

FIN 237f
Security Analysis
Fall 2012, Module 2
Thursdays, 6:30-9:15pm
Room: International Hall, Sachar Building

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OVERVIEW

Academic research has demonstrated the broad efficiency of financial markets and the difficulty of 'beating the market' on a risk-adjusted basis. Despite this, investors allocate trillions of dollars to mutual funds and hedge funds looking to generate alpha and 'beat the market'. These funds have a sizeable and growing influence on worldwide capital markets, with hedge funds now deploying over \$2 trillion in investment capital. In this course, we examine fundamental-based investment strategies funds use to generate alpha, or positive risk-adjusted returns. We will have a particular focus on long-short equity strategies used by hedge funds and 130/30 mutual funds. Topics include:

- Market efficiency – where does it hold, where does it break down?
- History and structure of public market investing vehicles, including both mutual funds and hedge funds
- Fundamental-based strategies for generating alpha, with a special focus on long-short equity funds
- Fundamental investing in the context of the efficient market hypothesis, establishing the need for an investor to have an informed, differential view to deliver alpha
- Developing core fundamental investing tenets:
 - 'Idea generation': Identifying potentially attractive investments
 - 'What will happen': Developing a fundamental point of view on a company's prospects, with a focus on forecasting company revenues and cash flows
 - 'Where is my alpha?': Comparing that point of view to 'conventional wisdom'
 - 'What can go wrong?': Evaluating risks to your thesis
 - 'Manage risks': applying options and derivatives to a core equity holding
 - 'Declaring victory': setting and applying exit targets
- Application of fundamental investing using alternative strategies
 - 'GARP' (Growth at a Reasonable Price)
 - Relative Value Arbitrage
 - Activist Investing
 - Deep Value Investing
 - Short selling

The course is designed to be relevant not only to students considering a career in stock fund investing, but to those in related careers such as investment banking and asset management.

LEARNING GOALS

At the conclusion of this course, the student should be able to understand:

- How to identify and evaluate a potential investment that can 'beat the market', applying fundamental investment principles, with a special focus on legal and ethical data collection
- How to set and maintain exit targets for an investment, using DCF/NPV and comparable analysis
- How and when to short sell, and how short selling can add value and reduce risk in a portfolio
- How to develop an integrated 'stock pitch', supported by research, justifying a specific investment

COURSE REQUIREMENTS

Required Reading: I have created a course area on the Harvard Business Online website where you can order the required materials for this course. Click on the link to order: <http://cb.hbsp.harvard.edu/cb/access/14318704>. If you have not registered with Harvard Business Online, you will be required to do so. This URL will prove you with a list of required materials for use in this course. The products are listed at the end of this curriculum.

Electronic course materials are in PDF (Portable Document Format) and should be viewed with Adobe Reader, available free at www.adobe.com. Students can access PDF files of course materials via a link of Harvard Business Online for six months from the date of purchase. You will have immediate access to the materials upon placing your order; for subsequent access, you must login to <http://harvardbusinessonline.org/> For technical assistance, please view the Quick Tips section or contact Harvard Business School Publishing at 1-800-810-8858 or 617-783-7700. They are open 8am-6pm Eastern time. They can also be reached at techhelp@hbsp.harvard.edu

In addition to the Harvard casepack, I have other readings which will be distributed via LATTE and recommended readings for students wishing to go deeper in selected areas. See Exhibit A for full details.

Prerequisite: ECON 210f, FIN 201a/205a and FIN 212a or equivalents are mandatory. FIN 233f, FIN 217f and FIN 216f are recommended but not required. The course assumes that you have a working knowledge of accounting and financial ratios, probability theory and the ability to perform and interpret regression analysis. I would strongly urge you to retake this course at a later date if you do not have sufficient statistical, finance, accounting and financial statement analysis background.

Class Participation: Class participation is expected of everyone in this course, and **class attendance is required**. Each week there will be a new stock assigned for evaluation and every student is expected to be prepared to discuss the company in detail, including a thorough analysis of the financial statements. To facilitate participation, I will ask all students to place a name card on their desks. Unexcused absences will adversely affect your participation grade.

Perfect attendance but no participation receives a grade of “B-“ towards the overall grade. Each unexcused absence results in a reduction in this grading element (B+ to B, and so on).

Written Assignments: Team assignments must be done in groups of 3 students. My expectation is that you will have “language diversity” in your groups; this diversity helps ensure that English is the language spoken at team meetings. Grades on each assignment are assigned to all members of the team (although I reserve the right to alter individual grades in certain circumstances, e.g., when it is clear to me that an individual did not contribute to the assignment in a consistent and meaningful way). You will form your teams at our first class, any changes to your team roster must be approved by me.

Grading (50% individual, 50% team)

• Class Participation	INDIVIDUAL	15%
• Income Statement Financial Projection	TEAM	10%
• Value Investing homework	INDIVIDUAL	15%
• Activist Investor summary	INDIVIDUAL	15%
• Short Selling	TEAM	15%
• Simulation homework	INDIVIDUAL	5%
• Final ‘stock pitch’	TEAM	25%

(17.5% for written assignment, 7.5% for class presentation)

Class Format. Classes will be a mixture of lectures introducing new material, discussions of homework assignments and guest speakers. Each team will be required to give a 10 minute ‘stock pitch’ presentation of their final project.

Office Hours I will be available from 5:00 – 6:20 on days before class, or by appointment

Academic Honesty. You are expected to be honest in all your academic work. The University policy on academic honesty is distributed annually as Section 5 of the Rights and Responsibilities handbook. Instances of alleged dishonesty will be forwarded to the Office of Campus Life for possible referral to the Student Judicial System. Potential sanctions include failure in the course and suspension from the University. If you have any questions about my expectations, please ask. *For any work involving historical cases, under no circumstance may you search the internet (or turn to any other outside source) for any information regarding these cases without my permission. Failure to comply with this directive is cheating.*

Special Accommodation. If you are a student with a documented disability on record at Brandeis and wish to have a reasonable accommodation made for you in this class, please see me immediately. Please keep in mind that reasonable accommodations are not provided retroactively.

COURSE OUTLINE

CLASS ONE

Introduction to Security Analysis and Hedge Funds (HFs)

Thursday, 10/25

In this introductory lecture we will answer the following questions, which will provide the foundation for our remaining sessions:

- What is the Efficient Market Hypothesis? Where does it hold, and where does it break down?
- What is a hedge fund? Who invests in them? How are they structured? What are they trying to achieve?
- Given the above, what are the motivations for a HF investor? Where are they convergent and divergent vs. their limited partners and financing sources?

The second half of this class will introduce the class to how fundamental investors find, make and monitor investments, using a specific case example of a successful investment (Bare Escentuals). The example will illustrate the basic 'alpha creation formula' we will develop over the course of the class:

Develop an investment thesis -> Test the thesis to validate 'differential point of view' -> Evaluate and manage risk -> Develop exit target -> Monitor progress -> Exit

Lastly, we will introduce basic techniques for building a financial forecast, providing background context for the first week's homework.

Homework for Week 1 (MINI: team assignment) – Teams will develop a revenue forecast for Mobile Mini (ticker: MINI). That will form the basis for class discussion Week 2.

CLASS TWO

Financial Forecasting Discussion / Intro to Value Investing

Thursday, 11/1

Financial Forecast team assignment due!

Reading: MINI Public Filings (most recent 10-K at minimum) for target of week, + 1-2 representative analyst forecasts which demonstrate 'conventional wisdom' on a business.

Readings: Earnings Game: Everyone Plays, Nobody Wins (HBR OnPoint Enhanced Edition, available through HBS Publishing)

Case: Kmart and ESL Investments (A)

First half: Discussion of how to build a starting point forecast for a 'typical' company, using revenue, profit, cash flow projections, driven from historical analysis. Class discussion will walk through the company the class prepared for homework that week. Key discussion topics to include: drivers of profitability, evaluating company performance in the context of its industry, assessing if this is a 'good business'.

Second half: Lecture introducing the concept of value investing and how funds apply it. We will focus on how to look for value in the balance sheet and footnotes of financial statements. We will also introduce comparable analysis as a tool for evaluating the relative valuation of different stocks.

Homework for Week 2 (individual assignment: BOBE) – Some analysts think BOBE’s sum-of-the-parts value is much greater than its current stock price. Is BOBE a good business? What is the sum-of-the-parts? Students will have to comb the balance sheet and footnotes of a company to identify possible sources of hidden value and apply comparable analysis to establish the value of those different parts. This will form the basis for class discussion Week 3. Students may discuss ideas in their teams, but must turn in an individual assignment.

CLASS THREE

Value Investing Discussion / Testing the Proprietary Viewpoint / Intro to Short Selling

Thursday, 11/8

Value Investing Individual Assignment due!

BOBE Public Filings (most recent 10-K at minimum) for target of week, + 1-2 representative analyst forecasts which demonstrate ‘conventional wisdom’ on a business.

First half: We will discuss the learnings from the value investing assignment.

Second half: Robert Small, Managing Director, Stockbridge Capital Partners. Rob founded Stockbridge, a long-short hedge fund affiliated with private equity fund Berkshire Partners, in 2006. He will discuss, among other things, his approach to developing and testing investment theses.

Homework for Week 3 (team assignment). I will assign a stock and provide a thesis for why it might make sense to sell it short. That thesis will involve assumptions about its historical performance and things that primary data can affirm or refute. The teams will need to both evaluate the public sources and collect primary data, and then summarize their agreement or dispute with the short thesis in the stock.

CLASS FOUR

Intro to Activist Investing

Thursday, 11/15

Short Selling team assignment due!

Reading: **Blockbuster's Former CEO on Sparring with an Activist Shareholder (through HBS Publishing)**

First half: After a short debrief on the short sale assignment, we will introduce the concept of activist investing as an approach for generating alpha. We will review the history of activist investing, including successes and failures by noted hedge funds.

Second half: Lecture introducing the topic of building and testing a ‘differential point of view’.

Key topics are: developing an investment thesis, how that differs across different kinds of business (revenue based, margin based), how to get 100% of the usable information out of public filings, how to collect primary market data (effectively and ethically), how to interview management while complying with Regulation FD. We will then discuss short selling, and how to apply these techniques to short selling. The lecture will draw from selected examples from my personal experience doing all of the above.

Homework for Week 4 (individual assignment) – Select a situation where activist investors have attempted to generate alpha. I will provide some current and recent examples, but students will be free to select any example they are interested in learning about. 2-4 page paper, answering the following questions:

- Why did the fund in question believe there was value to be gained from taking an activist approach? (put another way: what was their investment thesis)
- What is the fund's history – is it typically activist in their approach, or was this unusual for them? Was their approach on this company always activist, or did become activist over time?
- What happened? Did the activism deliver 'alpha'? Why or why not?

CLASS FIVE

Developing Exit Strategies using Monte Carlo Simulation / Arbitrage

Thursday, 11/29

Activist Investing individual assignment due!

First Half: After a short debrief on the activist investor assignment, we will introduce how to think about an exit strategy. Core to this is thinking about a range of possible outcomes, and understanding the point at which you have generated as much alpha as you can reasonably expect. We will discuss Monte Carlo simulation as a tool to help devise exit targets and learn how to use Crystal Ball, a popular Monte Carlo Excel add-in.

Second Half: I will begin with an introduction to the strategy of arbitrage, then introduce a guest speaker, James Jampel, Managing Partner of HITE Hedge. HITE is an arbitrage fund, James will share how he assesses relative value to generate alpha without taking market exposure.

Homework: Individual Assignment – use Crystal Ball to build a Monte Carlo simulation
Team Assignment – one paragraph investment thesis for final project, due 2 days BEFORE next class

CLASS SIX

Options and ETFs as a Risk Management Tools / Developing an Investment Thesis

Thursday, 12/6

Crystal Ball individual assignment due!

Investment Thesis team assignment due December 4! (2 days before class)

Reading: Public Filings (most recent 10-K at minimum) for your final project, + 1-2 representative analyst forecasts which demonstrate 'conventional wisdom' on a business

First Half: We will talk in more depth about approaches for applying comparable analysis, particularly for companies with relatively few 'comps'.

Second half: We will begin with a general debrief on the investment thesis assignment to ensure that all teams are as well positioned as they can be for their final project. We will then discuss how to develop a plausible investment thesis. In the real world, the investment thesis is the first stage in the process. We have held off discussing investment thesis development until now because it presumes the building blocks that we have been developing over the past several classes.

Thesis development is part rigorous evaluation of the profit and balance sheet drivers of a business, part creative exercise. We will use several examples to give a range of the types of theses funds might develop and test through their work.

Homework: Each team will test the investment thesis it has developed (incorporating my initial ungraded feedback), developing its findings into a 'stock pitch' that advocates an investment, complete with exit targets and any risk management recommendations. That material should be turned in as a 2-4 page written recommendation, along with a short (<10 pages) PowerPoint the team should be prepared to present at the last class.

People will also receive a short 'investor style' questionnaire to prepare for discussion at the last class. It should take no more than 10 minutes to prepare.

CLASS SEVEN

Making a Stock Pitch / Knowing Yourself as an Investor

Thursday, 12/20 (note - this is scheduled during the final exam block, room assignment may vary)

Stock Pitch team assignments due!

First Half: Each team will have 10 minutes to deliver its 'stock pitch' - its investment thesis and recommendation (complete with exit strategy), based on its primary and secondary research facts.

Second Half: An important part of being an investor is knowing your own strengths and weaknesses. We will discuss the 'investor style ratings' from the style questionnaire, and talk about how to apply each person's strengths and weaknesses to make better investment decisions.

EXHIBIT A – Case and Reading Assignment List

- For most classes, I will assign the reading of a set of public filings and analyst reports. I will be selecting specific stocks to assign during the summer months to ensure that our reviews are topical and current. Those materials will be posted each week on LATTE.
- We have selected required readings, available through HBS Publishing:
 - Week 2: Earnings Game: Everyone Plays, Nobody Wins (HBR OnPoint Enhanced Edition), Kmart and ESL Investments (A)
 - Week 4: Blockbuster's Former CEO on Sparring with an Activist Shareholder
- In addition, I suggest the following recommended readings to students looking to get a fuller understanding of the topics we will develop during this class
 - Week 1: Malkiel, “A Random Walk down Wall Street”
 - Week 2: Graham and Dodd, “Security Analysis”
 - Week 3: Graham, “The Intelligent Investor”
 - Week 6: Brown and Goetzmann, “Hedge Funds with Style”, EFA 2001 Barcelona Meetings (distributed via LATTE)
 - Week 7: Goodspeed, “The Tao Jones Averages”