

5B Classes-To-Go! Smashing BI Myths

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Smashing BI Myths




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 **BETTERINVESTING**
The Leader in Investment Education

Classes-To-Go! 5B

Disclaimer

- The information in this presentation is for educational purposes only and is not intended to be a recommendation to purchase or sell any of the stocks, mutual funds, or other securities that may be referenced.



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Two Big Ones

- The "Preferred Procedure is "Too Hard" to mess with*
- The upside/downside (U/D) ratio properly measures risk in buying a stock*
 - Corollary: Price zoning is flawed as well*

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BI Myth #1

- The "Preferred Procedure is "Too Hard" to mess with*
 - Not sacrosanct, some truly disagree, but very widely held
 - Largely a result of misunderstanding what's going on with all methods of projecting future EPS

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BI Myth #1

- Remember, our ultimate goal is to project potential high EPS *figure* in five years, not a *growth rate*
- Three broad ways to do this:
 - Applying a projected EPS rate of increase to historical results (probably most common)
 - Preferred Procedure (based on projected sales growth)
 - Use analyst projections

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BI Myth #1

- Preferred Procedure involves four judgments:
 - Projected total sales/revenues five years out
 - Projected pre-tax profit margin in five years
 - Projected income tax rate five years out
 - Projected shares in five years

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BETTERINVESTING NATIONAL CONVENTION

BI Myth #1

- Preferred Procedure involves four judgments
- And results in "Expected Income Statement"

ORACLE CORPORATION
CONSOLIDATED STATEMENT OF OPERATIONS
For the Year Ended May 31, 2008

	2008	2007
Revenues	\$ 33,937	\$ 32,600
Operating expenses:		
Sales and marketing	6,679	6,049
Software license updates and product support	967	967
Cost of services	3,084	3,084
Research and development	2,741	2,741
General and administrative	869	869
Amortization of intangible assets	1,252	1,252
Acquisition related and other	128	128
Restructuring	41	41
Total operating expenses	16,551	16,551
Operating income	17,386	16,049
Interest expense	(984)	(984)
Nonoperating income, net	251	251
Income before provision for income taxes	16,653	15,316
Provision for income taxes	(2,822)	(2,822)
Net income	\$ 13,831	\$ 12,494
Earnings per share:		
Basic	\$ 1.30	\$ 1.22
Diluted	\$ 1.28	\$ 1.20
Weighted average common shares outstanding:		
Basic	10,610	10,310
Diluted	10,720	10,310

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BI Myth #1

Four judgments → Expected Income Statement

Oracle Corporation (Ticker: ORCL) Income Statement

	Current 5/31/2008	Expected 5/31/2013	Calculation for Projections
Revenues	\$22.6 billion	\$39.8 billion	2008 revenue increased at 12% proj. growth rate
Pre-tax Profit	\$9.6 billion	\$16.3 billion	Revenues times 41% proj. pretax margin
Income Taxes	\$2.8 billion	\$4.7 billion	Pre-tax profit times 29% tax rate
Net Income	\$6.8 billion	\$11.6 billion	Pre-tax profit minus income taxes
Diluted Shares	5230.8 million	6230.8 million	
Earnings per share (EPS)	\$1.30	\$2.22	Net income divided by proj. diluted shares

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BI Myth #1

- "Graphical" Expected Income Statement
- Same four judgments

07 2008 2009 2010 2011 2012 2013

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BI Myth #1

- Some reasons given not to use the Preferred Procedure:
 - "Too many 'guesses' "
 - But **all** methods require projecting sales growth, profitability, taxes and shares (preceding slide)
 - Would you rather do it "implicitly" (blindly) or "explicitly" (intentionally)

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BI Myth #1

- Some reasons given not to use the Preferred Procedure:
 - "It results in projected EPS being too 'low' "
 - Usually caused simply by using "defaults" - projecting current into future
 - Could be a good reason to use the Preferred Procedure

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BI Myth #1

- Other considerations:
 - Historical sales often more consistent than EPS
 - Thus growth rate can be easier to project
 - Where do you start the EPS future trend line?
 - Last fiscal year (usual method), last fiscal quarter or end of historical trend line?
 - It's really not "harder," just a little more detailed

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BI Myth #1

And realize...

The “Preferred Procedure” really was preferred

“Usually it is better to estimate EPS five years in the future by applying profit and tax margins to the projected sales five years in the future *rather than by drawing an EPS trend line.*” [emphasis added]

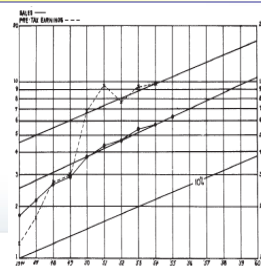
– George Nicholson, NAIC Investors Manual, 1st Edition (1984), page 53.

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BI Myth #1

There was NO earnings per share graph and trend on early SSGs!



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BI Myth #2

- *The upside/downside (U/D) ratio properly measures risk in buying a stock*
 - First, volatility isn't risk
 - Second, U/D ratio doesn't take into account dividend payments
 - Thus, useless in comparing stocks with different dividend yields

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BI Myth #2

- *The upside/downside (U/D) ratio properly measures risk in buying a stock*
 - Finally, you can't rationally quantify market irrationality on either high (exuberant) or low (pessimistic) end
 - Just how well did your projected low prices hold up in 2008-2009?

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BI Myth #2A

- Corollary:
 - Zoning based on low price as well
 - Same problem with rationally projecting irrationality
 - Omission of dividends can impact as well

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Questions?

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