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HOW LOW EXPECTATIONS CAN YIELD HIGH RETURNS

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Discussion Topics

- **Compliance** – our friends at the SEC prohibit us from making specific recommendations in a venue such as this. As a result some of the stock names are withheld.

- **Loss aversion** – how human behavior creates problems and opportunities in investing

- **Technical analysis** – how the use of stock charts can aid our investing

- **Fundamental analysis** – how we can use company fundamentals and valuation to gauge expectations in a stock and improve our odds of success

- **Questions**

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Loss Aversion Is A Pain

- Anticipation of winning money affects the brain similar to addictive drugs

- Studies show pain from losses is twice as great as the joy felt by a gain of the same dollar amount
  - Most investors avoid or delay taking losses
  - 2005 study showed that people with a certain type of brain damage that inhibited emotions outperformed in investing compared to others without the condition

- Why does this matter?
  - This phenomenon can be used to our advantage in finding stocks with low expectations

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Technical vs Fundamental Analysis

- Technical analysis is the study of stock price and volume -- investor behavior.
  - Once called "voodoo" and other disparaging names.
  - Now most professional investors pay some level of attention to it
  - Fidelity Investments has made enormous investments into technical analysis in order to improve their fund performance
- Fundamental analysis is the study of the operations of a company and the relation to the stock price.

- **Both** methods are **important**

Helpful framework:

“Fundamental analysis tells you what to buy. Technical analysis tells you when to buy.” - Ralph Acampora, Head of Technical Analysis at Altaira Capital Partners

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It's All About the Base

- A stock that repeatedly fails to meet expectations often endures prolonged selling (remember our lesson on loss aversion?)

    - Most investors "hope" for improvement so are slow to sell

    - With each new low in price or deterioration in the company a new group of investors sells

- The result (after a prolonged period) is a low expectations stock with few holders willing to sell. This period of sideways movement is called **building a base.**

- Low expectations stocks are usually less risky.

- Charts and a review of the fundamentals can help us find such stocks.

- Finding a stock where most of the weaker investors have sold is key
    - Negative news is often less damaging to the stock
    - Moderately good news can move the stock much higher

Define "selling" and "buying"

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Tech Company #1

Tech Company #2

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Retailer #1

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Light at end of the tunnel may be a train

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Expectations from the Fundamental Side

- **Valuation: What you get for a given price**
  - What you're willing to pay reflects what you receive now *and* what you might receive in the future.

- **Example: Your child comes home with a recently graded math test and a "C+" in big red letters on the top. What determines your reaction?**

- The simplest valuation measure for stocks is the price-to-earnings ratio or P/E → the stock price divided by earnings from the last year. Example: A $50 stock with earnings of $5.00 per share would have a P/E of 10.
  - The P/E now reflects past earnings and expectations for higher earnings.

- All stocks have expectations embedded in them. The key is understanding how reasonable such expectations may be.

- **IMPORTANT**: High expectations, **even if met**, may not result in positive returns for the stock.

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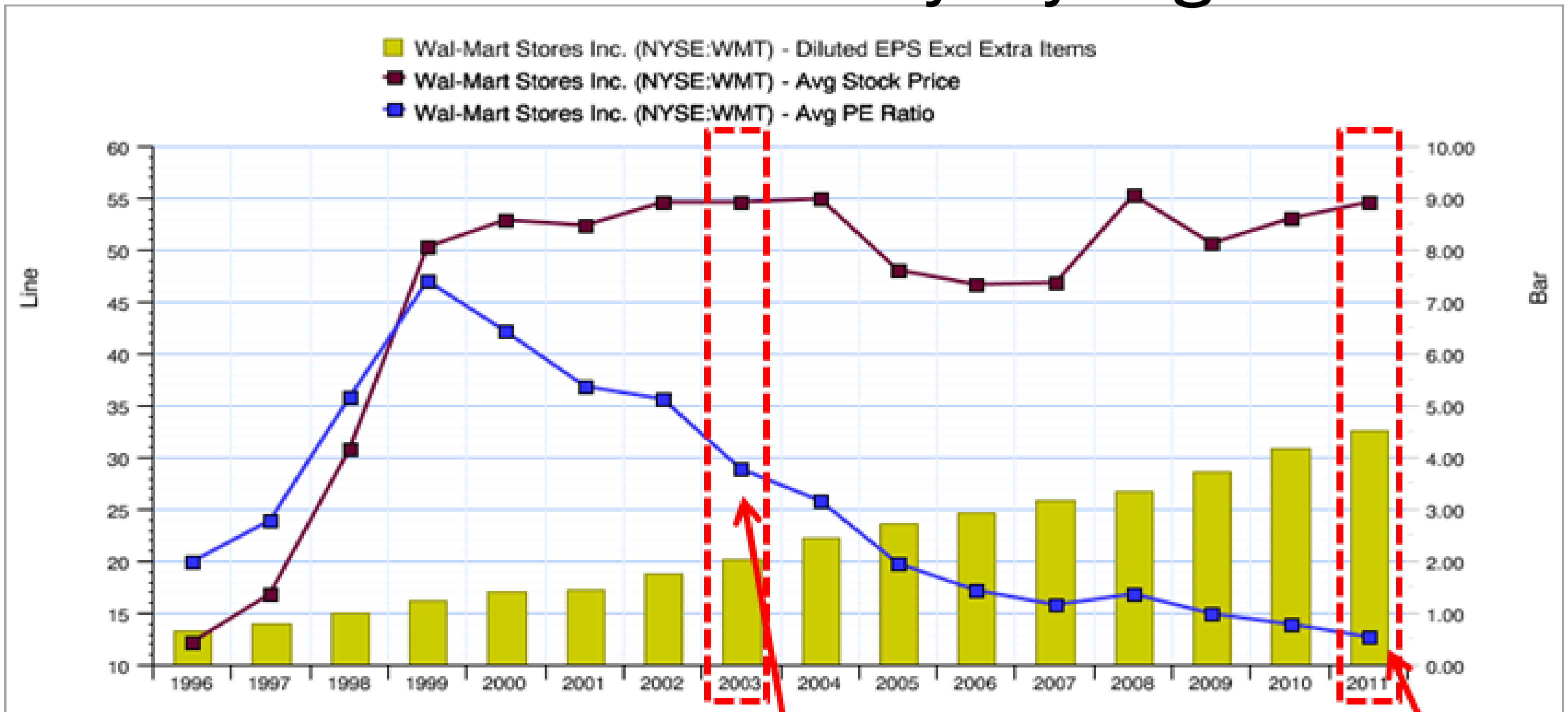
Wal-Mart in 2003: Everyday High Valuations



Source: S&P Capital IQ

Wal-mart (WMT)				
	2003	2011	total change	annual change
P/E	29	13	(55%)	(9.5%)
EPS	$2.03	$4.53	123%	10.6%
Price	$55	$55	0%	0.0%

A) Even after declining 30%, the P/E was still high as were expectations

B) Subsequent earnings were good but below expectations and investors paid less (the P/E) for future earnings --> expectations decline evidenced by the P/E falling.

C) Earnings grew but stock return was zero

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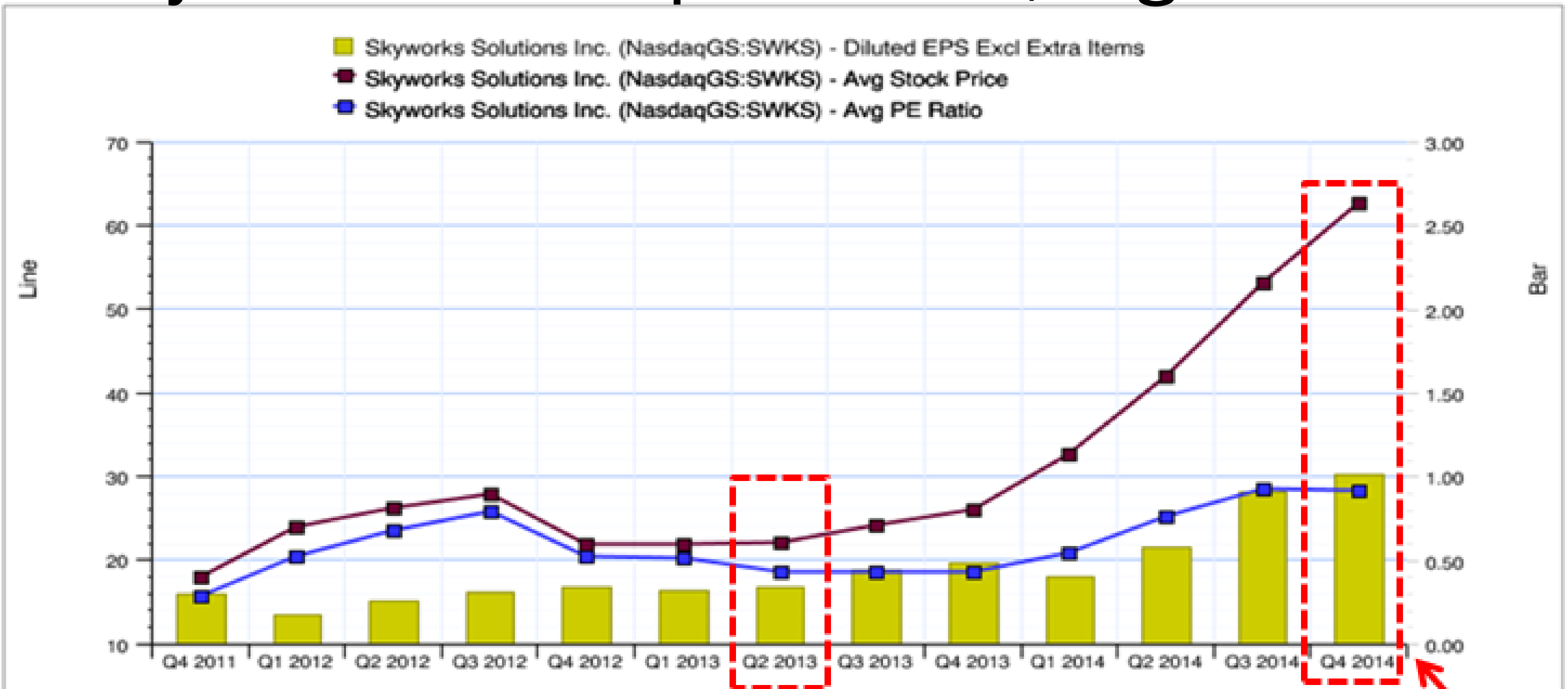
Skyworks: Low Expectations, High Potential



Source: Capital IQ

A) Stock declined 40%, P/E declined 30% because of delay in the new iPhone 4S. P/E was low relative to long-term growth opportunities.

B) New iPhone finally launches along with new phones from Samsung driving strong earnings growth

Skyworks (SWKS)

	June 2013	June 2014	total change
P/E	18	25	39%
EPS	$1.31	$1.91	46%
Price	$22	$42	91%

C) In 2013, the P/E reflected disappointments ahead. When earnings finally grew there was a huge positive surprise. The stock increased more than 90% in 1 year.

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Questions?