

10 Years, 100 Analysts, and 2,000 Stocks: Learning from Experience

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Introductions

- ▶ Dir. of Equity Research at Morningstar for 10 years, now DoR at Sanibel Captiva Trust
 - ▶ Competitive Advantage / Economic Moats
- ▶ The Sanibel Captiva Trust Company
 - ▶ Independent trust company, founded in 2001
 - ▶ High-touch “family office” business model serving primarily high net worth clients
 - ▶ Buy great businesses at reasonable prices, and let them compound

Agenda

▶ Lessons

- ▶ 100 Analysts + 2,000 Stocks + 10 Years = many successes, many mistakes, and many lessons.
- ▶ Consistent framework
- ▶ Wide range of companies
- ▶ Wide range of market environments

▶ Ideas

- ▶ What looks interesting now?

Process Matters

- ▶ “We enjoy the process far more than the proceeds.” – Warren Buffett
 - ▶ Easy for him to say!
 - ▶ Of course, better process → more proceeds
- ▶ Think *kaizen* (continuous improvement)
 - ▶ Standardize a process, then measure the results
 - ▶ Compare measurements vs. requirements
 - ▶ Innovate to improve results
 - ▶ Standardize new, improved process
 - ▶ Rinse and repeat

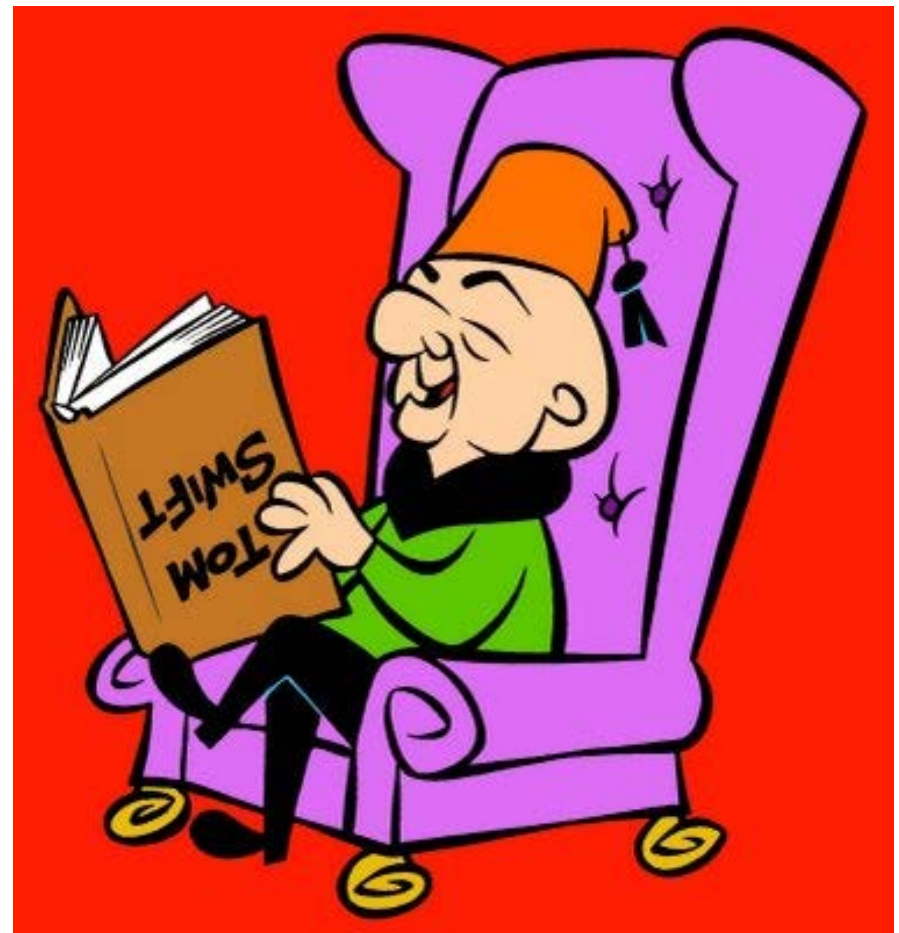
Continuous Learning

- ▶ Great investors take time to reflect
 - ▶ How can I get better?
 - ▶ Can I refine something I do well?
 - ▶ Can I improve an area in which I'm weak?
- ▶ A good investment process evolves
 - ▶ Buffett B.C. (before Charlie) vs. Buffett now
 - ▶ “Nothing has served me better in my long life than continuous learning.” (Munger)

Seven Lessons

- ▶ Mr. Market has Myopia
- ▶ No Comps = Good Value
- ▶ Operating Leverage is Mispriced
- ▶ Numbers Can Lie
- ▶ Disruption Creates Value Traps, Not Values
- ▶ Use the “Too Hard Bucket” Early and Often
- ▶ Moats Are Often Mispriced

My Mental Picture of Mr. Market



#1: Mr. Market has Myopia

- ▶ The Street is *abysmal* at incorporating longer-term information into market prices.
- ▶ Reasons are manifold.
 - ▶ Average mutual fund has ~120% turnover
 - ▶ Annual performance incentives
 - ▶ Increased influence of hedge funds on sell-side research revenue streams
- ▶ Absent a paradigm shift in the structure of money management, *this won't change.*

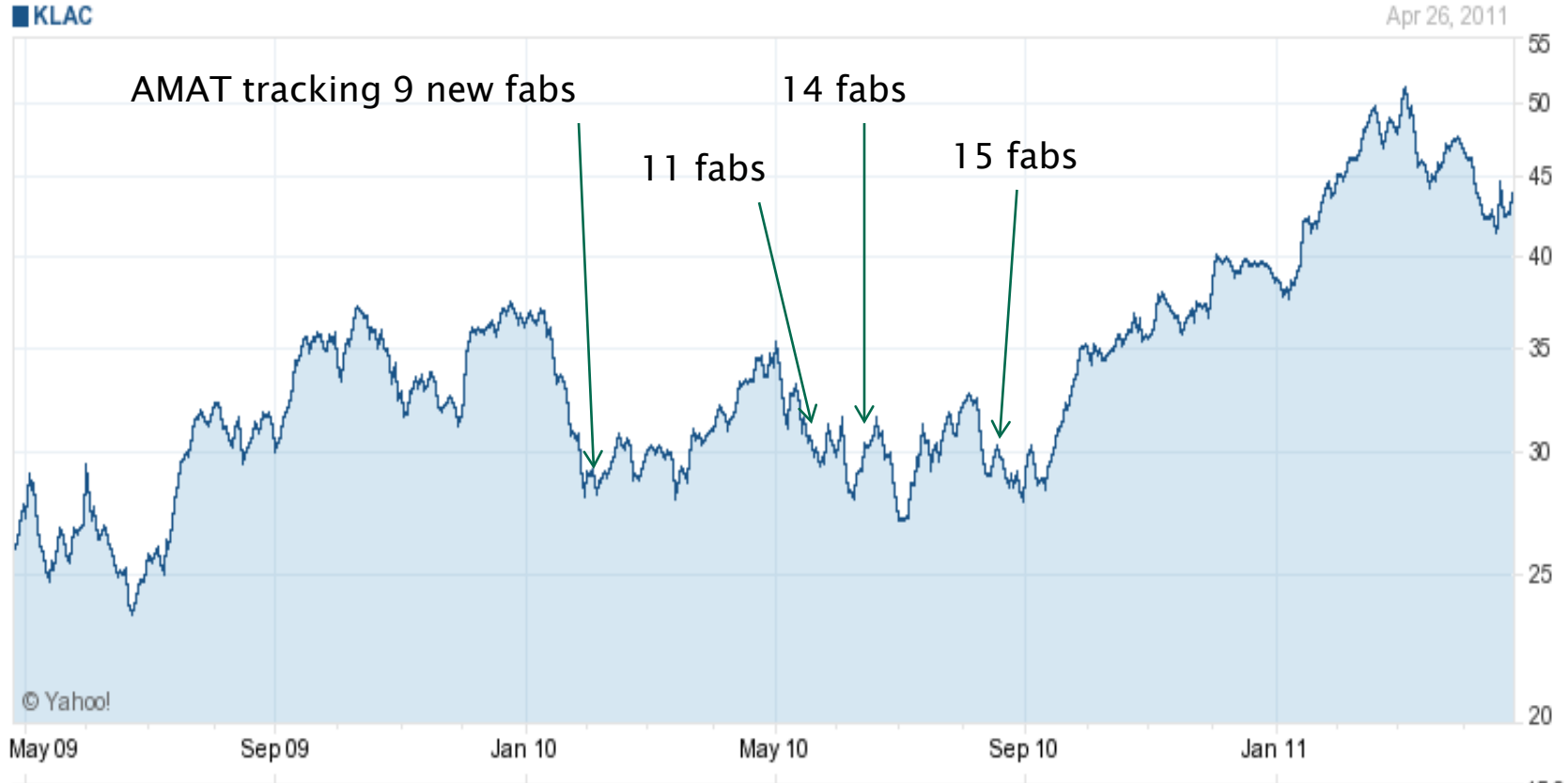
#1: Mr. Market has Myopia

- ▶ A few examples
 - ▶ KLA-Tencor
 - ▶ Ford
 - ▶ Tiffany
 - ▶ Beckman Coulter
- ▶ Takeaway: Focusing on the next few years, (vs. the next few quarters) pays off.
 - ▶ Time-horizon arbitrage is not just a fancy phrase.
 - ▶ A view on cash flow two years out is a variant view

#1: Mr. Market has Myopia

KLA-Tencor Corporation

■ KLAC



#2: No Comps = Good Value

- ▶ The more unique a business is, the more likely it is to be mispriced.
 - ▶ Chicago Merc Exchange: 1st public exchange
 - ▶ 13x trailing earnings @ time of IPO (11x fwd)
 - ▶ Mastercard: 1st public credit card network
 - ▶ 17x trailing earnings @ time of IPO (6x fwd)
 - ▶ Google: 1st public...whatever it is.
 - ▶ 75x trailing / 22x forward
 - ▶ Moody's: Only public bond-rating agency
 - ▶ 23x trailing / 17x forward

I Love Lazy Analysts

- ▶ The sell-side is paid to think inside the box



#2: No Comps = Good Value

- ▶ Takeaway: Look for businesses that don't have good analogues.
- ▶ When you find them, have greater confidence in your variant perception.
- ▶ Odds are that you are one of the few to have actually bothered to look beneath the hood.
- ▶ Odds are also that results will best expectations.

#3: Operating Leverage is Mispriced

- ▶ Anchoring
 - ▶ Hard not to be biased by past margins
- ▶ Linear thinking
 - ▶ We don't naturally think in terms of step changes or power laws
- ▶ Social proof
 - ▶ What's the payoff in showing your boss (or your clients) projections that look "nuts?"

#3: Operating Leverage is Mispriced

- ▶ Company “A” went public in 2006. Pretty hard to make an earnings/cash flow forecast based on a 30% operating margin when the company had never printed better than 13%.

Margins % of Sales	2004	2005	2006	2007	2008	2009	2010
Revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0
SG&A	81.0	80.3	76.9	69.8	58.7	52.8	47.6
Other	5.6	6.3	16.2	3.0	2.3	2.9	2.8
Operating Margin	13.4	13.4	6.9	27.2	39.5	44.3	49.7

Pro-Forma

#3: Operating Leverage is Mispriced

▶ A few examples:

▶ SuperMedia / Dex / Newspapers

▶ Chico's

▶ CME

▶ Ford

▶ Mastercard

#3: Operating Leverage is Mispriced

▶ Takeaways:

- ▶ Forecast in *dollars*, not percentages
 - ▶ Removes some of the anchoring bias, keeps you focused on what matters: Fixed vs. variable costs.
- ▶ Don't fear projections that look "silly."
 - ▶ How many analysts forecasted Mastercard's operating margin increasing from 13% to 44% in three years? Or forecasted the New York Times' margins shrinking from 16% to zero in two years?

#4: Numbers Can Lie

- ▶ The Excel Fallacy
 - ▶ Just because you can chart something doesn't mean it's necessarily useful for forecasting.
- ▶ Inflection points often show up in scuttlebutt before they show up in the data.
 - ▶ Housing Bubble
 - ▶ Cost-cutting during the Great Recession: "We've done five years of restructuring in five months."
 - ▶ Dell

#4: Numbers Can Lie

- ▶ Takeaway: Forward-looking anecdotal evidence may trump backward-looking quantitative evidence.
 - ▶ When everyone points to history to justify a thesis, trouble may be brewing
 - ▶ “All of the data is in the past, but all of the value is in the future.” (Bill Miller)
- ▶ Caveat: Sometimes “the math is the math is the math.”

#5: Disruption Creates Value Traps

- ▶ If a business is being disrupted, it's a value trap, not a value.
 - ▶ “Disruption and commoditization are the long story arc of technology.”
- ▶ Dell
- ▶ Nokia
- ▶ Eastman Kodak
- ▶ Garmin
- ▶ Avid
- ▶ Best Buy
- ▶ Newspapers
- ▶ Encyclopedias

#5: Disruption Creates Value Traps

- ▶ Current example: Research in Motion RIMM
 - ▶ 9x earnings and an 11% cash return...
 - ▶ Whatta deal!
 - ▶ Or maybe not...
 - ▶ Consumer push has flopped (Storm? Torch?)
 - ▶ Multiple OS platforms are a pain for developers. Why develop for BB OS and QNX when you can just write for iOS – and have a bigger market?
 - ▶ Shipped a tablet *without an email app*.
 - ▶ Company is trying to do too much, rather than focusing on core strengths.

#5: Disruption Creates Value Traps

- ▶ Classic “regression to the mean” investing may not work *if the mean is shifting*.
- ▶ Technological change + competitive evolution create non-stationary data series.
- ▶ Takeaway: Be careful when a business in a changing industry is “statistically cheap.”

#6: Use the “Too Hard” Bucket

- ▶ You can't reliably forecast commodity prices.

Commodity	Expected 2007 % Change (as of 12/06)	Actual Year to Date Change	Current Expected 2007 % Chg
Uranium	-6.41	56.94	-23.50
Nickel	-38.91	45.24	-39.42
Tin	-30.40	30.32	-35.55
Copper	-15.63	28.73	-27.03
Lead	-39.31	21.02	-30.98
Platinum	-6.84	12.81	-9.01
Natural Gas	1.96	11.08	-0.08
Gold	7.19	7.90	-2.51
Silver	-10.92	7.79	-3.06
Aluminum	-13.70	3.08	-9.55
Oil	2.84	-1.03	-3.68
Zinc	-30.49	-12.06	-1.41

#6: Use the “Too Hard” Bucket

- ▶ Political/regulatory risk isn't much easier
 - ▶ True, the initial nasty regulatory proposal is often watered down by well-heeled lobbyists.
 - ▶ But sometimes messianic zeal (or ignorance) trumps the politico's need for campaign cash.
- ▶ What's your edge in reliably forecasting the outcome of a regulatory/political decision?

#6: Use the “Too Hard” Bucket

- ▶ Political risk is worse than legal risk. Juries may be even less rational than politicians, but at least their decisions can be appealed.

- ▶ For-profit education
- ▶ Sallie Mae
- ▶ Tier-1 capital ratios
- ▶ Interchange fees for debit cards



#7: Moats Are Mispriced

- ▶ Competitive advantage is not part of the modal investor's mental framework.
 - ▶ Recency bias looms large.
 - ▶ "Spreads" on time-horizon arbitrage are material.
 - ▶ Inefficiencies abound, even in larger-cap stocks.
- ▶ Fuller's three sources of alpha
 - ▶ Informational, analytical, and behavioral
 - ▶ Thinking about moats gets you two out of three

#7: Moats Are Mispriced

▶ Simple index

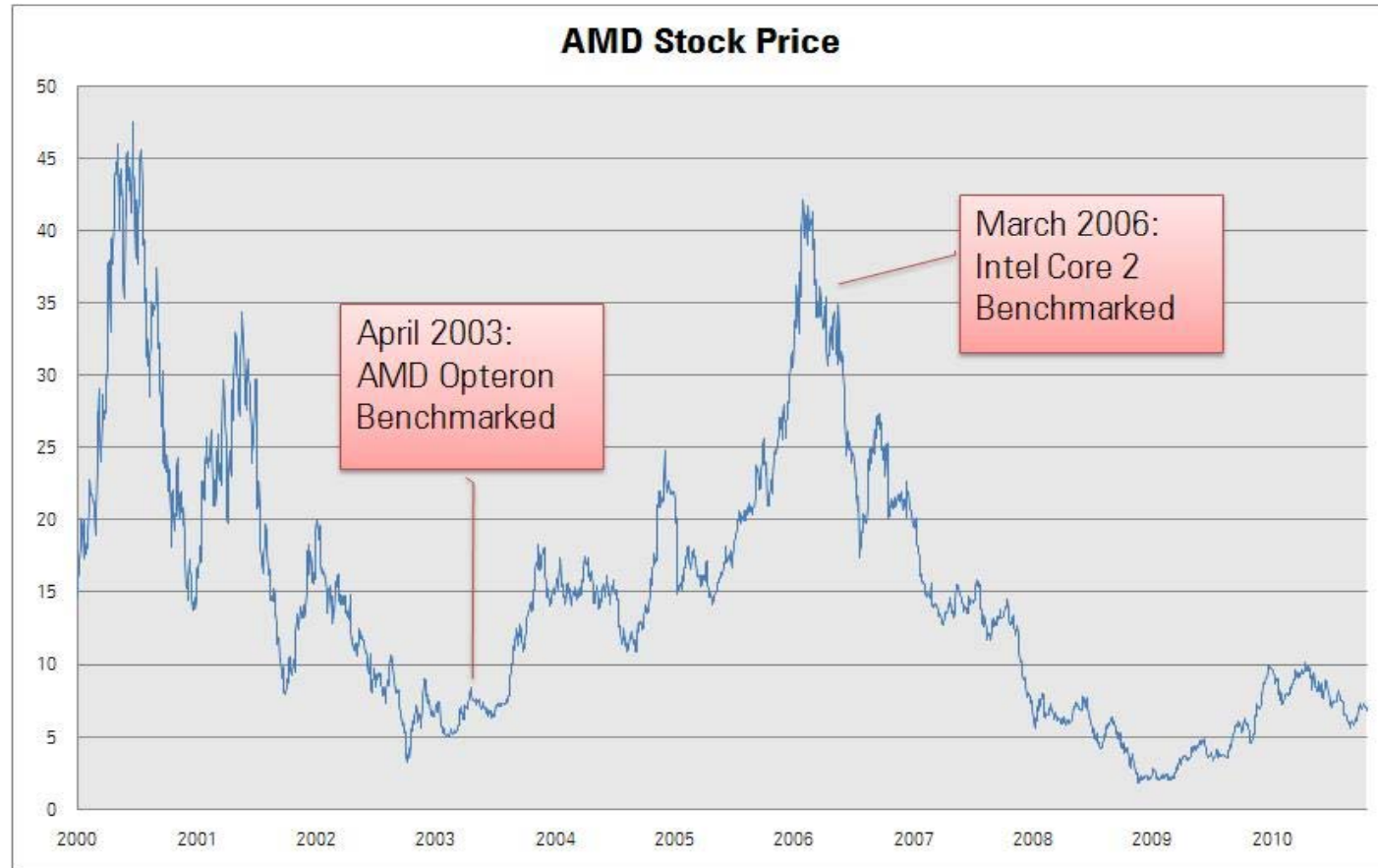
- ▶ Start with universe of ~120 wide moat stocks
- ▶ Select 20 at largest discount to intrinsic value
- ▶ Equal-weight, and rebalance quarterly

	YTD 2011	Trailing 1-Year	Trailing 3-Year	Trailing 5-Year	Inception (10/2002)
Morningstar Wide Moat Focus	7.2%	8.2%	10.1%	8.9%	15.2%
S&P 500	4.3%	11.7%	0.1%	2.1%	7.9%

An Idea

- ▶ Advanced Micro Devices AMD
 - ▶ Huh?
 - ▶ No moat, but low expectations
 - ▶ Less capital intensive after foundry spinoff
 - ▶ New chip architecture gives opportunity to capture market share from Intel, which would drive sales and substantial margin expansion
 - ▶ Intel has 95% share in servers – little left for AMD to lose
 - ▶ New AMD chips should have an advantage in datacenters
 - ▶ Gaining 10 percentage points of server share would double AMD's operating income @ 65% gross margin

A Little History



Source: Morningstar Equity Research

An Idea

- ▶ Thesis centers on AMD's "Bulldozer" server chip, shipping in mid-2011
 - ▶ More cores per server = more efficient usage of physical space and power consumption, vs Intel
 - ▶ Should be very attractive to virtualized datacenters
- ▶ However, notebook and desktop chips have potential as well
 - ▶ ATI acquisition puts GPU and CPU on same chip
 - ▶ Much better metrics than Intel's Atom

An Idea

- ▶ Bottom line: Very good risk/reward
- ▶ Worst case: New architecture flops, putting AMD back where it was six months ago.
 - ▶ Maybe \$6 or \$7 per share
- ▶ Base case: Server OR desktop/notebook chips gain share, other one flops.
 - ▶ Incremental ~\$125mm in op income = \$15/share
- ▶ Upside case: Market extrapolates small share gains into large (and improbable) share gains.

Thanks

▶ Questions?

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