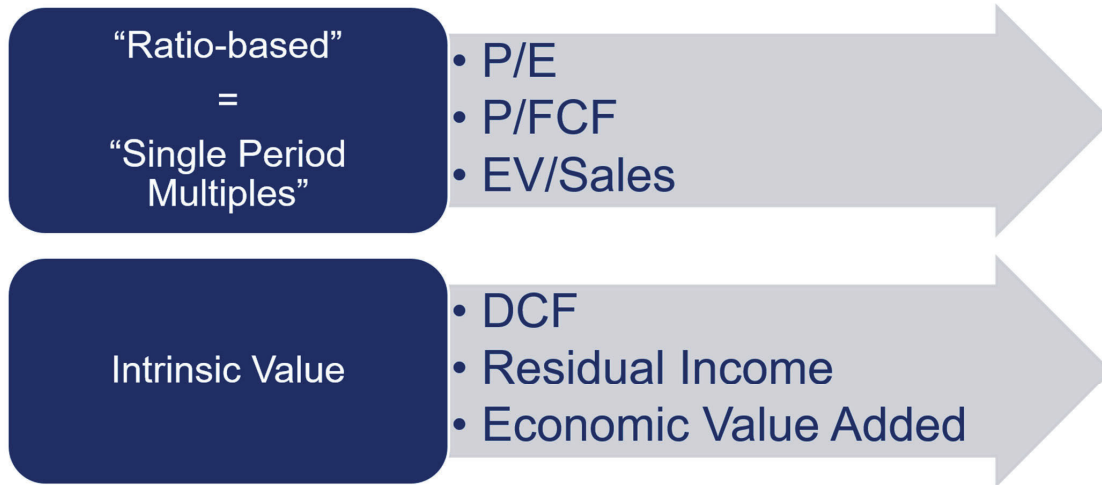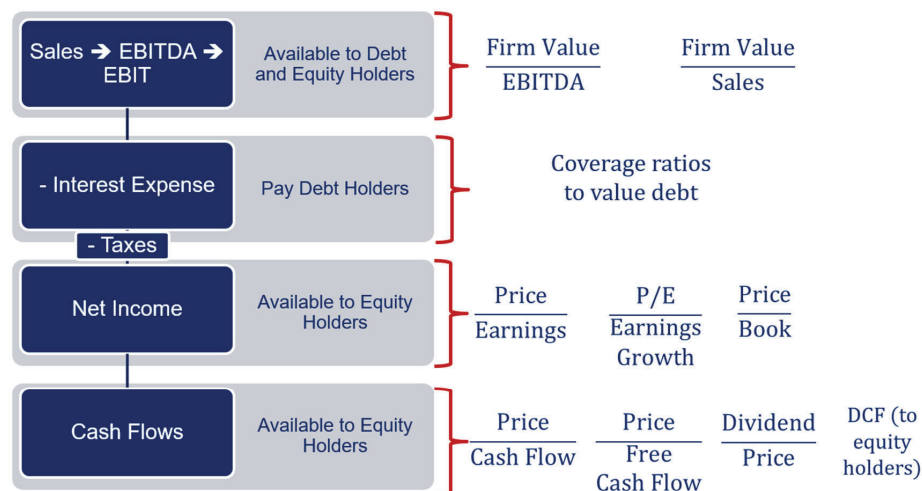
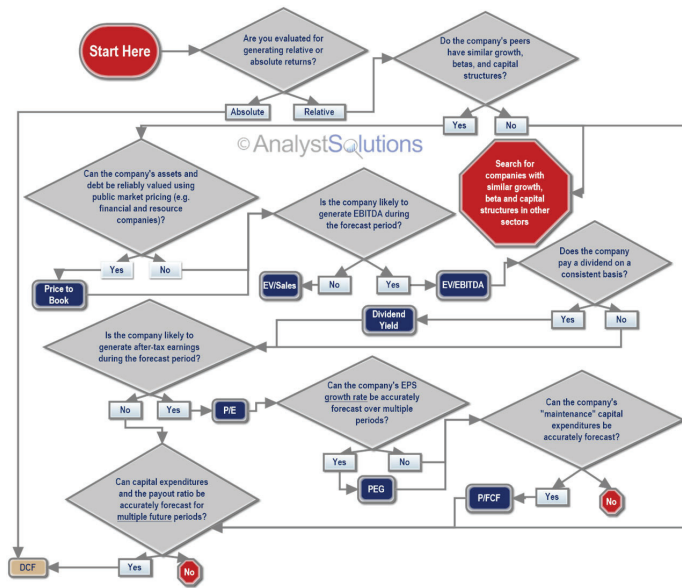*Firm Value = Enterprise Value = (Value of equity + Value of debt + Minority interest - Cash and investments)

APVTFMAPT

1208

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Two Broad Valuation Approaches

"Ratio-based" **=** **"Single Period Multiples"**
- P/E
- P/FCF
- EV/Sales

Intrinsic Value
- DCF
- Residual Income
- Economic Value Added

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What Are We Valuing?

Sales ➔ EBITDA ➔ EBIT	Available to Debt and Equity Holders	$\dfrac{\text{Firm Value}}{\text{EBITDA}}$ $\dfrac{\text{Firm Value}}{\text{Sales}}$
- Interest Expense	Pay Debt Holders	Coverage ratios to value debt
- Taxes		
Net Income	Available to Equity Holders	$\dfrac{\text{Price}}{\text{Earnings}}$ $\dfrac{\text{P/E}}{\text{Earnings Growth}}$ $\dfrac{\text{Price}}{\text{Book}}$
Cash Flows	Available to Equity Holders	$\dfrac{\text{Price}}{\text{Cash Flow}}$ $\dfrac{\text{Price}}{\text{Free Cash Flow}}$ $\dfrac{\text{Dividend}}{\text{Price}}$ DCF (to equity holders)

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MCD's Absolute and Relative P/E Ratio

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MCD P/E ratio relative to an index (left axis)
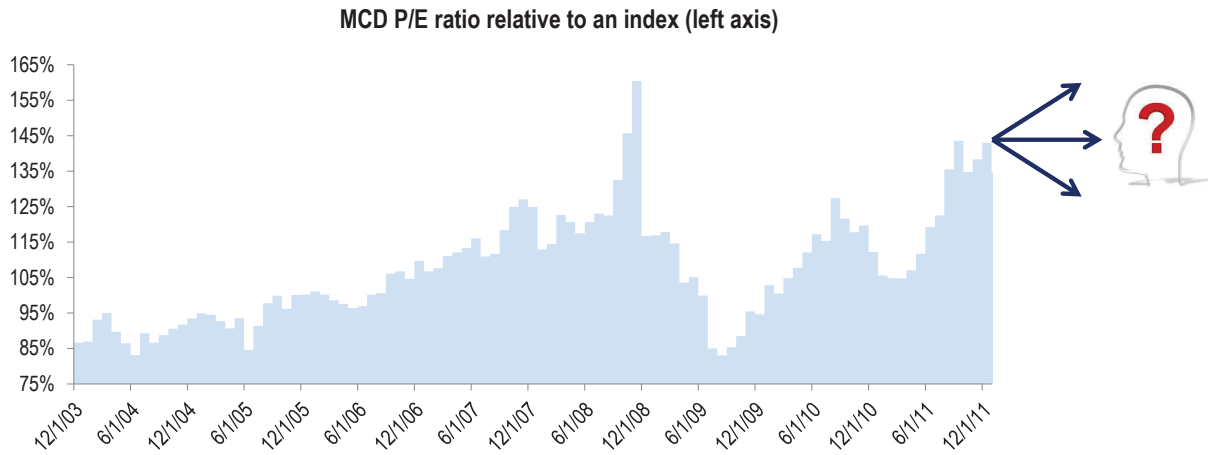MCD Next 12-month PE (right axis)
SPAL Next 12-month PE (right axis)

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What Should We Use For a Future Price Target Valuation Multiple?

MCD P/E ratio relative to an index (left axis)

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Price Target Components for Relative P/E Ratio Valuation

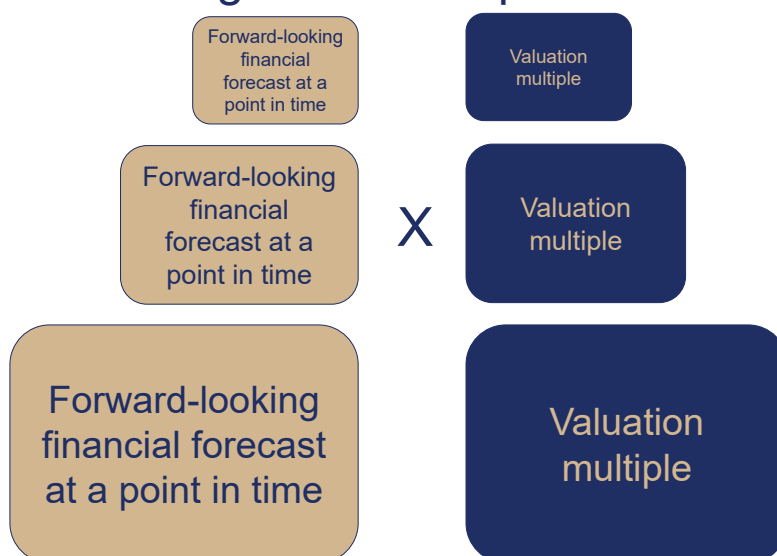| Forward-looking financial forecast at a point in time	X	Market's P/E multiple	X	Stock's relative P/E multiple	=	Price Target
$1.00		14		Market multiple		$14.00
$1.00		14		10%		$15.40
$1.00		14		-10%		$12.60

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Be Aware of the Market Multiple You Select

Forward-looking financial forecast at a point in time	X	Market's P/E multiple	X	Stock's relative P/E multiple	=	Price Target

					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%	

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Price Target in Its Simplest Terms

Forward-looking financial forecast at a point in time

Valuation multiple

Forward-looking financial forecast at a point in time   X   Valuation multiple

Forward-looking financial forecast at a point in time   Valuation multiple

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Peak on Peak or Peak on Trough?

Forward-looking financial forecast at a point in time

Valuation multiple

X

Valuation multiple

Forward-looking financial forecast at a point in time

Valuation multiple

Forward-looking financial forecast at a point in time

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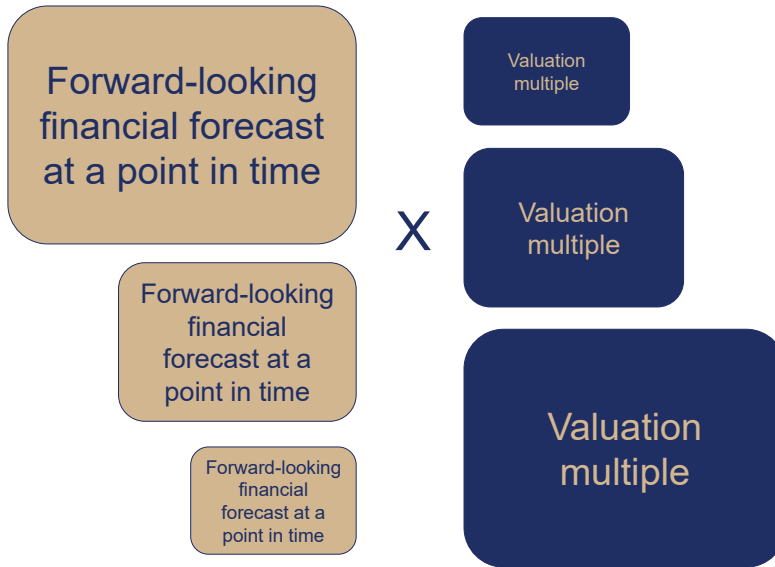
Consider a Second Valuation Method If It Adds Value

Discover new insight

Avoid Blow Up

Avoid Wasting Time

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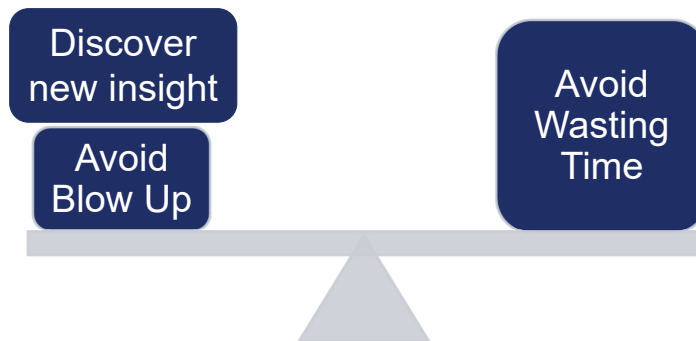
Opening Case Examples We Covered in this Module

- Best Practices by Robert and Lucas:
  - Robert breaks down the potential upside into the two key components: the forecast or valuation
  - Robert wants to explore what could go wrong
- Bad Practices by Lucas:
  - Doesn't have a price target or range of targets
  - Doesn't know why some analysts value the stock with a PEG ratio while others use P/E ratio
  - Doesn't know if the stock has seen an expanding P/E in the past
  - Hasn't considered what could go wrong with his call

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Target Realistic Price(s) DRCs

Detailed Reference Card (DRC)
Best Practices for Making Accurate Stock Recommendations

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

Create an accurate financial forecast(s)

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

Select valuation method(s)

Detailed Reference Card (DRC)
Best Practices for Making Accurate Stock Recommendations

Perspectives for Target Realistic Price(s) (Step 1 of TIER™)

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

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Complete Your TAP

Section 2

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

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Test Your TIER™ Knowledge

T_____ realistic price(s)

Identify & forecast catalyst(s)

Ensure ideal entry point

Review performance and thesis

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Module 2

Target Realistic Price(s) (SHARE™ Framework)	Identify & Forecast Catalyst(s)	Ensure Ideal Entry Point		Review Performance and Thesis
Create an accurate financial forecast(s)	Identify & forecast potential catalyst(s)	Avoid costly psychological shortcuts	Monitor trading data	Dynamically rank and review
Select valuation method(s)	Focus on catalysts meeting optimal criteria	Ensure call is differentiated (FaVeS™)	Know consensus	Avoid "fear or failure"
Historical & current sentiment	Proactively prepare for next catalyst	Avoid Pollyannaish or hopeful thinking	Survey market sentiment	Review original documentation
Adjust for future time period		Weigh risk as well a return	Avoid following the herd	Review unbiased comparisons
Range of multiples and price targets		Ensure no imminent danger	Monitor technical indicators	Re-think recommendation if thesis wanes
Evaluate as circumstances change		Document thesis	Influence the market	Re-think recommendation if catalyst is ineffective
		Sleep on it		Avoid placing blame or denying responsibility

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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

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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: $0.42 ($50 pre-splits)
 - Blodget's price target: $3.33 ($400 pre-splits)
- Who was right?
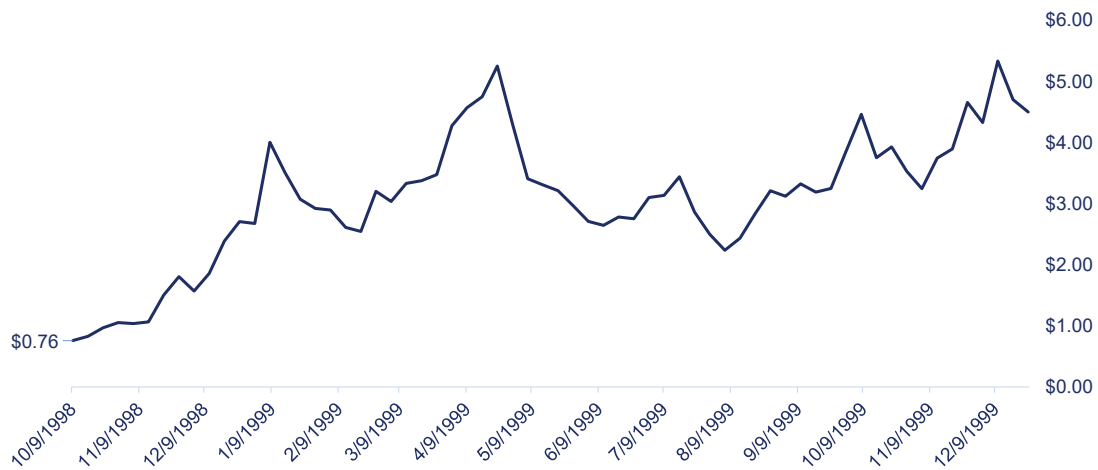
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AMZN Share Price Over 1 Year

Cohen's price target: $0.42 ($50 pre-splits)
Blodget's price target: $3.33 ($400 pre-splits)

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AMZN Share Price Over 3 Years

Cohen's price target: $0.42
Blodget's price target: $3.33

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AMZN Share Price Over 23 Years

Cohen's price target: $0.42
Blodget's price target: $3.33

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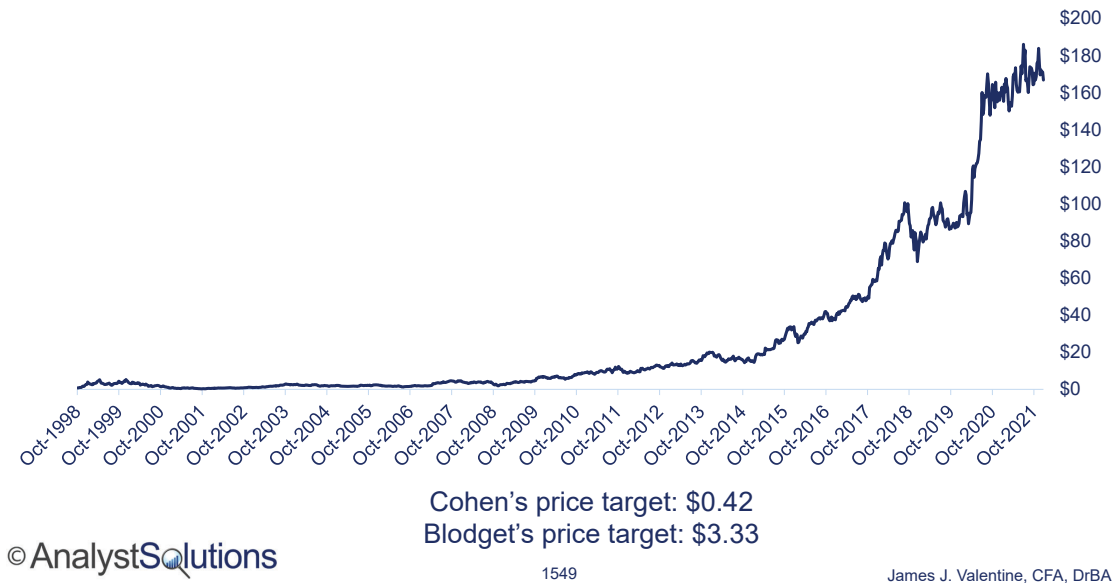
Elements of a Catalyst

- 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

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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

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Identifying & Forecasting Catalyst(s)

	Catalyst	
	Doesn't Occur (or occurs late)	**Occurs on time**
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

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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

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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

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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

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EXERCISE: "IDENTIFY THE CATALYST" PART 1

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Identify the Catalyst, Scenario 1

	Stock Call	Catalyst	Quality of Catalyst: High, Medium, or Low	Timing of when the catalyst will be noticeable enough for the stock to begin to react
1.	We are recommending purchasing McDonald's Corp (MCD) and have a one-year price target of $116 (up 21% from its current $96). We believe accelerated growth from remodeled stores and expansion in China will allow the company to beat this year's consensus of $5.80 by $0.20 (most noticeable in 3Q and 4Q) which will be even more apparent next year, causing next year's consensus of $6.20 to rise to our $7.00.	Store remodeling and growth in China	Moderate quality because these are factors the analyst may not be able to forecast with a high degree of accuracy	Earnings during the second half of this year and all of next year

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Identify the Catalyst, Scenario 2

	Stock Call	Catalyst	Quality of Catalyst: High, Medium, or Low	Timing of when the catalyst will be noticeable enough for the stock to begin to react
2.	We are no longer recommending purchasing SBUX because we believe the consensus expectation for the next fiscal year is 11% too high. Using our EPS forecast for next year of $2.85 (while consensus is at $3.20), we arrive at a base-case scenario price target of $68, which would be a 9%-10% drop from the stock's close of $75. Our proprietary work (survey and interview with industry sources) suggests by 3Q of this year the company will be unable to pass through the upward labor cost pressure driven by increases in minimum wages. By early next year, the company will see higher cost inflation or, if it raises prices, slower unit sales, either of which will slow EPS growth.	Inability to pass through wage inflation to customers	Medium to high quality because it's plausible, with effort, the analyst can determine if wage inflation is being passed through to customers	Third-quarter results should see some of the impact and will become more pronounced going into the following year

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Identify the Catalyst, Scenario 3

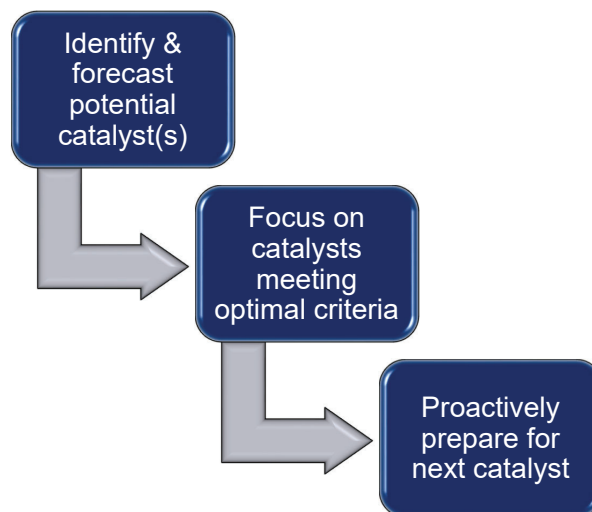|	Stock Call	Catalyst	Quality of Catalyst: High, Medium, or Low	Timing of when the catalyst will be noticeable enough for the stock to begin to react
3.	We are upgrading Alaska Air Group (ALK) because we believe it will be taken out at a premium as part of the North American airline industry consolidation trend. The stock is currently trading approximately 15% above its historical relative P/E ratio on forward earnings, which we believe could expand further as part of a takeout.	Industry consolidation	Low because it is almost impossible to forecast the timing. Also, the market may already be anticipating as shown in the stock's current premium.	Unknown

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EXERCISE: "IDENTIFY THE CATALYST" PART 2

See exercise in Learner Workbook

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Step 2: Identify & Forecast Catalysts Summary

Identify & forecast potential catalyst(s)

Focus on catalysts meeting optimal criteria

Proactively prepare for next catalyst

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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 & forecast potential catalyst(s)

> Identify and forecast potential catalysts that would need to occur in order for the market to accept your out-of-consensus thesis. Be specific by estimating the <u>future</u> earnings or cash flow impact in areas such as:
> • Pricing
> • Volume
> • Costs
> • Margins
> • Free cash flow
> • R...

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

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Opening Case Examples We Covered in this Module

- Best Practices by Robert and Lucas:
  - Robert is trying to ascertain the catalyst that will move the stock (i.e. the date of the new products being released)
  - Robert wants to explore what could go wrong (negative catalyst)
- Bad Practices by Lucas:
  - 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)

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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
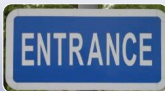
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Test Your TIER™ Knowledge

_____ r_____ price(s)
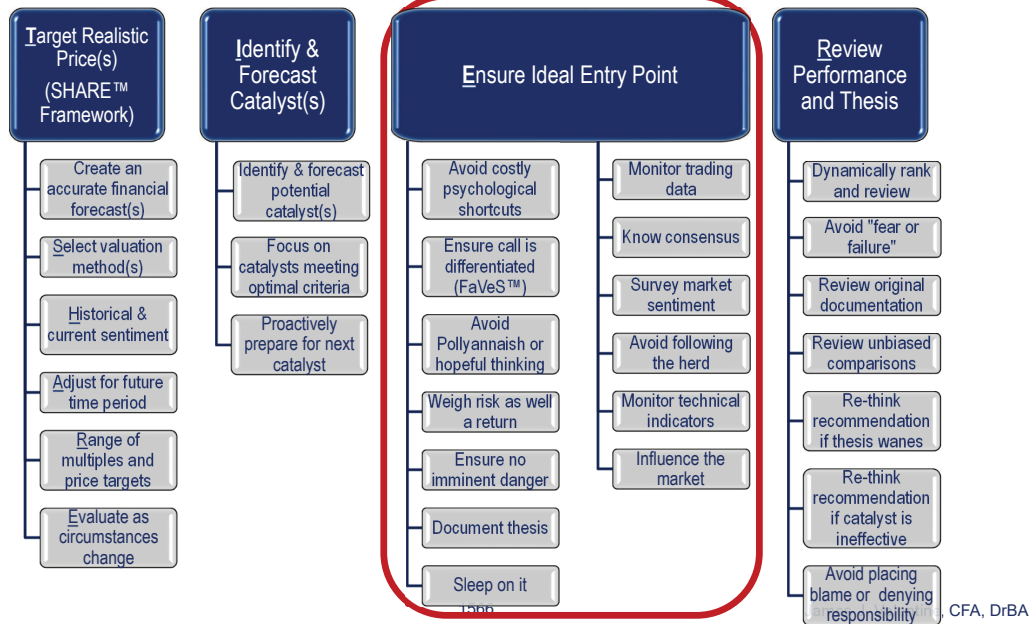
_____ & forecast c_____(s)

Ensure ideal entry point

Review performance and thesis

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Module 3

Target Realistic Price(s)
(SHARE™ Framework)

- Create an accurate financial forecast(s)
- Select valuation method(s)
- Historical & current sentiment
- Adjust for future time period
- Range of multiples and price targets
- Evaluate as circumstances change

Identify & Forecast Catalyst(s)

- Identify & forecast potential catalyst(s)
- Focus on catalysts meeting optimal criteria
- Proactively prepare for next catalyst

Ensure Ideal Entry Point

- Avoid costly psychological shortcuts
- Ensure call is differentiated (FaVeS™)
- Avoid Pollyannaish or hopeful thinking
- Weigh risk as well a return
- Ensure no imminent danger
- Document thesis
- Sleep on it
- Monitor trading data
- Know consensus
- Survey market sentiment
- Avoid following the herd
- Monitor technical indicators
- Influence the market

Review Performance and Thesis

- Dynamically rank and review
- Avoid "fear or failure"
- Review original documentation
- Review unbiased comparisons
- Re-think recommendation if thesis wanes
- Re-think recommendation if catalyst is ineffective
- Avoid placing blame or denying responsibility

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Step 3A of TIER™: Ensure Ideal Entry Point

Part A: Validate Your View

Part B: Assess and Influence the Market's View

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Avoid Mind Traps
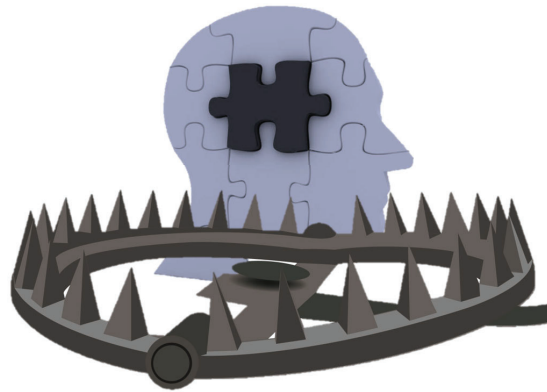
1568

Poll Everywhere

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

Find the F's exercise

- Instructions for the "Find the F's" exercise:
  - Step 1: Write down the number of "f's" you see in the sentence when it appears below (do not say it aloud)
  - Step 2: Wait for additional instruction from the facilitator

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Heuristics Mind Trap

- Problem: Blindly relying on or over-using mental shortcuts ("rules of thumb") to make investment decisions without checking to ensure they are reliably accurate

- Manifestation:
  – You rarely use rigorous valuation techniques
  – You blindly rely on heuristics without checking the underlying reasoning

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Avoid Heuristics Mind Trap

- Make sure that any heuristics you use come from proven facts or historic trends

- If someone tells you to follow a "simple rule" in forecasting or valuation, test it with historical analysis before applying it

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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

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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)

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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

Most Recent

HOW DO YOU DIFFER?

Ensure a Differentiated Stock Call with a Superior FaVeS™ Insight

Forecast
- Financial forecast <u>superior</u> to the market (used at least 85%)

Valuation
- Valuation methodology or valuation multiple <u>superior</u> to the market

Sentiment
- Forecast of short-term investor sentiment <u>superior</u> to the market

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Ensure a Differentiated Stock Call with a Superior FaVeS™ Insight

Forecast
- Financial forecast <u>superior</u> to the market (used at least 85%)

Valuation
- Valuation methodology or valuation multiple <u>superior</u> to the market

Sentiment
- Forecast of short-term investor sentiment <u>superior</u> to the market

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Use "Change in Valuation" Sparingly

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

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

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Ensure a Differentiated Stock Call with a Superior FaVeS™ Insight

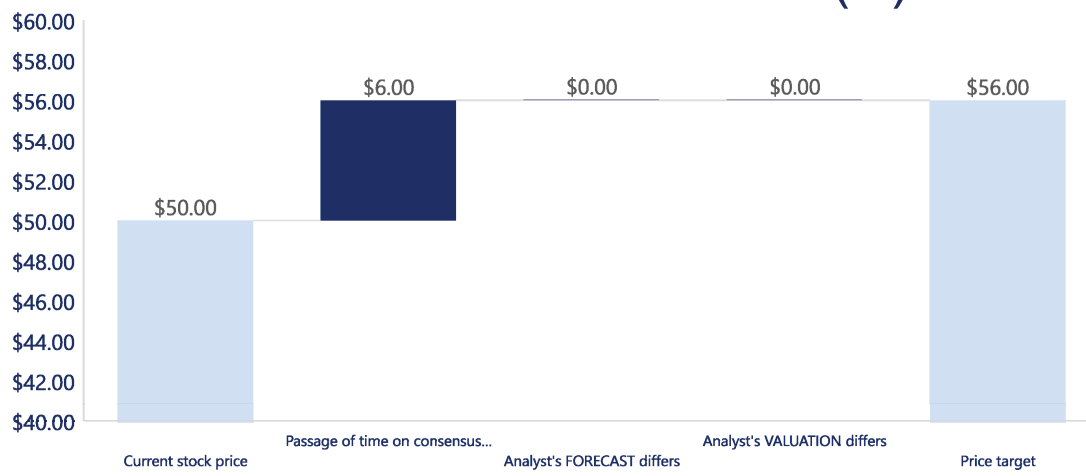| **F**orecast	• Financial forecast superior to the market (used at least 85%)
Valuation	• Valuation methodology or valuation multiple superior to the market
Sentiment	• Forecast of short-term investor sentiment superior to the market

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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%	-26.7%	-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	$66.00	$79.20
Change from current price	12%	20%	32%	58%

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Dissect How You Differ (A)

FaVeS™ Element

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Dissect How You Differ (B)

Current stock price: $50.00
Passage of time on consensus...: $6.00
Analyst's FORECAST differs: $4.00
Analyst's VALUATION differs: $0.00
Price target: $60.00

FaVeS™ Element

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Dissect How You Differ (C)

Current stock price: $50.00
Passage of time on consensu...: $6.00
Analyst's FORECAST differs: $4.00
Analyst's VALUATION differs: $6.00
Price target: $66.00

FaVeS™ Element

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Dissect How You Differ (D)

FaVeS™ Element

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"HOW DO YOU DIFFER?" EXERCISE

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Forecasting Financial Results that Differ from Consensus

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

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"RANK YOUR ABILITY" EXERCICE

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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

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# "HOW DOES YOUR FUTURE LOOK?" EXERCISE

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Optimism Bias Mind Trap

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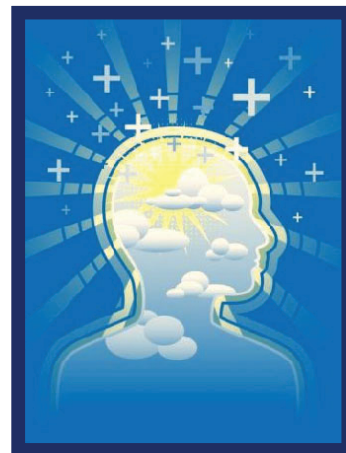
James J. Valentine, CFA, DrBA

Avoid Optimism Bias Mind Trap

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

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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

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Resist Predetermining the Rating

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

- Seeking only information to confirm your thesis
- Summarily rejecting information that refutes your thesis
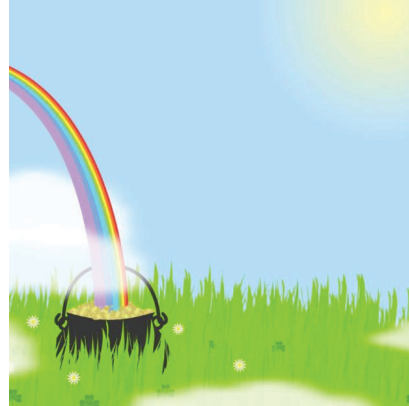
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Conviction Should Equate to Probability

- 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

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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

1606

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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

REUTERS

1607

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Document Your Thesis

Can help reduce these types
of mind traps:

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

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Sleep On It

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Yerkes-Dodson Law
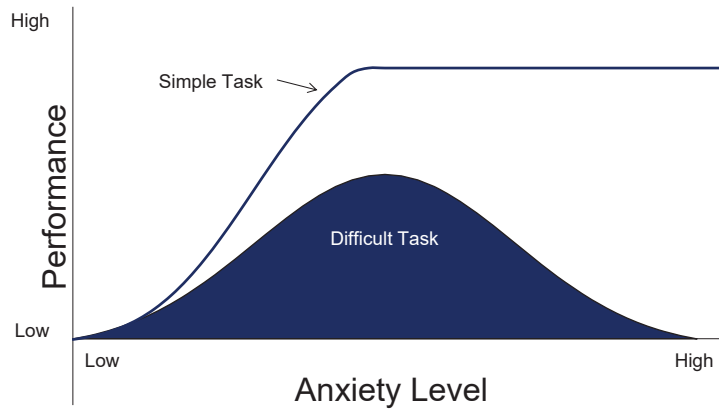
1610   James J. Valentine, CFA, DrBA

Opening Case Examples We Covered in this Module

- Best Practices by Robert and Lucas:
  - Robert is trying to ascertain the catalyst that will move the stock (i.e. the date of the new products being released)
  - Robert wants to explore what could go wrong (negative catalyst)
- Bad Practices by Lucas:
  - 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)

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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

Resist predetermining the rating	Avoid confirmation bias by waiting until all (or most) of the research has been done before considering the rating. Deciding the rating early in the process will bias future research towards discovering insights that support the view and away from those that conflict with it.
Validate	If a ratings change is based on heuristics (e.g. rules of thumb), such an "ideal entry

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Step 3B of TIER™: Ensure Ideal Entry Point

Part A: Validate Your View

Part B: Assess and Influence the Market's View

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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

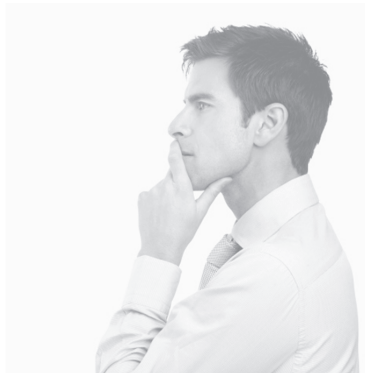**Investment Style of SBUX Largest Institutional Holders (late 2013)**

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
Vanguard Institutional Index Fund	Index	543,150,307	5,878
Vanguard 500 Index Fund	Index	533,037,280	46,211
SPDR S&P 500 ETF	Index	521,562,333	-946,968
MainStay Large Cap Growth Fund	Aggressive Growth	463,338,408	0

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%
THI.TO	1.0%
SBUX.O	0.6%

Insider Buying and Selling of SBUX

Trade Date	Participants	Net Sell (Shares)	Net Buy (Shares)	Close Price
11/15/13	SCHULTZ HOWARD D, ALST	-104,840		$81.19
11/14/13	SCHULTZ HOWARD D, ALST	-53,171		$81.14
9/30/13	ALSTEAD TROY M, CULVER		431	$76.97
9/30/13	ALSTEAD TROY M, CULVER		431	$76.97
8/19/13	HOBSON MELLODY		141,573	$70.29
8/2/13	SCHULTZ HOWARD D, ALST	-7,056		$74.23
6/28/13	ALSTEAD TROY M, CULVER		568	$65.51
6/28/13	ALSTEAD TROY M, CULVER		568	$65.51
6/17/13	HANSBERRY JEFFERY	-735		$66.03
5/31/13	HELM LUCY LEE	4,066		$63.44

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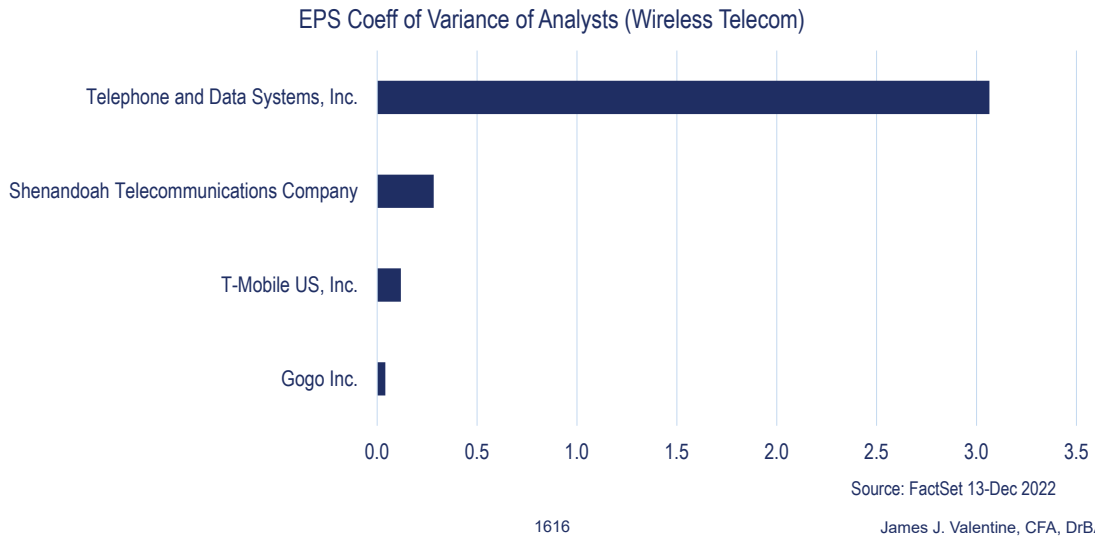

Know "Consensus" For the Stock

- 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?

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Investigate "Consensus"

EPS Coeff of Variance of Analysts (Wireless Telecom)

Telephone and Data Systems, Inc.	
Shenandoah Telecommunications Company	
T-Mobile US, Inc.	
Gogo Inc.	

0.0   0.5   1.0   1.5   2.0   2.5   3.0   3.5

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Investigate "Consensus"

EPS Coeff of Variance of Analysts (Technology Hardware Storage & Peripherals)

Western Digital Corporation	
Seagate Technology Holdings PLC	
Corsair Gaming, Inc.	
Xerox Holdings Corporation	
Diebold Nixdorf Incorporated	
Apple Inc.	
HP Inc.	
Hewlett Packard Enterprise Co.	
Avid Technology, Inc.	
NetApp, Inc.	

0.0   1.0   2.0   3.0   4.0   5.0   6.0   7.0
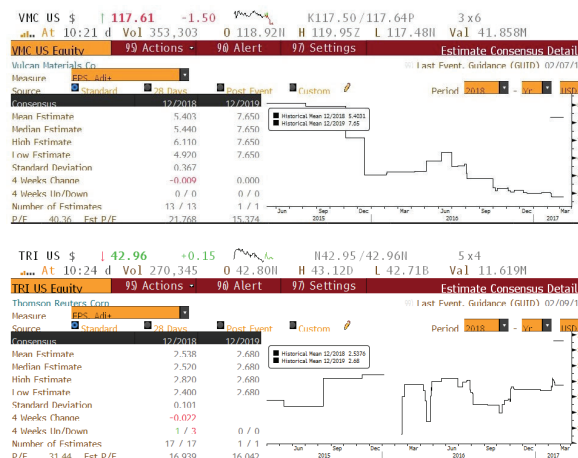
1617

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COEFFICIENT OF VARIANCE

Stocks with high coefficients of variance may be more influenced by a critical factor

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Investigate "Consensus"

Source: Bloomberg 9-March 2017

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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)

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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)

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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
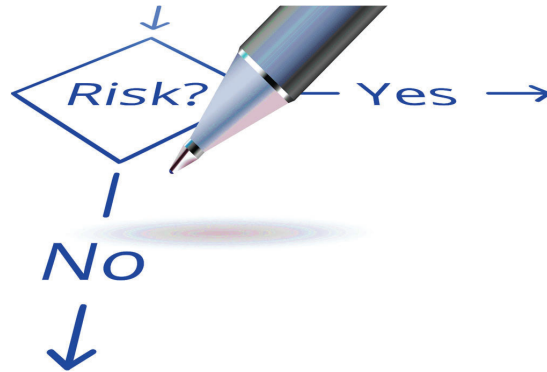
1622

Review QRC

Quick Reference Card (QRC)
Information Sources Pros and Cons

Individual Conversation

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

1623

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

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"Circle the Symbols" Exercise

- Review the table of symbols
- For each row, identify the one that you find the most intriguing
- Write down the letter for that symbol

Note: those shaded are currently ranked as most intriguing by analysts who have participated in this activity in the past

Row	A	B	C	D	E
1.	©	‖	♥	ထ	ϴ
2.	℧	«	ઝ	Ẅ	⚐
3.	Ⱨ	ŋ	₵	Ï	Ӝ
4.	℗	Ƕ	₹	√	∞
5.	₸	β	ʒ	È	Ȝ
6.	↕	»	∂	Δ	∏
7.	∟	⌂	ǂ	ᴙ	Ξ
8.	⊦	⚏	≥	♫	ꟽ
9.	ϒ	₩	˥	☼	⊥
10.	≈	≤	♂	₱	⅃⅃

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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"
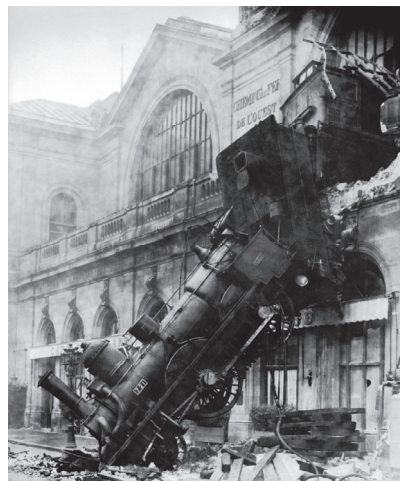
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Avoid Momentum Bias Mind Trap

- 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

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Monitor Technical Indicators

Monitor technical indicators

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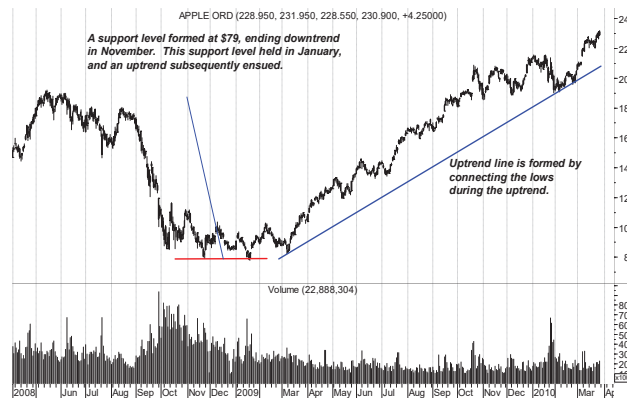
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Influence the Market

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

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Opening Case Examples We Covered in 3B of this Module

- Best Practices by Robert and Lucas:
  - Lucas is aware of how his estimate compares to consensus
- Bad Practices by Lucas:
  - 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

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

- Avoid costly psychological shortcuts
- Ensure call is differentiated (FaVeS™)
- Avoid Pollyannaish or hopeful thinking
- Weigh risk as well a return
- Ensure no imminent danger
- Document thesis
- Sleep on it

1633

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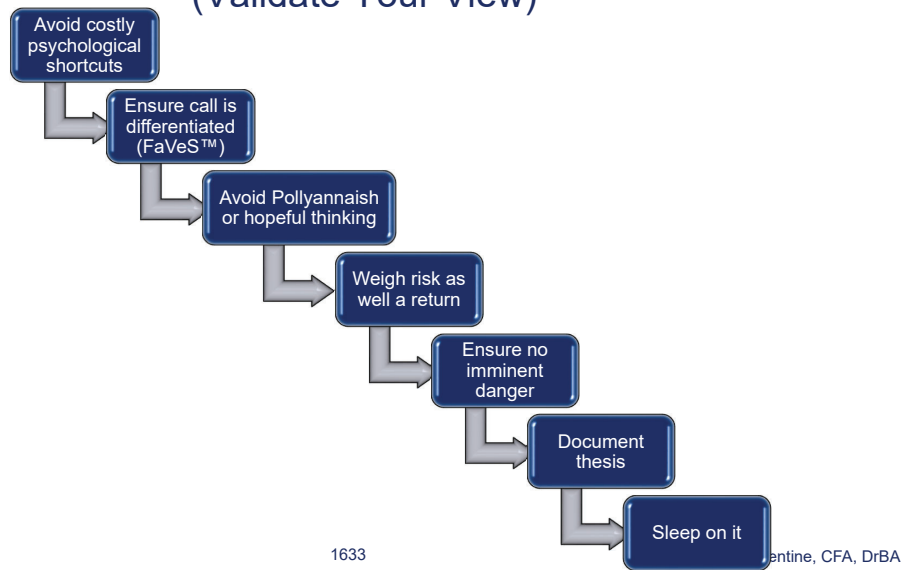
Step 3B: Ensure Ideal Entry Point
(Assess and Influence the Market's View)

- Monitor trading data
- Know consensus
- Survey market sentiment
- Avoid following the herd
- Monitor technical indicators
- Influence the market

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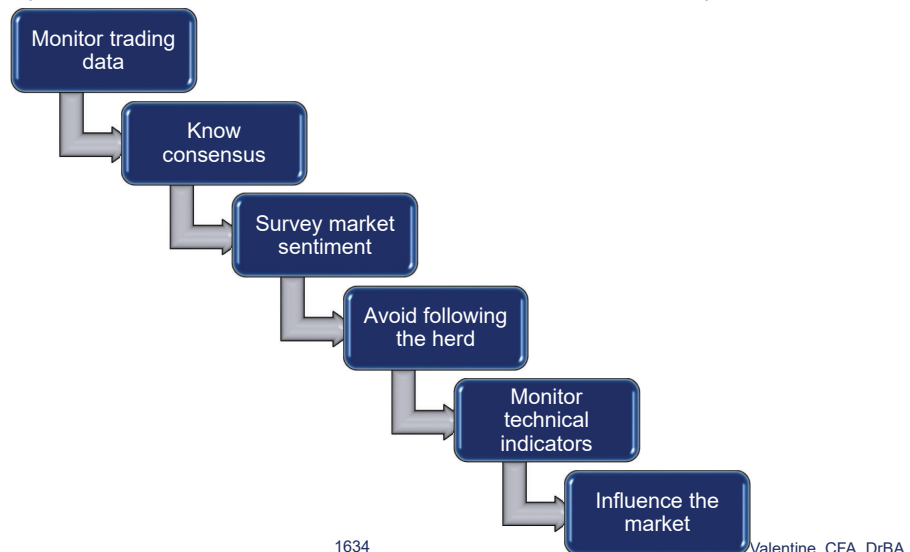
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Ensure Ideal Entry Point DRCs

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

Monitor trading data

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

Know consensus

Analyze the consensus estimate, specifically determining:
• How many analysts comprise "consensus" (more than 1 or 2 in outer years?)
• Are their estimates disparate or similar?
• Are any estimates stale?

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Complete Your TAP

Section 5

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

James J. Valentine, CFA, DrBA

Test Your TIER™ Knowledge

_____ r_____ p_____(s)

_____ & f_____ c_____(s)

E_____ ideal _____ point

Review performance and thesis

Module 4

Target Realistic Price(s)
(SHARE™ Framework)

- Create an accurate financial forecast(s)
- Select valuation method(s)
- Historical & current sentiment
- Adjust for future time period
- Range of multiples and price targets
- Evaluate as circumstances change

Identify & Forecast Catalyst(s)

- Identify & forecast potential catalyst(s)
- Focus on catalysts meeting optimal criteria
- Proactively prepare for next catalyst

Ensure Ideal Entry Point

- Avoid costly psychological shortcuts
- Ensure call is differentiated (FaVeS™)
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- Influence the market

Review Performance and Thesis

- Dynamically rank and review
- Avoid "fear or failure"
- Review original documentation
- Review unbiased comparisons
- Re-think recommendation if thesis wanes
- Re-think recommendation if catalyst is ineffective
- Avoid placing blame or denying responsibility

, CFA, DrBA

Dynamically Rank and Review

All analysts have comp tables, but does yours:

- Update stock prices automatically (via a feed to third-party service)
- Update your forecast estimates (e.g., EPS, CFPS, BV, etc.) automatically from your models
- Include consensus estimates which are automatically updated (via a feed to third-party service)
- Highlight when your financial forecasts differ materially from consensus
- For stocks you're recommending, show how much future valuation multiple differs from the current multiple
- For stocks you're recommending, include upside/downside returns to your target prices
- For stocks you're recommending, include 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

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Complete Your TAP

Section 6

Transformation Action Plan (TAP)

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Best Practices for
Building a Comp Table

Quick Reference Card (QRC)

Best Practices for Building a Comp Table

James J. Valentine, CFA, DrBA

Review Valuations Regularly

Review the valuation levels of your stocks regularly, preferably on a daily basis, but no less frequently 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

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"SKI VACATION" EXERCISE

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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

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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

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Best Practices for Eliminating
Psychological Biases
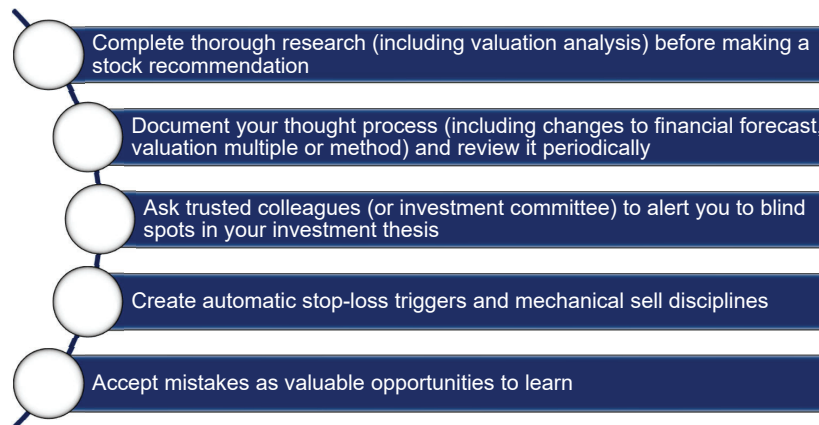
Quick Reference Card (QRC)
Best Practices for Eliminating Psychological Biases

Bias	Manifestation	Example	Increasing Self-Awareness

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Eliminate Psychological Biases from Your Stock Calls

Complete thorough research (including valuation analysis) before making a stock recommendation

Document your thought process (including changes to financial forecast, valuation multiple or method) and review it periodically

Ask trusted colleagues (or investment committee) to alert you to blind spots in your investment thesis

Create automatic stop-loss triggers and mechanical sell disciplines

Accept mistakes as valuable opportunities to learn

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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

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Review Unbiased Comparisons

**Avoid many typical destructive biases,
by periodically:**

- Conducting blind test
- Asking "If I switched firms tomorrow…"

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Re-think Recommendation If…

Thesis Wanes

Catalyst Is Ineffective

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Avoid Placing Blame or Denying Responsibility

Coping Strategies:

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

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Step 4: Review Performance & Thesis

- Dynamically rank and review
- Avoid "fear of failure"
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- Review unbiased comparisons
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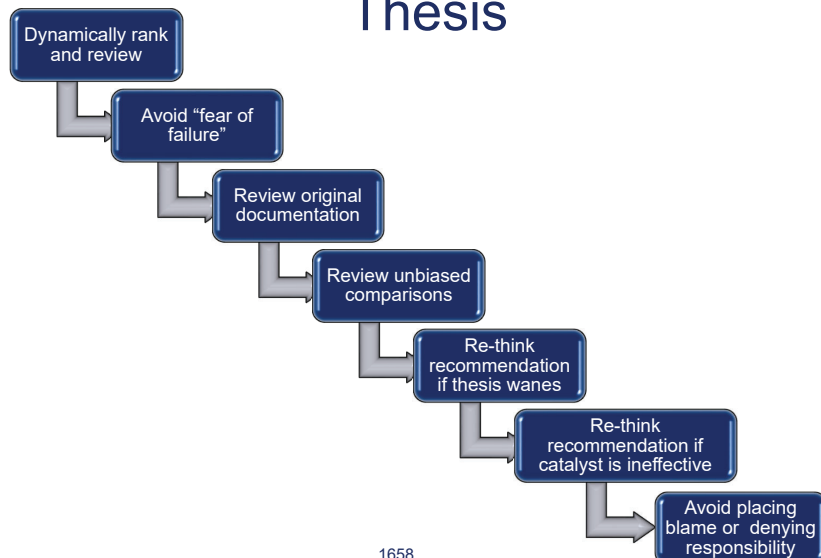
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Review Performance & Thesis DRCs

Detailed Reference Card (DRC)
Best Practices for Making Accurate Stock Recommendations

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

Review your comparison ("comp") table regularly (i.e. daily or a few times each week). To provide the best analysis, the table should:
• Update stock prices automatically
• Update your EPS (or CFPS) and consensus' forecasts automatically

Dynamically ra... and revi...

Detailed Reference Card (DRC)
Best Practices for Making Accurate Stock Recommendations

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

Don't mistake good stock picking with a bull market. Always evaluate performance relative to a similar basket of stocks. (This also holds true when evaluating company
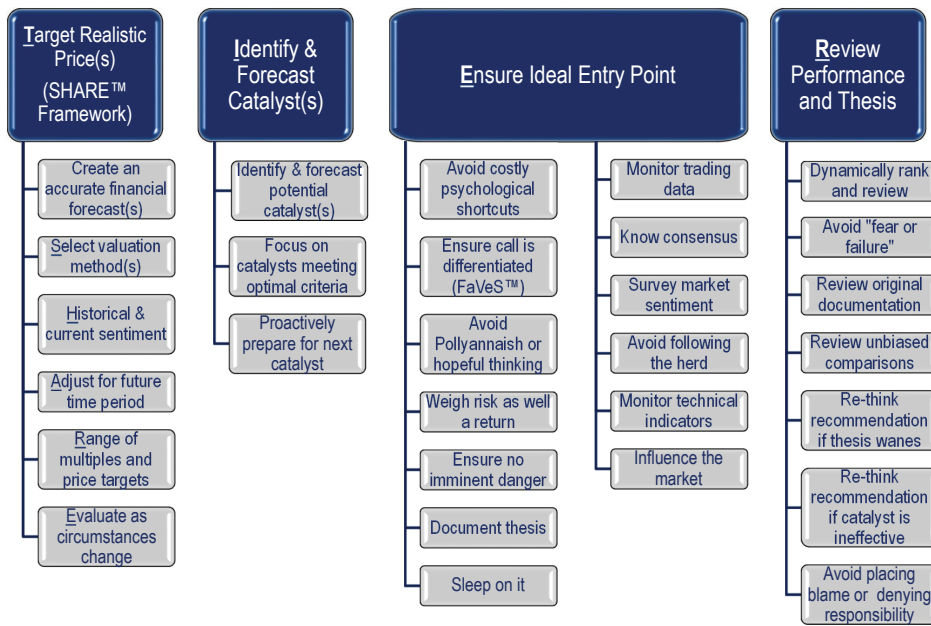
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Opening Case Examples Covered in this Module

- **Best Practices by Robert and Lucas:**
  – Robert correctly notes that most of the upside in the stock this year has been in line with the market's move

- **Bad Practices by Lucas:**
  – 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

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Slide 1661

Target Realistic Price(s) (SHARE™ Framework)
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Slide 1662

Test Your TIER™ Knowledge

T_____ r_____ p____(s)

I_____ & f_____ c_____(s)

E_____ ideal _____ point

R_____ p_____ and t_____

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Checklist DRC

Detailed Reference Card (DRC)

Stock Recommendation Checklist Using the TIER™ System

Step	Question to ask yourself
1. STEP 1 of TIER™: TARGET REALISTIC PRICES	
1.1. Create an accurate financial forecast(s)	• Have you followed the principles of the ENTER™ quality framework (expectational, novel, thorough, examinable and revealing) in deriving a base-case financial forecast more accurate than consensus? • Have you created plausible upside and downside forecasts to stress test the base-case scenario?
1.2. Select optimal valuation method(s)	• Have you identified the valuation method(s) currently being used for the stock and sector as well as any other methods used in the past? • If there was more than one, have you identified: ○ The catalyst(s) that caused it to change?

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Review Your TAP

Transformation Action Plan (TAP)

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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

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Workshops that Address Universal Analyst Needs

CRITICAL FACTORS	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
	Develop and Deploy a Marketing Strategy that Maximizes Wallet-Share

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Best Practices Bulletins

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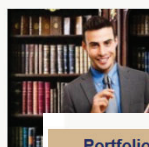
According to Reuters, one of its sister companies, Lipper, finds that roughly 85% of active large-cap stock funds are lagging their benchmarks year-to-date through late November. Investors are voting with their feet as shown by the $206 billion of inflows into ETFs through the first 10 months of 2014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

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