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Thoughts Galore

Finding a one-arm economist is a rare feat. We are, of course, not talking about finding a physical one-arm economist but rather an economist whose opinions are rarely saddled with “on the other hand.” The underpinning caricature is the economist’s penchant for being too vague. On the other extreme, you can make that case that it is equally as hard to find a one-indicator investor. The caricature, in this instance, is the investors’ obsession with information. Whereas economists tend to be vague, investors tend to be obsessed with information. Investors carry with them the notion that more is better and less is erroneous.

With the advent of the Internet, financial information and its availability have multiplied many folds. Investors are flooded with a myriad of statistics, commentaries, reports, and not least of all, expert opinions. The level of information has prodded investors into thinking that more information is better. A one-indicator investor – or an investor who based his investment on few indicators – is seen as unsophisticated, not “up-to-date,” lazy, and of course erroneous.

Filters are usually deemed by investors to be necessary. The objective of filters is to narrow down the list of available stocks

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based on indicators. Among some of the prevalent indicators are P/E ratio, dividend yield, commodity prices level, institutional ownership, beta, and alpha.

Along the same parallel line, traders, too, has led themselves into thinking that more is better. The more indicators – RSI, Fibonacci, CCI, moving averages, stochastic – the better the setup. This natural tendency of investors and traders alike sprouts from their perception of common sense. To them, it makes “sense” that having the best available information translates into a comparative edge in the market.

But that’s not always the case. To prove my assertion that more indicators are not necessary beneficial, I will resort to the least-used form of logic: *reductio ad absurdum*. In essence, I will start with premise and show that the conclusion is so frivolous that the initial premise must be wrong.

We’ll start out with the premise that more indicators (or information) the better the stock pickings.

Assume for the minute, that an investor uses only one indicator,

which gives him a 52% chance of selecting a stock that will outperform the market. Now assume that he adds another indicator to his repertoire. This indicator gives him an additional 1.5% in out performance percentage. In other words, combining the two indicators would give him a 53.5% chance of selecting a stock that will outperform the index.

Furthermore, assume that in a given year, he invests in 30 stocks. Using one indicator, his chance of outperforming the index that year will be 42.78%. How did I arrive at this answer? Use the binomial distribution property (refer to a statistic textbook or googize the topic).

Using binominal distribution property, we find that his chance of outperforming the index at least 7 out of the 10 years will be 7.84%.

Now, if he uses two indicators instead of one, his chance of outperforming the index in one year and at least 7 out of the 10 year vastly improve. 1 year = 51.55%. 10 year = 19.85%. In sum, this tells us that by adding

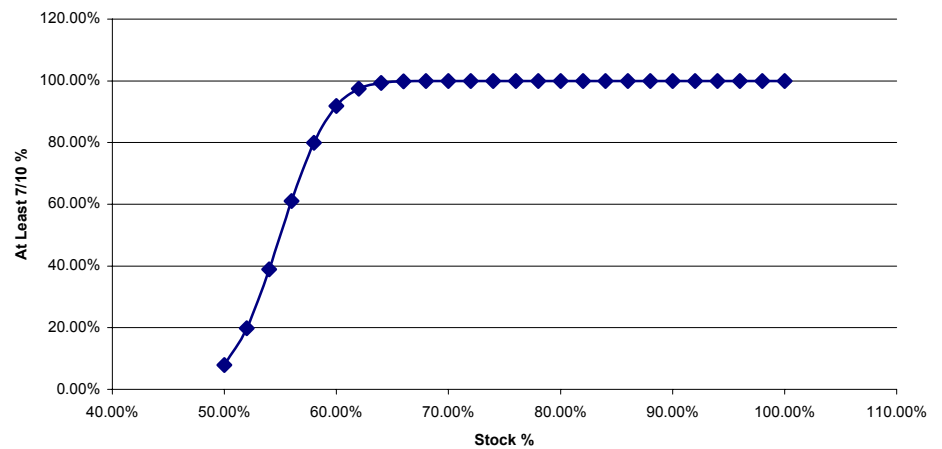
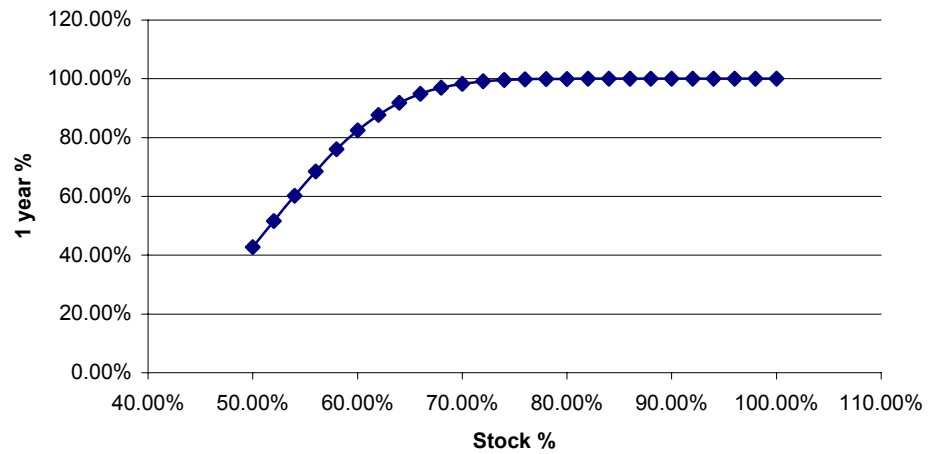
this one additional indicator, his chance of outperforming the index improves.

Now assume that by adding any additional indicator, the percentage of selecting a stock that will outperform the market improves by 1.5%. Thus a third indicator will mean a 55% chance (53.5% +1.5%) of selecting a stock that will outperform. In other words, we assume that adding additional indicators will *linearly* improve his chance of selecting a stock that will outperform

Number of Indicator	Stock %
1	52%
2	54%
3	55%
4	57%
5	58%
6	60%
7	61%
8	63%
9	64%
10	66%

The accompanying two graphs show the impact of increasing the number of indicators. The x-axis is the percentage of selecting a stock that will outperform the index. As we see in both graphs, the higher the percentage of selecting a stock that will outperform, the higher the percentage of beating the index on a yearly basis (holding 30 stocks) and the higher the percentage of beating the index at least 7 out of 10 year.

In fact, as we increase the number of indicators, the percentages of outperforming the index on a yearly and on the basis of at least 7 out of 10 exponentially increase. In other words, simply adding an indicator



will dramatically increase the investor's odds.

Note for emphasis that if the investors use 6 indicators, his percentage of selecting a stock that will outperform the index will be 60%. This leads to an 82.46% of beating the index on a yearly basis if the investors. And this also leads to a 91.84% of beating the index 7 out of 10 years.

Empirical observations, however, tells us that these percentages are difficult to match, if not unattainable. Beating the index on a yearly clip of 82.46% would have put investors in the ranks of Warren Buffet. Outperforming the index at least 7 out of 10 years at a clip of 91.84% is unheard of. Yet we see that by choosing only six indicators, the

investors would expect these percentages.

This frivolous conclusion can only lead us to two paths: either our assumptions are wrong or that our basic premise (more indicator the better) is wrong. The case for the former is very weak. Our assumptions are conservative if not downright too stringent. We assume that the initial indicators would give us a 52% chance of picking a stock that will outperform the index. 52% is a very low percentage. Moreover we assume that each incremental indicator will add 1.5%; this too is very low. The most stringent assumption might be that on a yearly basis, the investor is assumed to hold only 30 stocks. If we relax the assumption and allow him to hold say 50 stocks, the

percentage would exponentially increases.

Having said all of that, we can only come to the conclusion that our basic premise is erroneous. More indicators do not mean higher performance. Note that if the investor uses 10 indicators, the percentage of outperforming on yearly basis is 94.86% and the percentage of outperforming 7 out of 10 year is 99.89%. Not very realistic.

And yet, investors and traders alike routinely use more than 10 indicators.

So what am I implying? Should people stop using information? Should people start using their gut feelings? No. What I am advocating is the prudent usage of indicators. If you look at the table, a realistic number of indicators is either three or four. Investors using three or four would expect to outperform the index on a yearly basis at a clip of 60-70%. And investors would also expect to outperform the index at least 7 out of 10 years at a clip of around 65%.

Again reiterating our conclusion: more indicators are hardly optimal. A handful is more than enough.

Weekly Harbor

All bull markets – secular or not – are resilient in nature. The recent run up (whether it is secular or not is yet to be determined) is a case in point. Investors and pundits alike have called for the end of the recent run up – citing valuation problem, accounting boosting, transitory stimuli, and the weak job market. But the run

up remains intact – attesting to its resiliency. Moreover, despite the concurring observation that the market has already factor in the optimistic six-month forecast, market continues to drive forward on the back of mute economic reports.

The pressing uncertainty is still the duration of the bull. How long can it last? Two months, two years, perhaps ten years? No one seems to have a definitive answer.

What we do know definitively, however, is that this recent run up is muddled in the middle – lacking the strength reminiscent of the bull run of the 90s and lacking the weakness of a prototypical secular bull. What does this mean for investors? Investor should interpret this as a signal for playing the waiting game. Wait for what? Well, investor should wait to see whether or not capital expenditure and the job market could gain momentum. If they don't gain momentum in next six to twelve months, short with a vengeance.

Personally, I think valuation levels are offline. Earnings expectations are extremely optimistic for the next six to twelve months. Unfortunately, valuation analysis adds little to market timing. My beckoning is to wait for the aforementioned confirmation of a further weakening job market and capital expenditure.

What is in store for the next month and next week? I have no clue, and most pundits would give the same respond albeit with a spin. The market is at the first critical inflection point. I recommend we just sit on our hands for the time being.

Cash City

If something seems too good to be true, it usually is. But on occasions, the old adage might prove remiss. First American Corporation (NYSE: FAF), which provides business information and related products and services, currently has cash flow that is astoundingly equivalent to 57.07% of its market cap. To put this in better perspective, shareholders are “entitled” to \$13.10 (in cash) per share from FAF – something you don't see everyday.

Is this a signal of a good bargain or a façade of potential problem? If this is truly a bargain, then we must ask ourselves: why is FAF trading as such a ridiculously cheap level? With regard to the second question, housing concerns clearly has something to do with it. I discuss the potential extremity last week (see last week newsletter). To answer the first question, we'll just have to run a cash flow analysis.

As usually the case, we'll run a five-year cash flow analysis subjected to “stress test,” where determining “fair value” will be based on very stringent assumptions.

We'll assume that revenue growth in fiscal 2003 will come in at -30%; in other words, we're assuming a housing bust. All subsequent revenue growth will be at the estimated rate of GDP growth (3.50%). Note that for the six months ending 6/30/03, total revenues *actually* rose 35%. We're not factoring this in so as to add more cushions. Assume also that profit margin will chime in at

8.17% and cash tax rate in at 37% over the five-year span.

Author's Note

We'll assume that fixed-capital rate, as a percentage of total revenue, will come in at 2.20%. Working capital rate, too as a percentage of total revenue, will assumed to be 1% over the span. With regard to cost of capital, we'll assume 9% - pretty conservative considering that beta is only 0.17. We'll tag inflation rate at 2.20% - roughly the consensus of economists' estimate. And lastly, we'll assume nonoperating liabilities at 1% of corporate value.

Adding all the assumption up yields a "fair value" of \$29.37. Currently, FAF is trading at \$24.18 - a discount of 21.46%. Façade of trouble? Not likely. Bargain? Very.

Not much to comment on.
The two relevant excel files are
Indicatoris.xls for Thoughts
Galore and FAF.xls for Cash City.

	2002	2003	2004	2005	2006	2007
Revenue	\$4,633,278.0	\$3,243,294.6	\$3,356,809.9	\$3,474,298.3	\$3,595,898.7	\$3,721,755.2
Operating Profit	\$378,538.8	\$264,977.2	\$274,251.4	\$283,850.2	\$293,784.9	\$304,067.4
Less: Cash Taxes on Profit		\$98,041.6	\$101,473.0	\$105,024.6	\$108,700.4	\$112,504.9
Net Operating Profit After Tax		\$166,935.6	\$172,778.4	\$178,825.6	\$185,084.5	\$191,562.5
Fixed-capital investment		\$71,352.5	\$73,849.8	\$76,434.6	\$79,109.8	\$81,878.6
Working-capital investment		<u>\$32,432.9</u>	<u>\$33,568.1</u>	<u>\$34,743.0</u>	<u>\$35,959.0</u>	<u>\$37,217.6</u>
		\$103,785.4	\$107,417.9	\$111,177.5	\$115,068.8	\$119,096.2
Free Cash Flow		\$63,150.2	\$65,360.4	\$67,648.1	\$70,015.7	\$72,466.3
Present Value of Free Cash Flow		\$58,165.4	\$55,449.2	\$52,859.8	\$50,391.4	\$48,038.2
Cumulative Value of Residual Value		\$58,165.4	\$113,614.6	\$166,474.5	\$216,865.9	\$264,904.1
Present Value of Residual Value		\$2,466,894.8	\$2,351,695.8	\$2,241,876.3	\$2,137,185.2	\$2,037,383.0
Corporate Value		\$2,525,060.2	\$2,465,310.4	\$2,408,350.8	\$2,354,051.1	\$2,302,287.1
Add: Nonoperating Assets		\$0.0	\$0.0	\$0.0	\$0.0	\$0.0
Less: Debt and other Liabilities		-\$25,250.6	-\$24,653.1	-\$24,083.5	-\$23,540.5	-\$23,022.9
Shareholder Value		\$2,499,810	\$2,440,657	\$2,384,267	\$2,330,511	\$2,279,264
Shareholder Value Per Share		\$32.21	\$31.45	\$30.73	\$30.03	\$29.37

Figures in thousand