Applied Portfolio Management

How University of Kansas Students Generate Alpha to Beat the Street

CATHERINE SHENOY

KENT C. McCARTHY

John Wiley & Sons, Inc.

Applied Portfolio Management

Founded in 1807, John Wiley & Sons is the oldest independent publishing company in the United States. With offices in North America, Europe, Australia and Asia, Wiley is globally committed to developing and marketing print and electronic products and services for our customers' professional and personal knowledge and understanding.

The Wiley Finance series contains books written specifically for finance and investment professionals as well as sophisticated individual investors and their financial advisors. Book topics range from portfolio management to e-commerce, risk management, financial engineering, valuation and financial instrument analysis, as well as much more.

For a list of available titles, visit our Web site at www.WileyFinance.com.

Applied Portfolio Management

How University of Kansas Students Generate Alpha to Beat the Street

CATHERINE SHENOY

KENT C. McCARTHY

John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey

Published simultaneously in Canada

Library of Congress Cataloging-in-Publication Data

Shenoy, Catherine, 1952–
Applied portfolio management : how University of Kansas students generate alpha to beat the Street / Catherine Shenoy, Kent C. McCarthy.
p. cm. – (Wiley finance series)
Includes index.
ISBN 978-0-470-04172-7 (cloth)
1. Portfolio management. 2. Investment analysis. 3. Stock price forecasting. 4. Investments. I. McCarthy, Kent C., 1958– II. University of Kansas. III. Title.
HG4529.5.S535 2008
332.6–dc22

2007039473

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

KCM:

In memory of Clark Hestmark. In 25 years of managing money, one client stands out. Clark had a great sense of humor, a great outlook and philosophy on life, and most of all was loyal—especially when the chips were down. I was a young broker at Goldman Sachs when Clark became a client and wanted some safe, income-producing investments. I bought him some Bethlehem Steel Preferred Stock yielding 9 percent. Two weeks later this "safe" investment was cut in half. Later I tested Clark's loyalty by being short the Japanese market two years too early. If that wasn't enough, in the late 1990s, I was short the Internet stocks. This mania caused a lot of long-term clients to lose confidence in me—but not Clark. I will never forget a dinner with Clark in those "dark" days of 1999 when he encouraged me to stay the course and hold to our convictions. It's easy to be a loyal friend when things are good, but I will always remember Clark's loyalty during the hardest times.

Clark became a special friend and mentor to me. He was beloved by his family. I can only hope that I can become half the husband and father that Clark was to his family. One final thing: Clark knew that the Applied Portfolio Management class meant a lot to me. Even though he was a graduate of Utah and lived in Lake Tahoe, he made several financial contributions to the class. And in typical Clark fashion, he did so anonymously. I did not find out about his gifts until many years later.

CS:

For my parents, Jerome Allen and Mary Helen Smith.

Contents

Preface xi

Acknowledgments xv

PART ONE

Introduction to the Applied Portfolio Management Class 1

CHAPTER 1

APM History 3

In the Beginning 4
How Do Beginning Investors Think? 6
Student Groups: Short-Term Investing and Portfolio Contests 9
Getting Close to the Information 13
Onions, Poker, and Ants 17
What about the Ants? 18
Things to Come 19

CHAPTER 2

APM Guidelines 21

Professional Money Managers 22
Tactical Asset Allocation and Sector Benchmarking 25
APM Approach 32
Wrapping Up 36

CHAPTER 3

Conventional Wisdom 37

Diversification and Risk 38
Efficient Markets 45
Wrapping Up 49

CHAPTER 4
How Students Find an Investment Edge **51**
Build Your Own Information Network 51
Neglected Firms 52
Surface Analysis 55
Wrapping Up 62

CHAPTER 5
Alpha, Sigma, Beta: APM's Risk and Reward **63**
Risk-Return Trade-off 64
Other Risk Measures 68
Wrapping Up 75
Appendix: Risk and Return Calculations 75

PART TWO
Building an Investment Case **79**

CHAPTER 6
Many Ways to Be a Successful Investor **81**
Common Traits of Successful Investors 82
APM's Philosophy 84
LSB Industries 85
Wrapping Up 98

CHAPTER 7
Prepping for a Case **99**
Getting Started 100
Understand the Business 118
Ready to Write the Case 122
Appendix: 10-K Requirements 122

CHAPTER 8
Writing a Case **125**
Case Format 127
Description 129
Investment Thesis 141
Next Steps 142

CHAPTER 9
Gazing into the Crystal Ball: Pro Forma Statements **143**
Pro Forma Financial Statements and Free Cash Flow 145
Building a Pro Forma 153
Next Steps 159

CHAPTER 10
Valuation **161**
Relative Valuation 162
Discounted Cash Flow Valuation 171
Investing Is Dynamic 188
Appendix: Discounted Cash Flow Formulas 189

PART THREE
Class Specials **193**

CHAPTER 11
Investing in China **195**
Financial Systems in China 196
Raising Equity in China 199
Company Example: China Green 204
Wrapping Up 211

CHAPTER 12
It's a Big World (After All) **213**
Interceramic 214
World Commodities 217
Wrapping Up 227
Appendix: Valero's Numbers 227

CHAPTER 13
Local Biases **229**
American Italian Pasta 230
Novastar Financial 233
Inergy, L.P. and Inergy Holdings, L.P. 238
Tortoise Capital Advisors (and More about Inergy) 240
Wrapping Up 244

CHAPTER 14
Making Corporate Governance Pay **247**
Board Issues 248
Corporate Activists 254
Wrapping Up 259

CHAPTER 15
It's All about Who You Know **261**
APM Students 262
APM Speakers 268
The Last Word 271

Index **273**

Preface

In 1988 Kent McCarthy returned to Lawrence, Kansas, after several years in San Francisco. The last four had been spent in the Private Client Services division at Goldman Sachs. During his six-month sabbatical he taught at his alma mater, the University of Kansas, and planted the seeds for the Applied Portfolio Management program. Kent went back to Goldman for another six years but kept thinking about his teaching experience and ways to make bright, ambitious but sometimes naive Kansas students more knowledgeable investors.

Kansas students are typically smart and hardworking but aren't always as sophisticated as their brethren on either coast. They tend to believe the best of everyone and aren't always as skeptical of investment ideas as they need to be. They share many of the same traits as ordinary investors. Initially they are too quick to believe the "conventional wisdom" and end up as followers in the mainstream of the investment community. Kent's very successful career at Goldman wasn't sparked by following the crowd, and he wanted to share with students the basics of investment success that he has enjoyed. The story of the APM class is the story of educating individuals to be successful investors with hard work, patience, and persistence.

Cathy Shenoy has a Ph.D. in finance from the University of Kansas. In 1999 she visited with Kent to discuss a research idea that involved how successful portfolio managers made decisions. Kent convinced Cathy to begin teaching the APM class instead. The class had been on a hiatus for about a year and a half. Kent and Cathy taught the class together for the first time in the fall of 2001. It was a time of turmoil in the world and in the market. September 11 rocked the world and students. The fall of Enron introduced the importance of corporate governance to the masses. In class we had our first online chat and conference call with a new Chinese Internet company.

Lots of investing books have a winning formula. The biggest problem in investing is that the winning formula changes. How do you pick the right winning formula for today? One of Kent's favorite phrases in class—"Investing is dynamic"— captures the idea that you need to adjust your investment strategy as investment conditions change. In this book we provide some case studies of how to recognize when to change course. Changing your course does not mean timing the market but recognizing when fundamental changes in a company's business means a shift in investment strategy.

APM investing is not a story of market timing or benchmarking through market capitalization or sectors. The benchmark is hard work to dig deep to figure out a company's real story through detailed business analysis. The time to invest may be when the tide of opinion is swinging in the opposite direction. That's the time to have the courage to follow your own convictions and believe in your analysis. In the end the market always rewards good businesses. In the short term the market can get carried away with minor details or the fad of the moment.

A large part of the APM story is in teaching how to dig behind the facade of public numbers, press releases, and spin to figure out what's really going on. How does a company make money? What numbers from the financial statements and other public information demonstrates how well a company is accomplishing its mission? What are the people like who are running the company? Each week students in the APM class dig into these three questions. Each week they learn a little more about the best way to view a new situation. Another favorite APM phrase is "peeling the layers of the onion." Each quarterly report, each news release provides a little additional information to confirm or refute the original investment hypothesis. In investing, experience is important. In the APM class the students begin building experience by learning what type of information is important and how to answer the fundamental three questions.

At the beginning of every semester students typically fall into three main groups:

1. Students who don't know a lot about investing and have enrolled in the class to learn make up the majority.
2. Students who have been investing, have had some success, and think they can show the class how it's done make up the next group.
3. Students who have been investing and haven't been as successful as they had hoped make up the third group. They want to learn more and avoid the mistakes they've made.

All of these students have had investments theory courses. Most of them still don't know how to answer all of the big three questions: How does a company make money? What numbers from the financial statements and other public information demonstrates how well a company is accomplishing its mission? What are the people like that are running the company? We are writing this book because many people who are interested in investing fall into the same categories as our students. Those readers can learn to answer the questions just as the APM students have learned. Almost everyone can become a better investor with hard work and persistence.

At the end of the semester, students typically fall into two groups. The majority now realize that investing takes time, persistence, and hard work. Quite a few have been inspired or strengthened in their inspirations to pursue careers in the financial industry. This group realizes that the market isn't a get-rich-quick game. They come away from their experience ready to dig in some more. Many of these students stay in touch and stay connected to APM by offering the class new ideas, keeping up with the newsletter, and even coming back to present a case in class. There are always a few students who decide Cathy and Kent really don't know what they are talking about. Many times these are the students who want a "popular" strategy. The popular financial press stands ready to help all of those people who feel the need to join the crowd.

Another important part of the story is building a network of contacts. Each semester the APM program has a network of guest speakers that rivals any investment group's contacts anywhere. Speakers fall into two categories. The first group is investment professionals. This group includes mutual and hedge fund managers, traders, investment bankers, security analysts, and other asset managers. All are generous and provide the class with their best ideas. Even more important, they provide the class a glimpse of their decision-making process. Decision making isn't a one-time idea; these experts explain to students how to come up with ideas, what to read, and how to interpret what they read. The other group of speakers in class comes from the corporate side. This group includes chief executive and chief financial officers and other decision-making and operating professionals from firms. These people provide insiders' perspectives on what it takes to run a firm: what the industry is like, what the economic environment of the firm is, what variables can be controlled and what ones cannot be controlled.

Building a network of contacts is a significant advantage for any investor. No one can know everything about the many different industries, countries, and markets. Better information breeds better investment decisions. APM speakers are just the beginning of the network of contacts. Students form lifelong relationships in college. As they graduate and go on to work for different companies, they can provide the basis for a most productive network.

No one really knows how many universities have student portfolios. One estimate is there that there are over 200 student funds. Thirteen years ago, when APM began, there were probably fewer than 25 funds. APM was unique then in its emphasis on building a network of contacts, on discovering the fundamental drivers of business success, and on buying at the right price. Today as the number of student portfolios expands, the most common management technique is sector benchmarking, which most mutual funds and other large asset management companies follow.

There are two problems with this type of asset management.

1. It's very difficult to earn above-market returns using sector benchmarking.
2. This technique doesn't take advantage of a small fund's (or individual's) flexibility. Any megafund or individual can invest in Microsoft. However, a megafund will not invest in Chinese company trading on the Hong Kong Growth Enterprise Market (GEM) exchange with a market capitalization of less than $US 500 million.

APM takes advantage of its smaller size to invest in some areas that others do not. The APM advantage makes our approach ideal for an individual investors willing to go against the grain of conventional thinking.

In this book we relate case studies and ideas from speakers that illustrate the key ideas from class. Our hope is that readers will be able to experience some of the same learning that goes on in the APM class. We'll peel some onion layers away to show where the value lies and how to find it.

Acknowledgments

The authors would like to jointly acknowledge the students and speakers who since 1994 have made the Applied Portfolio Management class such a vibrant experience.

Class speakers we'd especially like to thank are Victor Almeida, Bob Ceremsak, Grant Donovan, Steve Farley, Steve Glennon, Jack Golsen, Clark Hestmark, Scott Jones, Andy Mathieson, Simon Michael, Edmund Miller, Mark and Betty Morris, Todd Preheim, Penny Pritzer, Josh Selzer, Brad Shoup, Tony Shelby, John Svoboda, Pat Terrell, and David Walthall. Many other speakers have also made a tremendous contribution. Lots of them traveled many miles at their own expense to share their wisdom with the class. We'd like to thank them all.

Faculty members at the University of Kansas who also helped make this possible are Jack Gaumnitz, Paul Koch, and Allen Ford. Without their initial and ongoing support, this class wouldn't have happened. Two deans of the Business School also deserve special mention. Joe Baumann was the dean who made the class possible initially. Bill Fuerst, the current dean, and Keith Chauvin, associate dean, are tremendous supporters and deserve a big thank you.

We would also like to thank the wonderful people at A.G. Edwards, especially Al Simmons and Gene Diederich, who have been supporters of the class since inception. They go the extra mile to find information to facilitate our trades. The traders who work our orders; Darrell Collins, who plans visits to A.G. Edwards headquarters; Scott Wren; and all the analysts who answer our questions have been a tremendous resource.

Thanks to Alberto Bassetto, Joe Onofrio, Michael Raupp, and John Thompson. Discussions and e-mails with Mark Fleischhauer and Kara Tan Bhala were especially helpful because of the clarity of their thinking.

We would also like to thank Bill Falloon, our editor, for convincing us that this book really was a good idea. The entire team at Wiley has been helpful and encouraging. Emilie Hermann has been a wonderful editorial assistant, as has Laura Walsh.

Thanks to Scott Jones, John Naramore, and Sushila Shenoy for reading and offering advice, comments, and suggestions. Sushila provided great assistance and editing on any questions or problems with the graphics. Also

thanks to Todd Preheim for his energy, enthusiasm, and encouragement. George Bittlingmayer helped put things in perspective. Jim Guthrie, wordsmith, also offered lots of useful suggestions, and Keith Chauvin helped with the bigger issues.

Cathy Shenoy would also like to thank the Garage Gang for their encouragement and suggestions. They are Ann, Dave, Eileen, George R., George P., John, Joyce, Steve, Surendra, Vicky, and especially Loren. Finally, big thanks go to my family: Prakash, Chandra, Sushila, Nick, Dusty, Piper, Landrie, Libby, and my mom and dad, Jerome and Helen Smith.

PART One

Introduction to the Applied Portfolio Management Class

Lots of universities have investment management classes that manage money. Some are older than our program, some have more assets under management, but we feel that the Applied Portfolio Management (APM) class at the University of Kansas is unique in the quality of the information that the students receive. "Quality of information" isn't exactly the catchiest slogan, but for investors the quality of the information is the key difference between average returns and extraordinary ones. Information drives the investment process. Getting great information and evaluating and interpreting it correctly is a major theme in the APM class.

In the first part of this book, we outline how we've gotten to where we are today and how what we do is different. In Chapter 1 we review how the class started and how it's changed. What worked that we kept and what changes we've made to make it better. "Investing is dynamic" is a phrase that APM students hear frequently. Teaching young investors is dynamic also. In Chapter 2 we discuss how the class guidelines work now. They will almost certainly evolve as we think of new and better ways to combine investing and teaching investing. In Chapter 3 we review finance theory and how breakdowns in the theory create investment opportunities. In Chapter 4 we illustrate "surface analysis" and how in the APM class, we try to make sure that we rely on the best-quality information in our investment decisions.

CHAPTER 1
APM History

When the Applied Portfolio Management (APM) class started, there were not a lot of student-managed portfolios. There were no “best practices” to follow. We think it’s instructive to go through the history of the APM class because in designing the class, we’ve helped educate many future successful investors. As a class, we’ve also succeeded in generating great returns. We’ve also had a firsthand look at the thinking of beginning investors. Through the APM class, we’ve learned a lot about the mistakes typical investors make, and we think our experience in helping students overcome these mistakes is useful to all investors.

In managing their own portfolio, individual investors make many of the same mistakes that students make at the beginning of the semester. Fortunately, it didn’t take too long to hit upon a workable strategy for the APM class that encourages what we consider the right kind of decision making—one that makes money over the long term. We’ve managed to earn a great return over the last 13 years. APM began with $230,000. As of this writing in mid-2007, the portfolio is valued at close to $1.5 million. That’s an annual rate of return of more than 20 percent, 10 percent per year higher than the return on the NASDAQ index or the Standard & Poor’s 500 Index (S&P 500). Figure 1.1 shows how APM’s return has compared to NASDAQ’s over the life of the portfolio.

The class strategy has changed over time. During the 1990s the portfolio strategy was more event driven. Now we have a more value-oriented buy-and-hold philosophy. The philosophy has changed because market conditions have changed. In class we focus on understanding what’s going on in the market, what’s happening in a company, and how those events can interact to create investment opportunities.

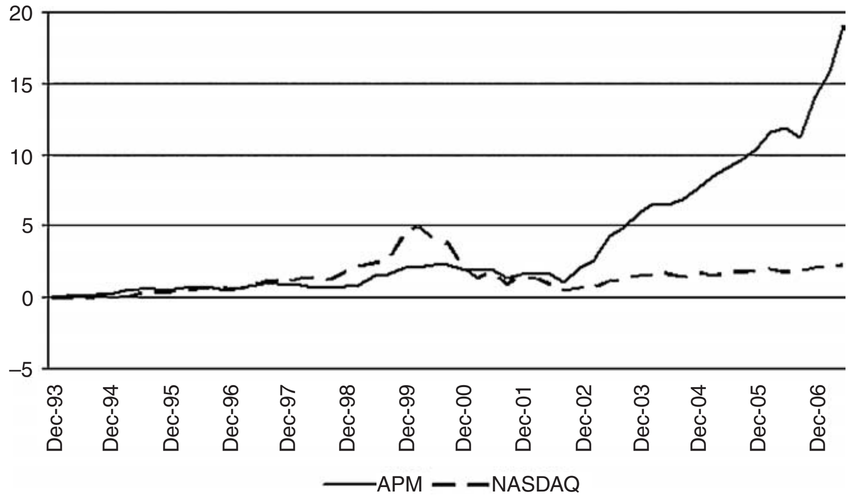

FIGURE 1.1 Cumulative APM Return vs. NASDAQ Return 1994–June 2007

IN THE BEGINNING

Kent McCarthy retired from private client services at Goldman Sachs in 1993 at the ripe old age of 35. At the time he retired, he was the largest producer ever for Goldman Sachs Private Client Services. He generated those fees because he decided to base his business on generating performance for his clients. He found good investment returns for his clients in many overlooked areas. Kent felt that the Japanese market was overvalued and Hong Kong stocks were undervalued. Consequently, he managed more trades with the Hong Kong Exchange than anyone else at Goldman. That time marked the beginning of his love affair with China.

He was ready for a change and decided to come back to his undergraduate alma mater, the University of Kansas, to teach classes about investing. He donated $230,000 to start the APM class. Professors Allen Ford, Jack Gaumnitz, and Paul Koch were instrumental in persuading the faculty and administration to accept Kent's seed money for the portfolio. The KU Endowment Association didn't rush to embrace the idea of a class portfolio. Jack met with Jeff Davis, the endowment's chief investment officer, and pitched the idea. Jeff was open but cautious. After reviewing investment management programs at other universities, such as Wisconsin's ASAP and Texas's MBA Investment Fund, KU Endowment was on board.

That first fall semester in 1994 Kent, along with Jack and Paul, taught two sections of Applied Portfolio Management to a select group of 30 students. One class was held at the main Lawrence, Kansas, campus, and the other at the Kansas City Regent's Center. The semester started with the $230,000 from Kent's gift in the fund. The students were divided into groups of four, and each group was allocated $10,000 to invest. At the end of the first semester, the APM portfolio stood at almost $275,000.

STUDENT COMMENTS FROM KENT'S EARLY CLASSES

Todd Preheim

APM Fall 1994

The APM class was very intense. I remember being very worried that Kent would call on me. When we talked about the cases, he would randomly call on people and pepper them with questions until the student could not answer one. I was always on edge and remember getting performance anxiety after Kent called on me to answer questions—even if the questions were elementary. I spent significantly more time preparing for the class versus others but still felt I never prepared enough.

My favorite case was International Speedway (ISCA). Guest speaker Steve Farley asked students how ISCA could increase sales in the coming years. A classmate answered they should not allow fans to bring their own coolers into the raceway. When determining what the additional revenue would be from this plan, another classmate suggested we model each fan will drink 10 beers.

Kent's teachings of aggressive event-driven strategies were way ahead of his time and are very prevalent today with many hedge funds. He challenged most claims of the buy-and-hold strategy and emphasized the importance of strong management. The case format along with Kent and his speakers' experiences allowed students to better understand how Wall Street works.

Paul Koch taught the class from inception with Kent until 2000. He was instrumental in laying the groundwork in the expectations of hard work and rigorous analysis in the class. Cathy Shenoy started teaching with Kent in 2001. By this time student groups were no longer allocated $10,000 to invest, but the idea of stock mentors guiding student decisions was starting to form. The switch away from active student management happened for several reasons. The first reason was poor decision making by students, especially early in the semester. The second reason was to encourage a longer-term mentality.

HOW DO BEGINNING INVESTORS THINK?

Let's examine what happens at the beginning of the semester. We'll focus on the poor decision making first and then get to what we hope is a cure for poor decision making. Several times Cathy starts the class by putting the two simple charts shown in Figure 1.2 on the board and asking students which stock they would prefer as an investment.

Almost universally, students pick Stock A with no hesitation. Cathy started putting up the charts after she noticed students coming to class saying "Why does the portfolio hold Stock X? It's a big loser." A lot of times the previous semester's class had picked Stock X. Students had selected the stock because they felt several things might happen in the future that would

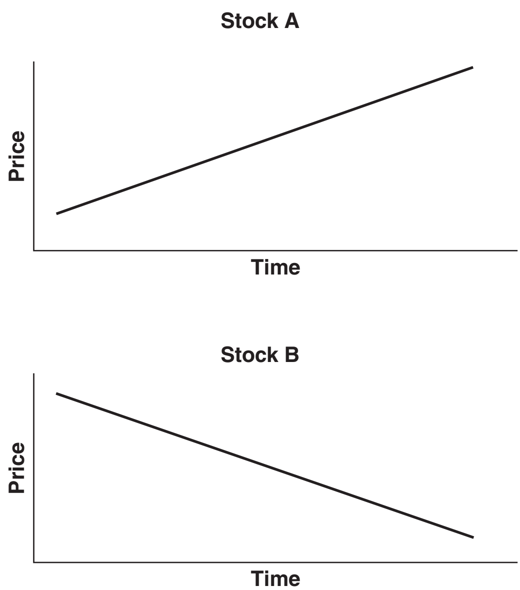

FIGURE 1.2 Where Would You Invest?

change its prospects. Selling now when it was down was exactly the wrong thing to do.

Psychologists have identified this type of behavior by investors, and call it the "recency effect." Kent calls it "ruler analysis." Generally, when people forecast stock prices, or anything else, it's easiest for them to assume that the past will be like the future. However, in stock markets, individual stocks, economies, and lots of other areas, cycles and changes in directions are very common. Because so many people like to jump on the bandwagon and invest in stocks with rapidly increasing value, those stocks with recent price increases are more likely to be overvalued.

A big example of ruler analysis is the recognized trading strategy of momentum investing. Momentum investors are those who look at recent trends and ride those trends up or down, selling stocks with recent poor returns and buying ones with recent good returns. During the bubble of the late 1990s, momentum investors made a lot of money because there was an extended trend (bubble?) upward. During the shake out in 2001–2002, momentum investors lost a lot of money.

We find that new students in the APM class are especially prone to ruler analysis because they are afraid to trust their own judgment. A student once said, "Everyone else thinks that things are great. What do I know about anything?" The story of the Emperor's New Clothes comes to mind. In a Danish fairytale, two con men sell an Emperor a new suit of clothes. They convince him that the suit is the latest and greatest, but emphasize that the most special property of the suit is that it is invisible to people who aren't fit for their position. Of course, there is no suit, but no one wants to say they can't see it. Finally, a child speaks up and asks why the Emperor isn't wearing any clothes. Sometimes it just takes a few clear-thinking people to see through the hype of the Street's new favorite stock.

"Buy high and sell low" happens when investors get stuck in a ruler analysis mode. People want to wait until others provide confirmation an investment is sound. By that time prices have gone up. They end up buying high—toward the end of Stock A's price increase. John Bogle, the longtime chairman of the Vanguard Group, testified before Congress in 2004 about the phenomenon. He calls it a "timing and selection penalty."[1]

> *[S]hareholders have paid a heavy timing penalty, investing too little of their savings in equity funds when stocks represented good values during the 1980s and early 1990s. Then, enticed by the great bull*

[1] Statement of John C. Bogle before the United States Senate Committee on Banking, Housing, and Urban Affairs, February 26, 2004.

> *market and the wiles of mutual fund marketers as the bull market neared its peak, they invested too much of their savings. Second, because they have paid a selection penalty, pouring money into "new economy" stocks and withdrawing it from "old economy" stocks during the bubble, at what proved to be precisely the wrong moment.*
>
> *The result of these two penalties: While the stock market provided an annual return of 13% during the past 20 years, and the average equity fund earned an annual return of 10.3%, I estimate that the average fund investor earned just 3% per year. It may not surprise you to know that, compounded over two decades, the nearly 3% penalty of costs is huge. But the penalty of character is even larger—another 8 percentage points. $1 compounded at 13% grows to $11.50; at 10%, to $7.10; and at 3%, to just $1.80. A profit of just eighty cents!*

It's not just mutual funds where people chase returns. It happens in all types of investing. Few people want to invest in a company that hasn't had good performance, especially if analysts or the media are not saying good things about it. So how does the APM portfolio avoid falling into this trap? The short answer is education. We educate students to think for themselves and do their own analysis. We also educate them in the "ways of Wall Street." By "Wall Street," we mean all of the participants in the investment industry. Some of the participants that influence investments and stock prices are mutual funds, investment banks, hedge funds, and private equity funds. Since these participants make up a large part of all the transactions in the market, understanding why and how each of these market participants makes money and their institutional incentives helps students unravel the mystery of stock prices. Another big influence on investment decisions is the financial media. The media, especially since the advent of CNBC, want to create a sense of crisis to keep viewers or readers tuned in to each tiny gyration in the market. How do they pick stories and stocks to follow? By understanding each participant's incentives, students can see when there may be some influence on prices outside of a stock's intrinsic value. In class we try to focus on making our own decisions about stock valuation and not being too influenced by temporary price aberrations caused by one of the market participants or the media.

We believe that a company's fundamentals eventually will be reflected in its price. Sometimes it takes longer than expected, but eventually a company's intrinsic value will align with its stock price. For this reason, education in two areas is important. First is education in the valuation techniques that many research analysts and portfolio managers use. The main valuation

S&P 500, 116, 118
2002 decline in, 26
Valero, 225, 226
and valuation, 59, 111, 148, 163, 165–170
Yahoo, 81, 84
See also Earnings per share (EPS); Valuation
Performance ratios:
calculating, 68, 73, 77
Sharpe, 39, 66, 67, 68, 77
Sortino, 68, 73, 77
Treynor, 39, 66, 67, 68, 69, 77
Pickens, T. Boone, 219, 254
Pink Sheets, 36, 202
Plains Exploration and Production (PXP), 113, 214, 270
Poker analogy, 17, 18
Portfolio competitions, 9–10, 241
Portfolio management, active v. passive, 22
Preferred stock, 112, 165, 183, 190
Price* (P*), 165, 166–167, 169, 190, 191
calculating by segment, 170
Price/earnings ratio. *See* P/E ratio
Price to book ratio. *See* P/B ratio
Price to sales ratio. *See* P/S ratio
Product life cycle, 158
Pro forma statement:
building a model, 143–144, 145, 153–154, 157–159
China Green, 207, 209
ConAgra, 154–157, 159, 185
and free cash flow, 145–147
LSB Industries, 168, 185
Valero, 228
valuation and, 125, 128, 161–162, 168, 169, 184, 185, 186
in writing a cases analysis, 125
Protection One (PONE), 229, 245
P/S ratio:
in case analyses, 100, 111
defined, 116–117
as valuation measure, 115, 163, 165
See also Valuation
Quarterly conference calls, 17, 101–102, 107
Quarterly reporting, 53
by mutual funds, 9, 23
10-Q requirements and, 15, 101, 201
See also Securities and Exchange Commission (SEC)
Quicksilver Resources (KWK), 214
APM investment in, 220–221
valuation metrics, 222
Quotation services, 36, 202. *See also* OTC Bulletin Board; Pink Sheets

Rauckman, Kevin, 244
Real Estate Investment Trust. *See* REIT
"recency effect," 7
Reg FD (Regulation Fair Disclosure), 14, 101–102
REIT, 190, 233–234, 235, 236, 238
Relative valuation, 9, 161–163, 164, 165. *See also* Valuation
Returns, APM, 3, 9–10, 19, 27, 29, 63, 217, 262
determining adequate, 35
on local investments, 243, 244–246
v. NASDAQ, 4, 27, 29, 65, 66
and risk, 64–66, 68, 70–71, 73
R.I.S.E. Symposium, 183–184
Risk:
beta as measure of, 39, 41–42
defined, 39–40
measures, 63–64, 66, 67–68, 71–74
regret, 73–74
and risk-return trade-off, 64–66
SleepWell and SeemsGood, 73–75
See also Beta; Idiosyncratic risk; Market risk
Risk and return calculations, 75–77
ROMAD (return over maximum drawdown), 68, 71, 72
"ruler analysis," 126, 144, 145, 154, 159
asset allocation and 26–27, 31–32
defined, 7
risk and, 74–75
Russell 2000, 23, 33

S&P 400 Index, 116, 118
S&P 500 Index, 63, 177
APM return over, 3
APM risk measures and, 71, 72–73
equity premium, 182
in estimating beta, 44, 181
valuation ratios and, 116–118, 163, 165
S&P 600 Index, 23, 33, 63, 116, 118
S&P 1500 Index, 116, 118
S&P Emerging Market Index, 213, 214, 215
S&P World Index, 178, 213–214
Sarbanes-Oxley (SOX) Act, 36, 169, 201, 213, 247
Schier, Jim, 81
Schulte, David, 240
Scientific Games (SGMS), 113, 180, 181, 264, 266
SEC. *See* Securities and Exchange Commission (SEC)
Sector benchmarking, xiv, 25–27, 30–32, 64, 66, 68
Sector rotation, 30–32
Securities and Exchange Commission (SEC):
cash flow recordings, 147
corporate filings on Internet, 14, 55
filing requirements, 15, 19, 16n3, 57, 101–102, 169, 172, 253
and foreign companies, 201
and gray markets, 202
Reg FD, 14
Security selection, 84–85
Shanghai Stock Exchange (SSE), 199, 201, 204, 205
Share count:
APM portfolio, 113
diluted, 112, 114, 115, 169
and shares outstanding, 111–112, 114
See also Earnings per share (EPS)
Sharpe ratio, 39, 66, 67, 68, 69, 72, 73, 77. *See also* Risk
Sharpe, William, 37, 39, 41
Shenzhen (SzSE), 195, 199, 201, 204, 205
Sherman, John, 238
Shoup, Brad, 219–220, 254, 255, 270
SleepWell and SeemsGood risks, 73–75. *See also* Risk
Small-cap equities, 22, 57
SOEs. *See* State-owned enterprises
Sohu (SOHU), 17–18, 35, 36, 113, 180, 181
as APM investment, 35–36, 113
beta, 180, 181
compound annual return, 41, 42
return distribution, 42
standard deviation, 41
stock return and growth, 17–18
Soros, George, 81
Sortino ratio, 68, 72, 73, 77
Sprint Corp. (FON), 229, 244, 245
Standard and Poor's. *See under* S&P
Standard deviation:
and APM returns, 65, 73
calculation, 76
market indices and, 178
as risk measure, 39, 66, 68, 70, 72
Standard Industry Classification (SIC), 30, 104
Starbucks, 149, 150
State-owned enterprises, 197, 204, 212
Stiglitz, Joseph E., 85
Stock mentors, 5–6, 21, 34–35
Stock valuation. *See* Valuation

Tactical asset allocation, 23, 25–27, 30, 31, 68
10-K:
American Dairy, 119–121
business descriptions, 118–119
Capitol Federal, 121
ConAgra debt, 173–174
Novastar, 235
requirements, 15–16, 101, 122–123, 129, 201
shares outstanding reported in, 112, 114

Starbucks income statement from, 149–150
writing a case analysis using, 100
10-Q, 15–16, 101, 112, 137, 201
Terminal value, 162, 172, 185–186
discounted, 189
models, 191
TEV, 111, 163, 230
calculating, 114, 115, 136
in determining discounted cash flow, 190–191
and TEV*, 165, 166
TEV/EBITDA:
American Italian Pasta, 231
by capitalization, 117–118
China Green, 210
in discounted cash flow model, 190–191
Interceramic, 215–216, 217
Quicksilver, 222
and valuation, 115, 163–167, 185–186
in writing a case analysis, 100, 111, 139
Thomson One, 101
Ticker symbols, 202
Time-weighted returns, 76, 65n1. *See also* Modified Dietz approximation
TomTom, 103, 104
Tortoise Capital funds, 229, 240
Total enterprise value. *See* TEV
Total return, calculating, 75–76
Treasury yield curve, 60–61, 172, 173, 176–177
Treynor, Jack, 39, 41
Treynor ratio, 39, 66, 67, 68, 69, 77. *See also* Risk
20-Fs, 16n3, 201
Tyco, 61–62, 247

UBS Investment Bank, 47, 241

Valero Energy Corp. (VLO), 44–45, 113
APM investment in, 214, 221–225
compound annual return, 41
enterprise value calculations, 227
pro forma statement, 228
valuation statistics, 226
Valuation
books on, 162
and cash flow timing, 145
methods, 8–9, 161–162
using comparable ratios, 165–167
in writing a case analysis, 127
See also Discounted cash flow (DCF) valuation; Relative valuation; Valuation ratios
Valuation ratios, 111, 115–118
by capitalization, 118
value stocks and, 163
in writing a case analysis, 129
See also P/B ratio; P/E ratio; P/S ratio; TEV/EBITDA
Value-at-Risk (VaR), 68, 69, 70, 71

Wall Street, 5, 8, 9
Wall Street Journal, 23, 235, 237
Watson Wyatt, 73, 74
Webster, Tim, 230, 270
Weighted average cost of capital (WACC):
defined, 172
formula, 183
and valuation, 184, 185, 186, 190, 191
See also Discounted cash flow (DCF) valuation
Westar Energy (WR), 229, 245
West, Ford, 89, 90
Whitsell, Frank, 83, 270
Wilshire Financial, 250, 252
Working capital, 148, 150, 151–153, 154

Yahoo!Finance, 23, 45, 59, 66, 138
Yanzhou Coal Mining (YZC), 214, 226–227
Yellow Corp., 245
YRC Worldwide (YRC), 229

Zell, Sam, 81