Investment Strategies that Emerge After Decoding Wall Street Propaganda
Agenda

I. Define Propaganda and Why It Matters
II. Outline Steps for Decoding
III. Present Emerging Investment Strategy
Part I
What Is the Propaganda and Why Does It Matter?

“…transfer property from the hands of many to the pockets of few.”

from Devil Take the Hindmost: A History of Financial Speculation by Edward Chancellor
What Is The Propaganda
Simple But Very Misleading Messages

Reported Earnings Are Reliable
• Quarterly Earnings Conference Calls Provide Adequate Information
• Earnings are a reliable measure of profitability

Earnings Growth Drives Valuation
• Price-to-earnings and other simple valuation techniques are accurate
• Market cares about this quarter’s earnings more than anything else.

Wall Street Wants To Help Investors Make $
• Research aims to help investors make more informed decisions
• Brokerage services help create wealth for clients
• Spitzer Settlement has been effective
• Wall Street research coverage is not-conflicted
Define the Audience for the Propaganda

Speculator

“If you are a speculator, your decision to buy or sell is based on what you believe about the near-term direction of price.” - Ben Graham

“…speculation is the activity of forecasting the psychology of the market.” - John Maynard Keynes

Vs.

Investor

“If you are an investor, your decision to buy and sell is based on the underlying economics of the stock you own.” - Ben Graham

“Investing is an activity of forecasting the yield on assets over the life of the asset…” - John Maynard Keynes
Jump On the Bandwagon
Proof That There Is Lots of Speculation

**Shorter Holding Periods for Stocks**
- Until mid-1960’s average holding period was 7 years.
- Today, average holding period is less than 1 year and annual portfolio turnover is more than 100%\(^1\).

**Major Reactions to Quarterly Earnings**
- Stock prices make large moves in response to earnings surprises.
- Suggests that long-term cash flows are less important.

**Amateur Individual Investors - growth market**
- Schwab, TD Waterhouse, Scottrade
- Day trading

**Media - growth market**
- TV: Mad Money, CNBC Squawk Box and Squawk on the Street.
- Web: Motley Fool, The Street.Com, CBS MarketWatch

Noise Trumps Knowledge & Skews Valuations
People Who Know Less Tend to Trade More

Percentage Breakdown of Institutional Investor Categories

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quasi-Indexers</td>
<td>61%</td>
</tr>
<tr>
<td>Transients</td>
<td>31%</td>
</tr>
<tr>
<td>Dedicated</td>
<td>8%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
</tr>
</tbody>
</table>

Institutional Investor Categories Definitions
1. Quasi-indexers - low turnover and small stakes
2. Transients - high turnover and small stakes
3. Dedicated - low turnover and large stakes

Speculators Skew Equity Valuations
Noise, Turnover and Volatility Create Aberrations

Unrealistic Expectations Become A Self-Fulfilling Prophecy
The Result: Bigger $ for Wall Street

Ignorance Is Bliss?

Private Capital $

Wall Street Toll $$$

Public Capital $

Investors $

The Bottom Line: Investment Banking Is What Matters

• Research is loss leader for banking, trading profits are going away
• Spitzer Settlement has not been very effective.
• Wall Street is sales and marketing for Corporate America’s best-grossing product
• Quarterly Conference calls are like commercials for selling stock
Part II
How to Decode the Propaganda

From Enron’s in-house risk management manual:

“Reported earnings follow the rules and principles of accounting. The results do not always create measures consistent with the underlying economics. However, corporate management’s performance is generally measured by accounting income, not underlying economics. Therefore, risk management strategies are directed at accounting, rather than economic, performance.”

- The Smartest Guys In The Room by Bethany McLean and Peter Elkind page 132
Earnings Are Not Reliable
Only Economics Show True Profitability

- Translate accounting data into economic information.
- Reconciling accounting rules with economic principles.
- Accounting rules were created by accountants for creditors, not equity investors.
- Analyzing the economics of businesses – quickly and easily.
The Core Problem
GAAP Offers Insufficient Information

- Actual profitability of businesses is obscured
- Valuation metrics based on GAAP metrics are misleading
- When EPS and Cash Flow diverge, the market follows cash

<table>
<thead>
<tr>
<th>Traditional P&amp;L</th>
<th>Economic P&amp;L</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>Revenues</td>
</tr>
<tr>
<td>- operating expenses</td>
<td>- operating expenses</td>
</tr>
<tr>
<td>= pretax earnings</td>
<td>= pretax earnings</td>
</tr>
<tr>
<td>- taxes</td>
<td>- taxes</td>
</tr>
<tr>
<td>= Reported Profit</td>
<td>= Profit</td>
</tr>
<tr>
<td></td>
<td>- capital charge</td>
</tr>
<tr>
<td></td>
<td>= Economic Profit</td>
</tr>
</tbody>
</table>
Misleading Earnings
More Companies Overstate Than Understate Profits
## Earnings Growth Does Not Drive Valuation
ROIC Drives P/E Multiples

<table>
<thead>
<tr>
<th>Earnings Growth</th>
<th>Return on Invested Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>8%</td>
</tr>
<tr>
<td>5%</td>
<td>8.5x</td>
</tr>
<tr>
<td>10%</td>
<td>5.7</td>
</tr>
<tr>
<td>15%</td>
<td>0.1</td>
</tr>
<tr>
<td>20%</td>
<td>NM</td>
</tr>
</tbody>
</table>

Assume all equity financed; 10% WACC; 20-year forecast period
Quantify Expectations Embedded In Price
Let Market Be the Fortune Teller

- Value of business boils down to three key drivers:
  1. How fast will the business grow
  2. How profitable will it be
  3. How long can it sustain profitable growth

<table>
<thead>
<tr>
<th>Stock</th>
<th>Davita (DVA)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue Growth</td>
<td>8.5% CAGR (organic)</td>
</tr>
<tr>
<td>ROIC - WACC</td>
<td>1% (versus -2% last year)</td>
</tr>
<tr>
<td>Growth Appreciation Period</td>
<td>21 years (maturing market)</td>
</tr>
<tr>
<td>Stock Price</td>
<td>$57</td>
</tr>
<tr>
<td>Asset Value</td>
<td></td>
</tr>
</tbody>
</table>

Every stock price reflects expectations for future cash flows.
Modeling Speculation
Expectations Reach Extremes

Find the Fat Tails in Valuation

# of companies

Low  Fair  High

Expectations
Part III
Investment Strategies that Emerge

Back To the Future: Understanding Risk/Reward
Finding the Dark Corners
Exploit Short-Termism and Misplaced Incentives

Find the Overlap in the Fat Tails

Profitability Distribution
Valuation Distribution

Undervalued and Understated Cash Flows
Fairly Valued and Accurate Cash Flows
Overvalued and Overstated Cash Flows

Long
Short

Qualifiers
Qualifiers
## Risk Versus Reward Rating System

Results Provided By Every Model

<table>
<thead>
<tr>
<th>Overall Risk/Reward Rating</th>
<th>Quality of Earnings</th>
<th>Valuation</th>
<th>Growth Appreciation Period (yrs)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Economic vs Reported EPS</td>
<td>Return on Invested Capital (ROIC)</td>
<td>FCF Yield 2yr Avg</td>
</tr>
<tr>
<td>Very Dangerous (5)</td>
<td>Misleading Trend</td>
<td>Bottom Quintile</td>
<td>&lt;5%</td>
</tr>
<tr>
<td>Dangerous (4)</td>
<td>False Positive</td>
<td>4th Quintile</td>
<td>-5%&lt;1%</td>
</tr>
<tr>
<td>Neutral (3)</td>
<td>Neutral</td>
<td>3rd Quintile</td>
<td>-1%&lt;3%</td>
</tr>
<tr>
<td>Attractive (2)</td>
<td>Positive EP</td>
<td>2nd Quintile</td>
<td>3%&lt;10%</td>
</tr>
<tr>
<td>Very Attractive (1)</td>
<td>Rising EP</td>
<td>Top Quintile</td>
<td>&gt;10%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Actual Values</th>
<th>Economic vs Reported EPS</th>
<th>Return on Invested Capital (ROIC)</th>
<th>FCF Yield 2yr Avg</th>
<th>Price-to-EBV Ratio</th>
<th>Growth Appreciation Period (yrs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>$0.12 vs. $2.48</td>
<td>13.0%</td>
<td>0.2%</td>
<td>1.5</td>
<td>25</td>
</tr>
<tr>
<td>Russell 1000</td>
<td>$0.12 vs. $2.36</td>
<td>13.0%</td>
<td>0.1%</td>
<td>1.6</td>
<td>28</td>
</tr>
</tbody>
</table>
Disconnects Between Price and Value
Better Mousetrap For Finding the Fat Tails

5-Point Rating System

- Attractive
- Undervalued
- Fair
- Overvalued
- Dangerous

Number of companies

1 2 3 4 5
No Substitute For Rigorous Analysis
Only 3 Ways to Beat the Market

**Better Data** - difficult and expensive to obtain
- Gathering and analyzing data from the Notes to the Financial Statements provides a competitive advantage.

**Better Analysis** - not just your neighbor, one must out-think the entire market
- Better data means better models.
- Better models provide better analysis.

**Better Discipline** - stick to your guns, don’t follow the herd.
- Long and short strategy is built on specific, quantifiable thresholds derived from a model we can trust.
- Our models do all the number crunching to supply our human capital with superior information and decision-making capabilities.
Most Attractive/Dangerous - documented picks
Hypothetical Long/Short Portfolio: Jan 05 - June 10

This graph represents the historical performance of a hypothetical portfolio of securities consisting of the stocks listed in New Constructs’ “40 Most Attractive Stocks” and “40 Most Dangerous Stocks” lists. This chart does not account for transaction costs, dividends, rebates or fees taken by the General Partner. The chart assumes equal-weighted holdings in all 80 stocks and assumes that the holdings will be updated upon the publication of new reports. Accordingly, the chart shown herein does not necessarily indicate overall portfolio performance that has been or may be expected to be achieved. Past performance is not an indication of future results.
Part 4 - Our Process

Most Attractive/Dangerous - Jan 05 to June 10
Hypothetical Long and Short Portfolios Outperform

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Paradigm Shift
Trade-off Between Depth and Breadth Is Overcome

Paradigm Shift In Research

Analytical Rigor

Wall Street Research
S&P, Morningstar
CNBC, Daytraders, Most Hedge Funds
Google Finance, Yahoo Finance

# of Stocks Covered

High
Low

Warren Buffet, Grantham Mayo and a few others...
Gathering and analyzing data from the *Notes to the Financial Statements* is key.
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