November 08, 2005

Project for Oct. 16th-choose one of these companies. These companies have not been chosen randomly. All are interesting.

Symbols

RCII	TBL	COLM
LXK	KCP	DPZ
IPG	CECO	EFD
PFE	KSWS	ABES
MAT	KG	KND
UST	MVL	LIZ
AEOS	NCOG	PETC
FL	OVTI	PGI
FOSL	TPX	WGO
GPS	INSP	COCO

GI: I want to go over your papers. In general for a first attempt they were very good. I guess big, big picture, I would like a more concise pitch.

I read an article about *Bill Miller* who runs the Legg Mason funds, and he has done tremendously and he has beaten the market for the last 14 or 15 years. He is an interesting value investor but they run billions and billions of dollars.

He wants a pitch very concise and fast. It helps you if you can summarize your pitch very quickly. This company is trading –it is out of favor now; it is earning less money but if you look at normalized earnings it is trading at 5 times normalized earnings and ROIC is 50%; they are closing their money losing division so that is why people don't see it. People see it this way and that is why it will get better. You should be able to say it.

You should be able to spit out the pitch and the valuation portion of why you think it is cheap in a few lines but then I want to see the back up. It is just very good practice for you to understand why you are or are not buying something. Or this is what I thought and this is how it turned out. It is a little harder when you are assigned something because you might not have a strong pitch on it. It looks fairly priced. I went through normalized earnings it comes out within the range of fairness. Or I can't predict what normalized is. I you can pick *BBI (Blockbuster)* and say I don't know where earnings are going to be so I have to stay away. Here are three scenarios and if it hits this one, I am going to lose a lot of money and I don't have a lot of confidence which one is going to hit yet.

In answer to the question which was asked of Brian, by the way, which is: "How do you value a company whose earnings are going to drop off a cliff in three years, five years or whatever? It is really nothing more than **a discounted cash flow question**. You make your assumptions about future cash flows and if you can buy it at half of all the cash you would collect, then you would buy it. It is not a Warren Buffett pick but it is a way to make money if you think you will collect that money. It is not super complicated—you are trying to figure out the thing you are buying—**what is it worth and pay a lot less for it.** That is what you are trying to do.

The way I answer most questions is that if I can't figure it out then I say I don't know. Then I have no business investing in that.

Student: How would you think about the terminal value used for BBI?

GI: You know what? Me personally, I would not get that complicated. What are they going to earn in year 1, year 2, …….Year 8 and then figure out what that is worth to me. If I pay $5 now will I get $10 within 8 years. $ of the dollars could be next year and the following year I would receive $1. If I can make an IRR (internal rate of return) on the money I have invested that might look pretty good. A. who cares what I make in year 9 because it will be next to nothing based on my assumptions. **I am not looking for exact answers.** I am looking for—hey, I think it is going to be worth $10 and it is trading $5 to $6. I think that is a pretty good bet there.

E's (a prior speaker who runs an activist fund and who spoke on arbitrage) presentation on Risk Arbitrage. Does anyone have any questions? I think many have misconceptions over what I wrote in the book. Don't try this at home. Not that it isn't a bad place to be but it isn't for amateurs who don't do a lot of work.

What *E* said is that spreads are so thin. Traders are investing in situations with 8% annualized returns or just above the risk free rate. I never looked at the business that way. And I think that is the flaw. I look at it as a risk reward business. I can make a dollar but I can lose $10 and all this happens in three months. A lot of people set it up as an annualized return business. One annualized return can be a lot better where you make ten and lose a dollar.

People look at it the wrong way which was always my complaint. There is too much money chasing returns. I don't think it is particularly relevant right now because plain vanilla arbitrage is not too good. There are always interesting things when something is changing. Brian just went through the takeover battle for Hollywood. There was a $14 bid and it went down to $10.25 that is an interesting one to think about. If you have a strong valuation opinion and you understand how takeovers work, there is a lot of back of forth and *game theory* involved as the buyer tries to get a cheap price. What are the incentives here? The CEO is not trying too hard for them to cut the price and they still are interested. They didn't walk away because the business is going nowhere. They probably wouldn't show up again.

There is a lot of stuff going on there, so it is still fertile ground. And we talked about merger securities to look at sometimes there is overbidding or management is trying to take it private. There is a chance to make money along the way. I am not saying ignore this are completely. I am saying it is its own special area. I originally did not write that book for MBAs. I hadn't taught MBAs yet. I wrote the book for MBA level readers but I had been doing it for 15 years so I didn't realize that. I really meant for lay people.

<u>Comments on Students papers</u>

This is in no particular order, I just went through the papers and made comments. Don't take it personally.

I bunch of people <u>slapped on</u> a bunch of 12 x EBIT numbers. I would not do that lightly; it has to be a pretty good business to trade at 12 x EBIT and people threw out pretty high numbers. Well, it is trading at half that. That might be, but that is a pretty high number. We talked about 10 x EBIT with a 40% take rate is 6% after-tax return that is a pretty good business to trade off for a government guaranteed bond. To take 12 x EBIT you would want to be pretty certain of the business and the growth. I wouldn't throw those numbers around so lightly. There are certain businesses that are worth that or more than that but it ain't cheap!

Once again if it is tough to know what normalized earnings are, the best thing is move on to something you can analyze. **If you can't analyze normalize earnings then you don't have a clue.**

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<u>How to Make Presentations to Portfolio Managers by Bill Miller, PM of Legg Mason</u>

BM: I want to emphasize in your presentations that if you go into capital markets, you will realize that portfolio managers have ultra-short attention spans. **And there is basically no successful portfolio manager of my acquaintance who has ever wanted to hear a story longer than ninety (90) seconds.** Peter Lynch, when a senior analyst came into a pitch him a stock, would turn on an egg timer for 90 seconds. The analyst had to complete the presentation within 90 seconds and be out of there.

If you can't get the portfolio manager's attention within that time with a convincing case then they will assume that you either don't have a convincing case or you are not able to articulate it, and you should go back and figure it out.

Stories not Atoms

The world is made of stories, not of atoms. Most people think of the world as analyzing atoms and its constituent parts, and then I am going to figure out how to value it and then describe it. The alternative way to think about it is to construct a convincing story. Take all your material together and construct a convincing story.

If you speak to a portfolio manager, the best thing to say is, "I want to talk to you about *Homestore* (HOM). It is at $2.25. The 52-week range is $4 to $2 and the all time high was $100 in 2000. I think it is a buy for the following five reasons:

1. Bam
2. Bam
3. Bam
4. Bam
5. Bam

The stock is trading a $2 and change. I think it is worth $6 or $8 or whatever. Here is why I think it is worth that. Here are the risks. Then you are done.

In the presentations: no more than five positive points and three negative points. What is it worth and then you are done.

END