Practicum in Portfolio Management

Indudeep S. Chhachhi
Overview of Investment Process, Helpful Research Hints, Useful Web Sites
Investment Challenge Guidelines

- Only equities and up to 5% in REITS
- Sector weights not to exceed 10% + sector weighting in S&P 500 Index.
- Must have at least 20 securities
- Maximum initial purchase of 5% and maximum individual holding of 8%.
- Market cap of at least $250 m. at purchase
- Av. Market cap of the portfolio > $10 b.
- Maximum of 5% in cash
- Can’t invest in competitors of TVA
Agenda for the Semester

http://www.wku.edu/~indudeep.chhachhi/hmtva.htm

Week of January 29: Economic Analysis, Sectors Allocation Reports: Analyst Teams

Week of February 5: Sectors Allocation Reports, Sector Weightings, Fighting Fires! Immediate Action Required? Lead Analyst Stock Re-evaluation

Week of February 12: Stock Re-evaluations
Managed Portfolio vs. S&P 500

Performance of Managed vs. Invest in S&P 500
(Aug. 25 to Present)

TVA Portfolio
S&P Index
WKU TVA Portfolio vs. S&P 500

TVA vs. S&P % Returns
(Aug 25 to Present)
## More Comparisons

<table>
<thead>
<tr>
<th>August 25 to Present</th>
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<tbody>
<tr>
<td></td>
<td>TVA Portfolio</td>
<td>S&amp;P 500</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>$23,089.61</td>
<td>1.509%</td>
</tr>
<tr>
<td>Holding Return</td>
<td>12.25%</td>
<td>10.37%</td>
</tr>
<tr>
<td>Weekly Average Return</td>
<td>0.56%</td>
<td>0.47%</td>
</tr>
<tr>
<td>Sharpe's Index**</td>
<td>0.3104</td>
<td>0.4159</td>
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</tbody>
</table>
Importance of Investment Policy Statement

- Emphasizes TVA Rules
- Gives Structure to Decisions
- States Desired Risk Level
- Describes Goals of the Portfolio
- States what is to be Considered when Evaluating Assets
The administration, monitoring, and investment decisions of the TVA endowment fund will be vested in the students of the Practicum in Portfolio class. Each classmate shall participate in the investment decisions of the TVA class while observing all applicable U.S laws, as well as the guidelines set by the Tennessee Valley Authority.

There must be a two-thirds majority vote to act on any investment decision.

The investment plan should produce adequate levels of real return as its primary objective. Given the portfolio’s risk tolerance, the investment actions should also seek to maintain or increase the amount of portfolio assets in order to emphasize a long term investment horizon, while also applying short term actions and goals to enhance the learning experience for the four-month class period.

Equities displaying promising earnings/dividend growth potential shall be considered for purchase or holding; those with low growth prospects or weak return-relative-to-risk characteristics shall be further monitored or ultimately disposed of. Consideration will be given to performance relative to benchmarks, relative risk levels, and company events and policies along with other subjective elements. Portfolio diversification will be maintained in order to avoid any drastic changes in value levels.
“Recovery” Sectors

Which sectors have traditionally done well in “recovery” years?

- Consumer Discretionary, Advertising
  Publishing, Financials, Transportation,
  Technology.

- Also, Past is not a guarantee of the future
Defensive Sectors

Which sectors have traditionally done well in down market years?

- Drugs, Food, Household Products, Beverages, Tobacco, and Utilities

Caveats: These sectors can get pricey (P/E) real fast when market is expecting economic slowdown.

Also, Past is not a guarantee of the future
Stock/Industry Research

- Money.cnn.com
  - (upcoming earning releases, investor research center)
- msn.com
  - (comprehensive: ratios {including P/E for industry}, SEC filings, B/S, I/S, etc.)
- Business.com (for industry reports)
- Earnings estimates— at least from two sources (First Call and Zacks)
- Value Line
- Links on TVA web site
Stock Presentation/Discussion Dynamics

- Start a topic for stocks that are being re-evaluated (or new stocks) on the BB.
- E-mail presentations at least 24 hrs. before the class.
- Non-Presenters need to look through the presentation and do research (if needed) to formulate critical questions.
- Active discussion in class.
Stock Presentation/Discussion Dynamics– Contd.

- Follow the checklist for stock presentations
- Get “free” annual reports
- Firms’ “expectations” for the future should be treated with a box (not grain) of salt!
- Analysts’ bias is very well documented (read article)
- For the stocks in our portfolio, purchase price is a “sunk cost.”
Security Analysis

- Look for “Goodwill” Problems— if any
  - How much goodwill is there (overall as well as a % of BV)? Where did it come from? Has the company written-off huge amounts recently?
  - When doing year-to-year comparisons of earnings, make sure you are comparing apples to apples!
- Look for write-offs (non-recurring, one-time, extraordinary, etc.)— frequency and magnitude (read article).
- Insider activity (ownership & recent transactions)
Security Analysis– Contd.

- Past growth is important to understand where we are but what is critical is an estimate of future growth and where it will come from?
  - Investment landscape is full of companies that had good 4-5 yrs. and then went off into the sunset.

- Compare Operating Earnings growth with Revenue Growth (in percentage terms)
  - Any earnings growth that is NOT a result of revenue growth is a result of cost cutting
  - Ideally, would like to see an ↑ in revenues and an even better ↑ in earnings (in % terms)

- Read Articles on Definition of earnings
Security Analysis– Contd.

- What is the industry dynamics? Future?
- How long has the current management been in place? Bonuses, Compensation?
- Breakdown of Revenue– different divisions, segments, Domestic vs. International.
- Consistency of earnings/margins/ROA.. etc.
- Debt? CF/Debt? How will growth be funded?
- Insider Holdings? Institutional Holdings?
Security Analysis– Contd.

- Net Margins and their growth rates; compared with competitors
- EPS, Revenue, CF numbers as well as growth rates– past 5 yrs. And future estimates (First Call, Zacks)
- Annual P/E ratios (co. as well as industry) and also Relative P/E (S&P 500 as well as industry)
- Set a Target Price (both above and below the purchase price) for subsequent sale (handout)
- Sell Discipline
Security Analysis– Contd.

- P/E can use either historical earnings or forward looking
  - Both have value; **know** which one you are using

Fiscal yr. ending 12/31/04 for ABC co.

\[ P/E \times \left\{ EPS_{12/31/05} \times (1+G_{exp}) \right\} = \text{Expected S.P. on 12/31/06} \]

- P/E used in the equation is based on historical earnings

P/E used is the one **YOU** expect (based on historical and future growth rates of the firm, historical and future market conditions as well as any improvement (or decline) in competitive position
Some Ideas/Industries/Stocks to consider

- Safety & Security (physical as well as computer)
- Bio-Technology/Nano-Technology
- Elderly Care (Nursing Homes, Assisted Living {SRZ})
- Digital Media
### 4 sources of Risk & Return

<table>
<thead>
<tr>
<th>Sources of Risk and Return</th>
<th>Potential Value Added</th>
<th>Predictability of Success</th>
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</thead>
<tbody>
<tr>
<td>Market Timing</td>
<td>4 (High)</td>
<td>1 (Low)</td>
</tr>
<tr>
<td>Currency Timing</td>
<td>3</td>
<td>2</td>
</tr>
<tr>
<td>Sector Rotation</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Security Selection</td>
<td>1 (Low)</td>
<td>4 (High)</td>
</tr>
</tbody>
</table>
Evaluating Risk & Return at the Security Level

<table>
<thead>
<tr>
<th>Stock</th>
<th>Industry</th>
<th>Appropriate Valuation Methodologies</th>
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<tbody>
<tr>
<td>Chrysler</td>
<td>Consumer Durables</td>
<td>Normalized earnings, peak-to-peak growth</td>
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<tr>
<td>Texas Utilities</td>
<td>Electric Utilities</td>
<td>Regulatory Environment</td>
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<tr>
<td>Apache Oil</td>
<td>Energy</td>
<td>Asset Value</td>
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<tr>
<td>Immunex</td>
<td>Biotech</td>
<td>Future Drug Pipe Line</td>
</tr>
<tr>
<td>Sprint PCS</td>
<td>Cellular</td>
<td>Price/customer</td>
</tr>
<tr>
<td>Adaptec</td>
<td>High-Tech</td>
<td>Sequential Qtrly. Ergs. Growth</td>
</tr>
<tr>
<td>Coca-Cola</td>
<td>Consumer-Non-Durables</td>
<td>Relative P/E Ratio; Enterprise Value</td>
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