From Bubbles to Busts

Real World Lessons About Stock Prices and Valuation

“Since 1871, the market has spent 40% of all years either rising or falling more than 20%.

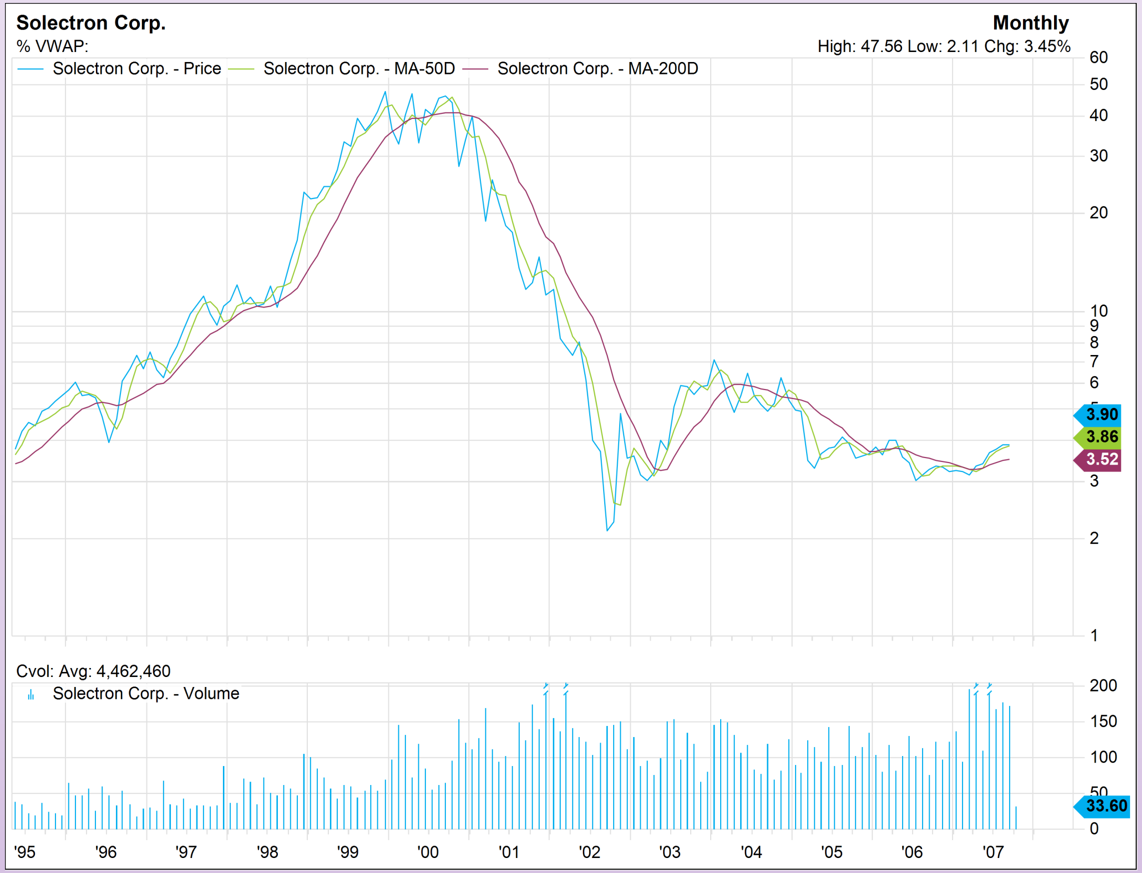
Roaring booms and crushing busts are perfectly normal.

- Morgan Housel, Journalist

“I was in the right place at the right time”

– Mel Allen

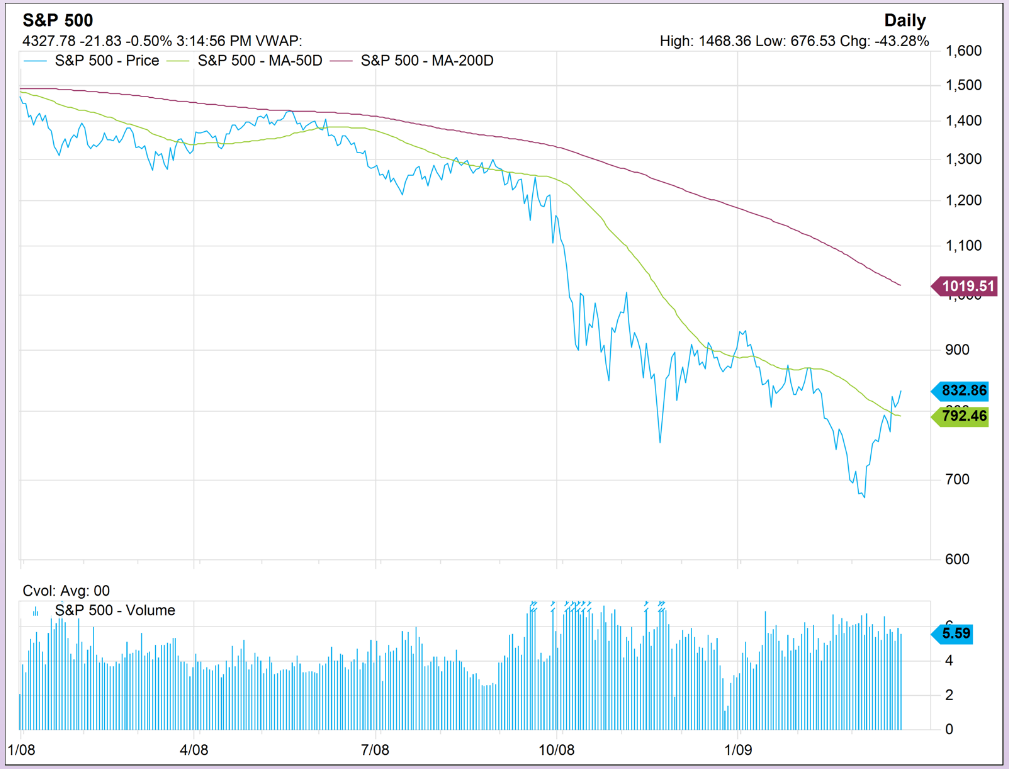
My First Stock Recommendation

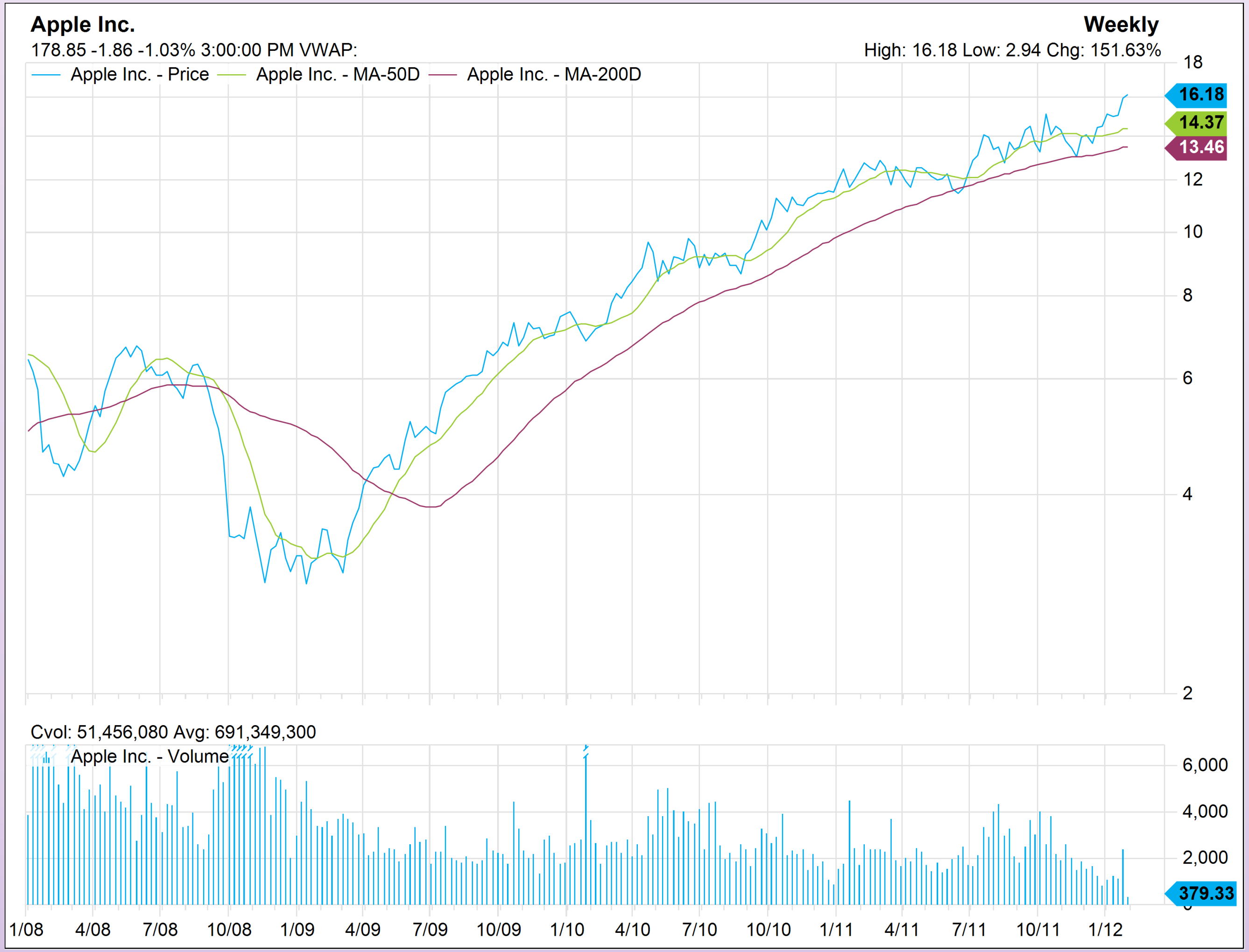


“*Being too far ahead* of your time is indistinguishable from *being wrong*”

– Howard Marks

The Perfect Time to Start a New Job?





Apple Inc.
Weekly
178.85 -1.86 -1.03% 3:00:00 PM VWAP:
High: 16.18 Low: 2.94 Chg: 151.63%
Apple Inc. - Price
Apple Inc. - MA-50D
Apple Inc. - MA-200D
18
16.18
14.37
13.46
12
10
8
6
4
2
Cvol: 51,456,080 Avg: 691,349,300
Apple Inc. - Volume
6,000
4,000
2,000
379.33
1/08
4/08
7/08
10/08
1/09
4/09
7/09
10/09
1/10
4/10
7/10
10/10
1/11
4/11
7/11
10/11
1/12

“If you have been playing poker for half an hour and you don’t know who the patsy is, you’re the patsy.”

– Warren Buffett

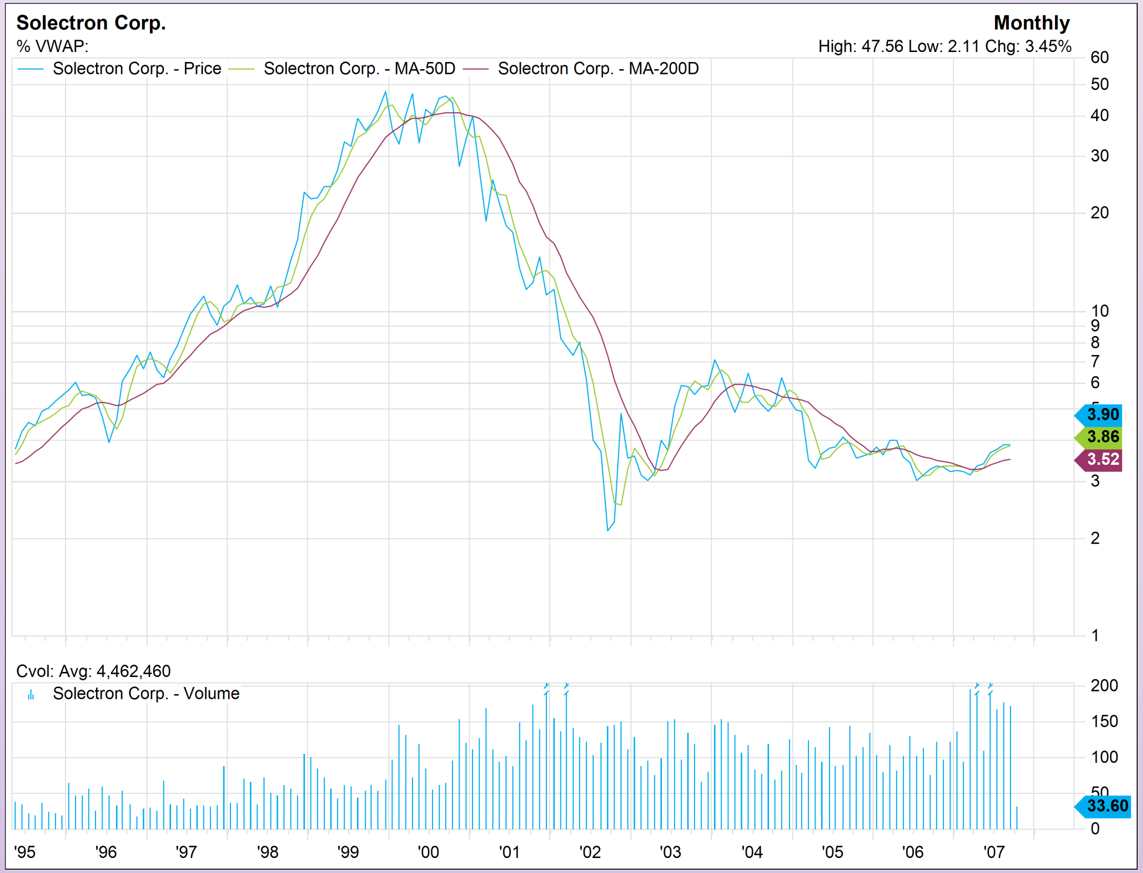
“In theory there’s no difference between theory and practice, but in practice there is.”

– Yogi Berra

Efficient Market Hypothesis

- Markets have many intelligent, objective and hard working participants
- They share roughly equal access to all relevant information
- Collectively these participants act upon new information, ensuring that assets are priced fairly in both absolute terms and relative to each other
- The market will set risk adjusted prices that are “fair”, riskier assets will offer higher returns to attract buyers
- Market prices represent accurate estimates of assets’ fair value and no participant can consistently identify instances when they are wrong

But What About This???



“Human nature makes it hard for markets to be efficient”

– Seth Klarman

Finance theory assumes we are rational

- Bias
- Noise
- Prospect theory

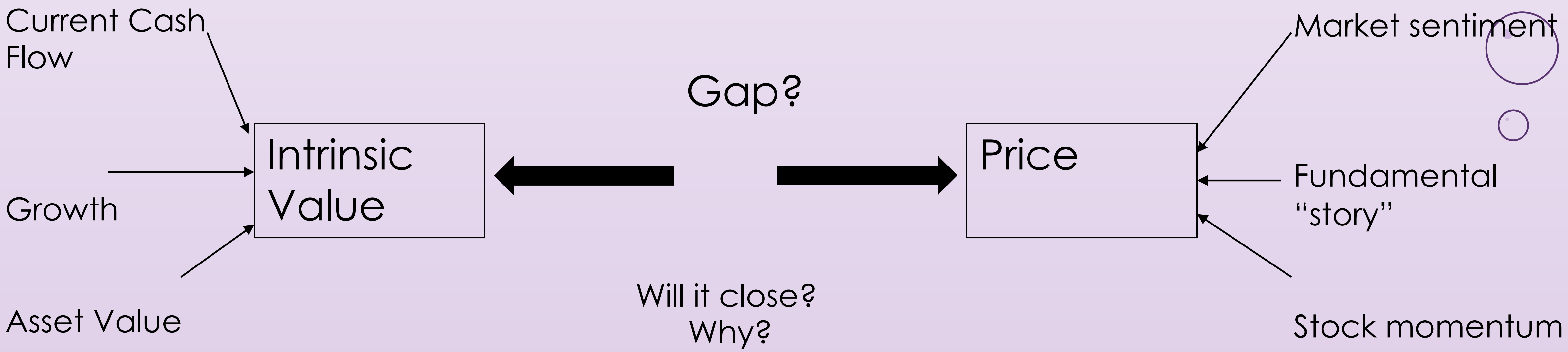
“Most of the time common stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble... to give way to hope fear and greed”

– Benjamin Graham


"Greed … is good. Greed is right.
Greed works."

“Price is what you pay, value is what you get”

– Warren Buffett


Current Cash Flow
Growth
Asset Value
Intrinsic Value
Gap?
Will it close? Why?
Price
Market sentiment
Fundamental "story"
Stock momentum

Determining Intrinsic Value

- Is it “knowable”?
- Discounted Cash Flow model
  - Project future cash flows
  - Determine the appropriate interest rate
- Advantages
  - Value the business to consider the stock
  - Forces you to consider the details
  - Build conviction about your point of view
- Challenges
  - Many more assumptions necessary than other methods
  - Result is easily manipulated
  - In certain market environments, everything might look over valued or under valued

Relative Valuation

- How do you price a business?
  - It’s not the stock price!
  - Need a way to compare similar assets
- Multiples are a price for a business
  - Variety of different multiples can be used, e.g. P/E ratio, EV/FCF, etc.
  - Deciding on the appropriate comparable companies
- Multiples are the most common way that “valuation” is conducted in the real world
  - Advantage - they’re easy to calculate and communicate
  - Disadvantage – it’s all relative so what happens when price is way above or below value?

Expectations Investing

- How I strike a balance
  - Do not make a stock decision based solely on its price, i.e. it’s multiple
  - But building and maintaining a detailed DCF for every holding is not practical
- I try to infer what we can learn from the current stock price
  - A set of DCF assumptions is embedded in any company’s price – those are the market’s expectations
  - My view on those expectations drives my stock view
    - My expectations may be higher or lower
    - Consider how conservative or aggressive key assumptions are