



# EARNINGS DRIVE BUSINESSES, BUT EXPECTATIONS DRIVE STOCK PRICES

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If you've ever been to the track, you know that big winnings come from betting against the crowd. Bet on the favorites and you may cash in a couple of small winning tickets; but scope out an underdog the crowd doesn't believe can win and you collect a big payoff. There simply isn't much reward in betting with the consensus. The same holds true in the investing universe. To be consistently successful, you must adopt a contrarian's mentality and bet against the crowd. There are a host of good businesses out there—even a lot of great businesses—you might invest in, but if you want substantial returns, you have to place less emphasis on the prospects for the business, and more on the prospects for the investment. Investors commonly confuse a good business with a good investment. Many good businesses have expectations embedded in their stock prices that are just too high. The reason is that investors tend to extrapolate events forward in a linear fashion—that is, they believe a company doing well will continue to do well and if performing poorly, will continue to perform poorly. Cisco Systems (CSCO) and Microsoft (MSFT) are highly successful companies, but their stock-implied growth expectations in the late 1990s would have translated into sales in excess of the U.S. gross domestic product. As an investor, you face the task of recognizing whether current expectations are overly optimistic or overly pessimistic. Changes in expectations—not earnings growth—move stock prices. The advantage lies in being able to determine whether the deficiencies in current expectations are too optimistic or too pessimistic.

## Good Companies

What makes a business a “good” business? There are certain characteristics inherent in all good businesses. In particular, good businesses are not only profitable, but they also generate free cash flow net of capital reinvestment (capital expenditure). Good businesses also generate a return on their invested capital over and above their cost of capital. They continue to grow their business—reinvesting in new assets—for as long as their return on their invested capital exceeds their cost of capital. Good businesses are able to sustain or increase their rate of return on their invested capital. A fading return on invested capital indicates the business is becoming average and no longer special; a choppy return on their invested capital indicates a cyclical business model. Investors should prefer businesses with revenue growth, operating margins and asset turnovers that are above average relative to others in their industry, since these drivers are the financial impetus behind return on invested capital. Accelerating dividend payments are also preferable, since they are a sign that the company's management is interested in paying shareholders income while maintaining sufficient cash flow to run operations.

## Good Investments

While there are many factors that constitute a good business, there is one primary consideration when it comes to a good investment: expectations. A business is worth the present value of its existing assets plus the net present value of its future investments. So the current price of a stock is based on what investors collectively (“the market”) expect the business' future to be. Of course, no one can predict the future, so when analyzing a stock's price you are left with two choices. One is to take a crack at forecasting a company's future performance, translate that into annual cash flows and calculate the firm's “warranted price.”

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As an alternative, one can analyze stock-implied expectations (the cash flow expectations embedded in a stock's current price), back out the cash flows, and determine whether the market's assessment of the future seems reasonable (see below). This helps determine whether the consensus view is sensible, and whether the company will meet, beat or miss expectations. Since changes in expectations drive stock prices, it only makes sense to start out by investigating what those expectations are. Divergent Opinion Rules Just because a company happens to run a good business, doesn't mean investing in it will be profitable. Remember, as an investor, you aren't rewarded for betting with the consensus. You need a divergent opinion, cultivated by an informational or analytical advantage. More often than not, it is information combined with common sense that contributes to outwitting the consensus.

Here are two examples:

- Dell Inc. (DELL) has consistently operated a great business, generating returns on invested capital in excess of 20% per year since 1996. Given the track record, investors focusing on the economics of the business instead of the embedded expectations would have thought this a prime candidate for investment. But if they had put their money into Dell in 2005, they would have lost over 30% of their capital—despite the fact that return on invested capital increased to a near all-time high level—because stock-implied expectations were calling for returns to be much higher.
- Century Aluminum Co. (CENX), another great business, has enjoyed an upward return trend since 1999—indicating an improving business—and generated returns nearly twice their cost of capital for the past three years. Investors have earned over 50% year-to-date 2006 because previous stock-implied expectations calling for the business to generate cost of capital returns have since been readjusted upward.

### **A Different Kind of Risk**

Market forecasters must accurately predict future cash flows and discount rates and then determine a fair market price. Expectations analysts take the current market price and back out market implied cash flows, asset growth rates (reinvestment rates), and return on invested capital. While somewhat complicated, this can be done repeatedly with surprising accuracy. The reliability of the conclusions drawn from expectations analysis is also based on the ability to assess the market's expectations as reasonable or unreasonable, which determines the direction of market error—either too optimistic or too pessimistic. The approach forgoes the exceedingly high level of accuracy required in market forecasting in favor of a more philosophical look at the investment's prospective future (i.e., will margins expand or contract, will revenues grow faster or slower, etc.). The level of risk can be further reduced by limiting the companies to those that trade at or below cash and book value. For example, if you choose to buy a stock with market expectations for negative future cash flow because you think the business will generate positive cash flow, and the stock trades slightly above cash, your downside risk is limited because if you are wrong, the stock will fall only to cash value (unless management spends that cash).

### **Calculating Implied Expectations**

Expectations analysis involves taking the current market price and backing out market implied expectations. How is this accomplished? The foundation for the pricing equation is that the value of a firm today is the value of its stream of expected cash flows over its life, discounted back at a specific rate of return. So you need to do the same kind of analysis as you would for any cash flow valuation method. The key components are the firm's current asset base, the return on investments the firm generates on its assets, the firm's future asset growth rates (reinvestment rates) and the degree to which these returns change as the company's life cycle matures. But by reverse engineering the calculation, you can determine the stock-implied expectations based upon current stock price, as well as put in your own assumptions to better understand what the stock should be

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trading at in the future. You can also compare these assumptions to those embedded in a company's peers, as well as against a company's own historical performance, to better understand where the most uncertain assumptions lie. Of course, there are many factors that can affect a firm's cash flows, and institutional investors like our firm use sophisticated (and expensive) software that can crunch a wide variety of factors into consideration to determine the implied expectations. For individual investors performing expectations analysis on a stock, the analysis can be performed using spreadsheet software and the equation: where is the sum of all future cash flows.[The on-line encyclopedia Wikipedia has a longer mathematical explanation of this under "discounted cash flow" at [www.wikipedia.org](http://www.wikipedia.org)]. So if you know the price and the discount rate, you can back out the firm's expected future cash flows. Once done, you have only to determine whether or not you believe those cash flows will be realized, missed or exceeded.

## Summary

It is important to understand and correctly interpret the expectations embedded in current stock prices when making investment decisions. Changes in expectations alone will cause changes in stock prices. Being a good business—or even a great business— isn't enough because the market doesn't reward you for investing with the consensus. Successful investing on a consistent basis is the result of developing a correct contrarian thesis and acting on it. ?

## To Find a Good Investment, Ask the Right Questions

One very important aspect of evaluating stocks lies in asking the right questions. Perhaps that sounds rather obvious, but investors tend to ask the wrong questions, or ask questions not to get objective information but rather to secure support for opinions they have already formed. Today, with so many sources of investment data, opinions and analyses, investors can easily find support for any hypothesis. Whether they think a particular stock will rise or fall, there is ample data to back up their judgment. For example, satellite radio companies XM (XMSR) and Sirius (SIRI) get a lot of play. Investors who like them as a buy will cite their triple-digit revenue growth as validation. In contrast, investors who think the companies have peaked and are ready for a fall can point to their negative margins and inability to generate more than 10 cents on the asset dollar in sales for reassurance. There is ample support for both viewpoints. Investors who can suspend judgment for as long as possible tend to be better investors, allowing the big picture to materialize before one or two data points steer them in the wrong direction. Active investing also means challenging market opinion, and asking what performance is expected of the company in order for it to merely achieve the level of valuation suggested by its current stock price. Inherent is the discipline to resist trying to prove you are right about a stock, but rather to question where the market's collective intelligence about a stock's price suggests the market is wrong. The subtlety of this insight can make a big difference. The quality of any investment process depends on the rigor and tenacity of the framework used. Here are some key questions that can help reveal where reality may be contrary to the market's view. What Is the Context of the "Good" Information? The context of information can be just as important as the information itself. Over the last few years, valuation levels of JetBlue (JBLU) have essentially "priced in" cash returns at their cost of capital. That's about the same level the company achieved in 2002 and 2003. (The spread between returns and the firm's cost of capital were essentially zero during those years.) The problem here is that there's no value to growing a business that only achieves its cost of capital. If the firm is paying 6% for its capital and only generates a 6% return, it hasn't created any value. It's only when it can achieve returns in excess of its cost of capital that value is created for shareholders.

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## How Good Does the Story Have to Be?

It's easy to get caught up in a great story. New products or newly launched businesses are frequently accompanied by breathless press releases suggesting a rosy future for the stock.

It's easy to see if the company's sales are strong, but understanding the expectations in the stock price helps frame the correct question:

"Just how good does the story have to be?"

Everyone knows the exciting Google (GOOG) story, but what has the collective market priced-in at its recent \$425 per share? Assuming Google's economic profitability remains stable, what level of revenue growth is necessary to support that price? Within five years, Google needs to achieve revenues 2.5 times current levels. And that's just to support its current price. For it to be considered as a worthy long-term position, one would have to believe that the market has underestimated Google's potential by at least 20% or more. This is not to question or denigrate the incredible performance of GOOG in the past, but rather to arrive at the correct investment question, which is, "How much better can GOOG get?"

## What Will Be the Catalyst to Market Efficiency?

In the case of undervalued stocks, what will be the catalyst that sends the market a signal that a correction is needed? Without that event, these stocks may never realize their potential. For example, in 2003, Motorola (MOT) returns had fallen to 20-year lows (nearly zero) and the stock price dropped in six of the previous seven years to an incredibly low \$8 per share. At that level, the stock price implied virtually zero growth and little chance for improved returns. The depressed price and performance expectation might have continued were it not for one salient event: CEO Chris Galvin stepped down. That catalyst was enough to attract a crowd of investors who otherwise would likely have ignored MOT's prospects. Combined with an expected change in business strategy, MOT's stock climbed over 30% in a matter of weeks and doubled over subsequent months. In addition to management change, earnings surprises and other corporate actions can drive performance. For some stocks, the key question to act on might simply be, "Is management change imminent?" Amazing investment opportunities may follow.



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