

# SSG Judgment Skills

March 25, 2006

<http://tyhughes.net/moosepond>  
<http://tyhughes.net/modelclub>

# Better Investing Principles

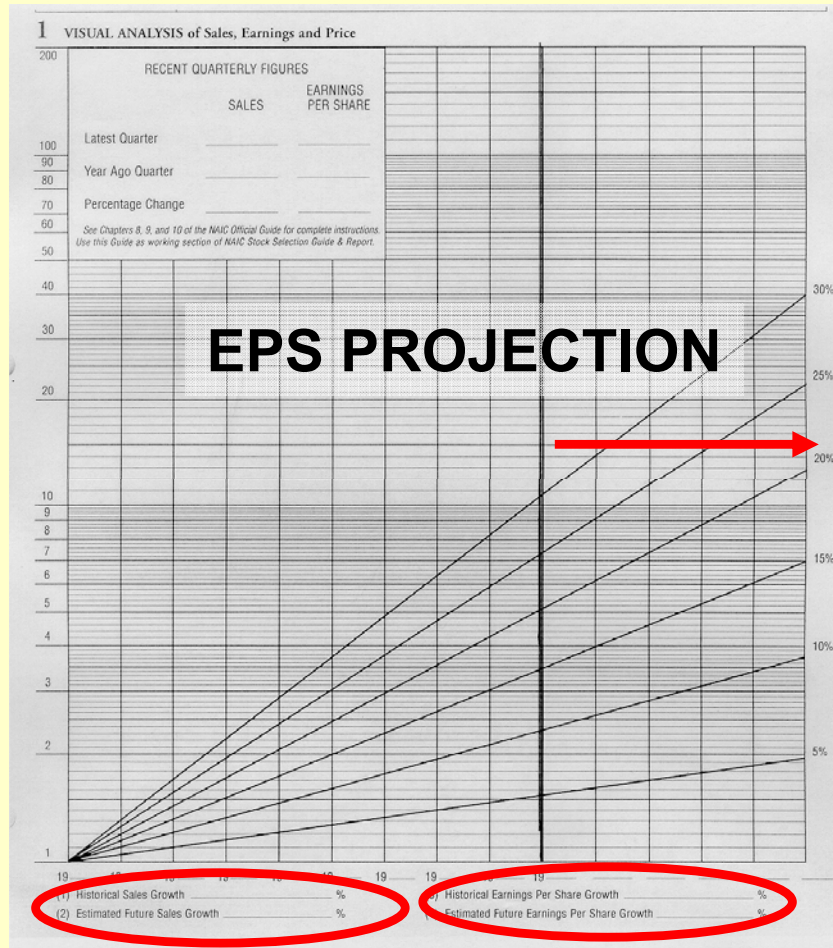
- Invest a fixed amount regularly for the long term
- Reinvest all of your earnings
- Invest only in good quality growth companies
- Diversify (by size and industry)

# Exercising Judgment

- Estimating EPS growth
- Using the preferred procedure
- Projecting 5-year high and low P/Es
- Estimating price in 5-years
- Estimating Dividend Yield

# Forecasting Growth

First two places to apply Judgment: sales and EPS growth



Decisions made on your forecasts for Sales and EPS Growth will impact the rest of the SSG.

# Forecasting EPS Growth

- Use several sources of information
- Make sales projection first
- Be reasonably conservative
- Generally, earnings projections should not be higher than sales projections
- Record your reasons

## Valuation Changes

# P/E Expansion and Contraction

**Example (contraction):**

**Current P/E = 20**

**Projected 5-year P/E = 12**

$$\left( \frac{FV}{PV} \right)^{\frac{1}{n}} - 1 = \left( \frac{12}{20} \right)^{\frac{1}{5}} - 1 = -9.7\%$$

## Valuation Changes

# P/E Expansion and Contraction

**Example (expansion):**

**Current P/E = 12**

**Projected 5-year P/E = 20**

$$\left( \frac{FV}{PV} \right)^{\frac{1}{n}} - 1 = \left( \frac{20}{12} \right)^{\frac{1}{5}} - 1 = +10.7\%$$

## Valuation Changes

# P/E Change More Examples

P/E changes from:

20	→	10	=	(12.9%)	← P/E Contraction
10	→	20	=	+14.8%	← P/E Expansion
18	→	12	=	(7.8%)	← P/E Contraction
20	→	10	=	+8.4%	← P/E Expansion

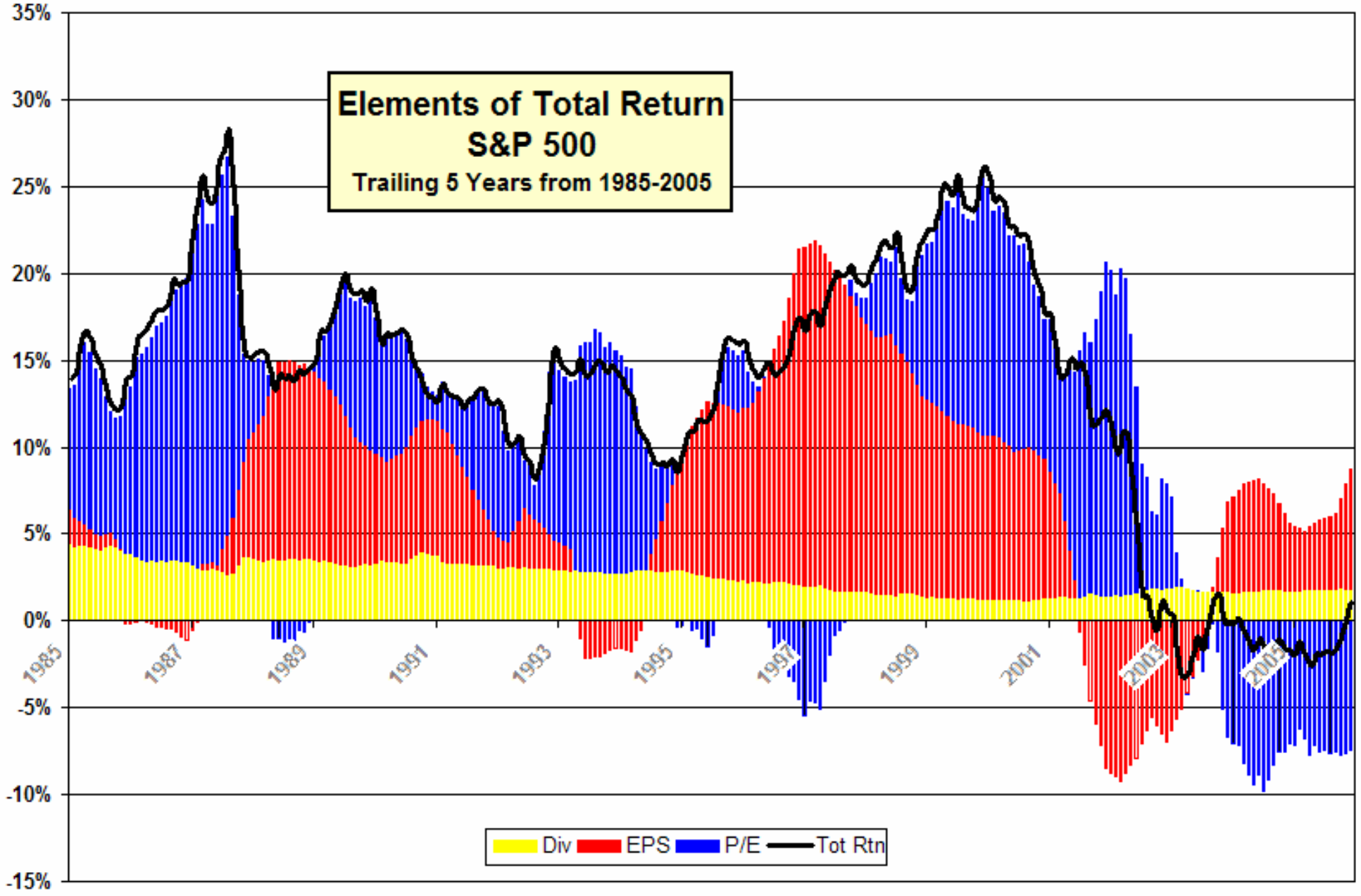
$$\text{Return} = \left( \frac{FV}{PV} \right)^{\frac{1}{n}} - 1$$



# Total Return =



**Elements of Total Return**  
**S&P 500**  
Trailing 5 Years from 1985-2005



Div EPS P/E Tot Rtn

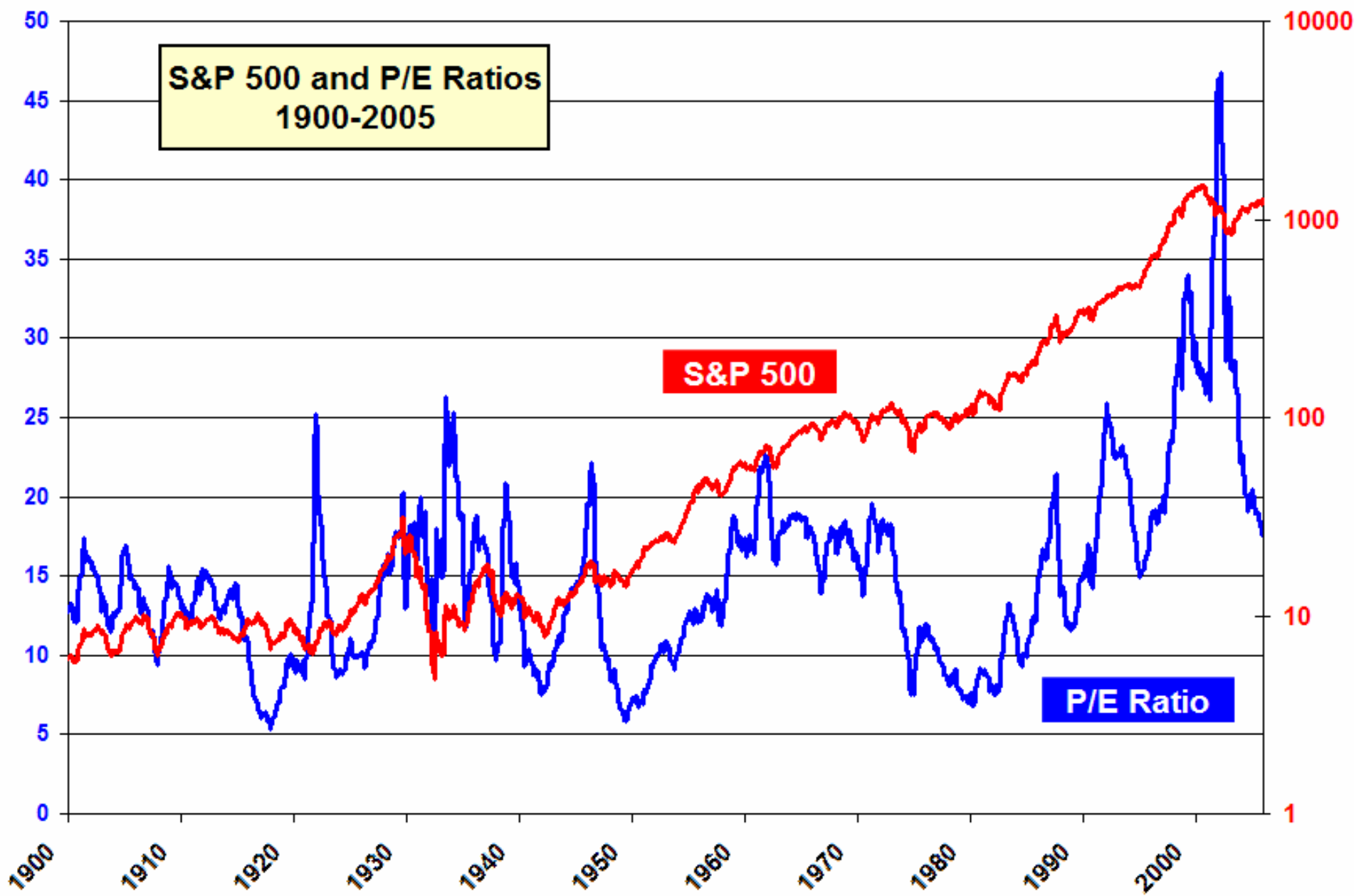
# Between 1988 and 2000

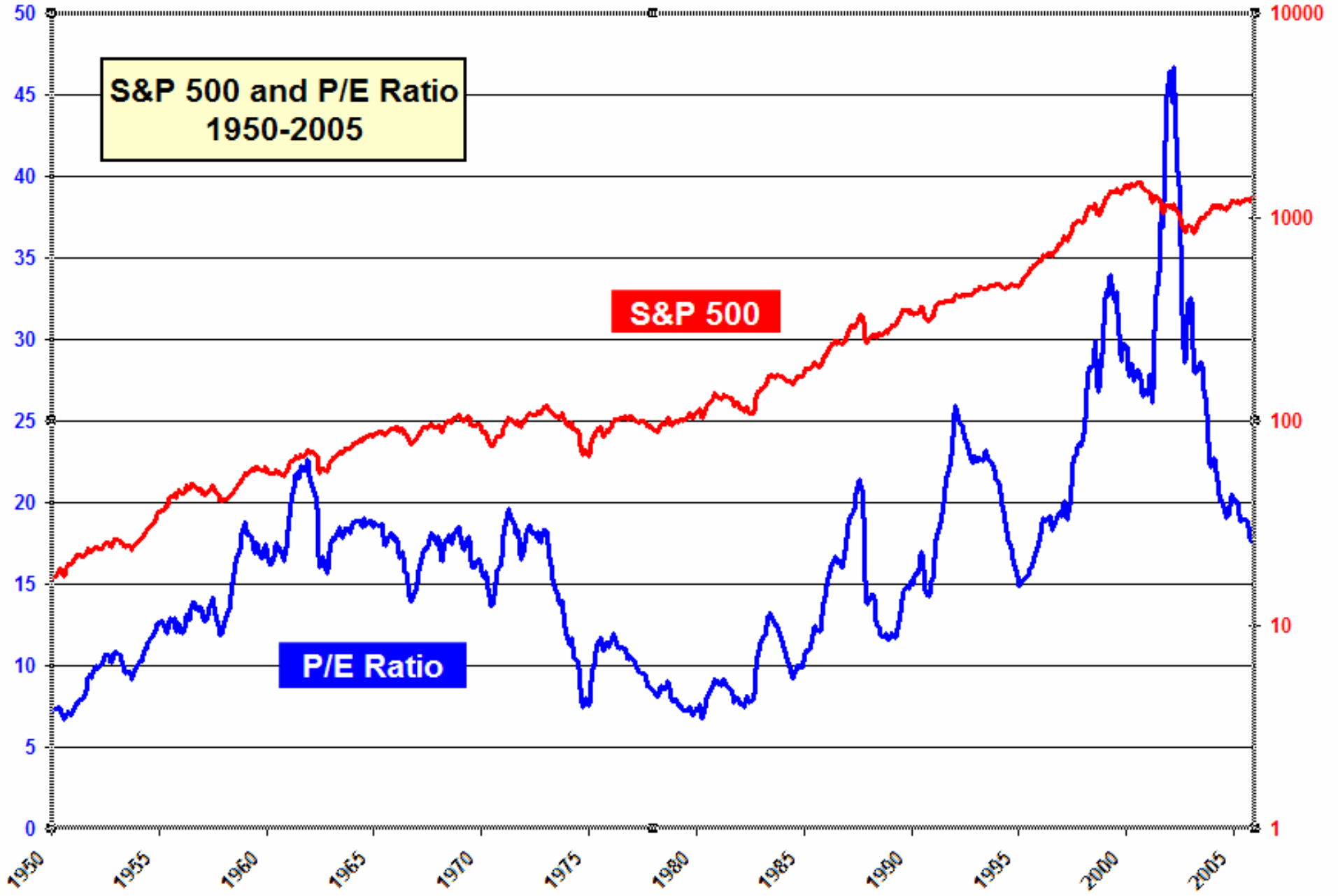


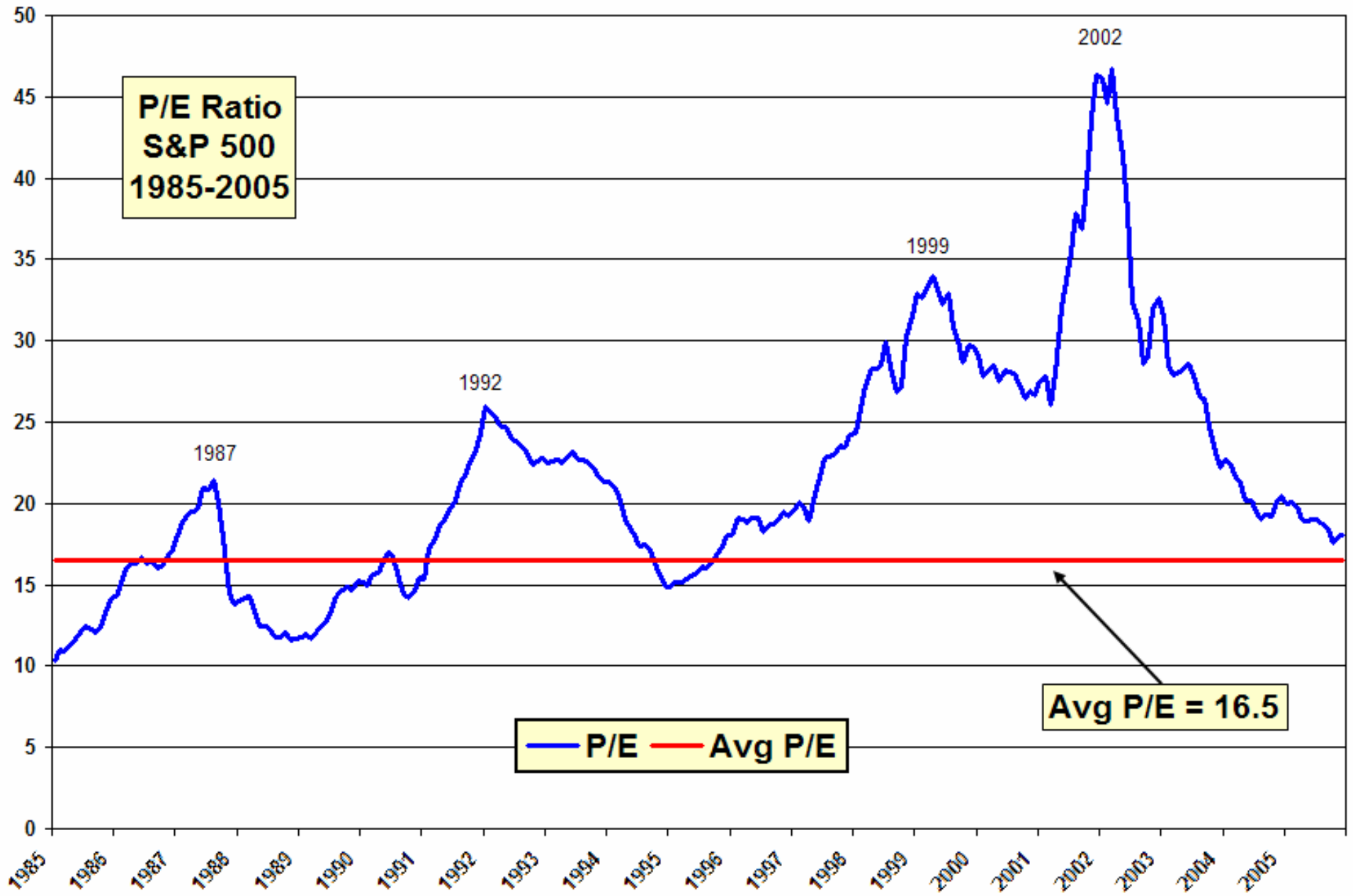
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**= 15% or more return!**







# What Changes P/Es?

**Overall  
Market**

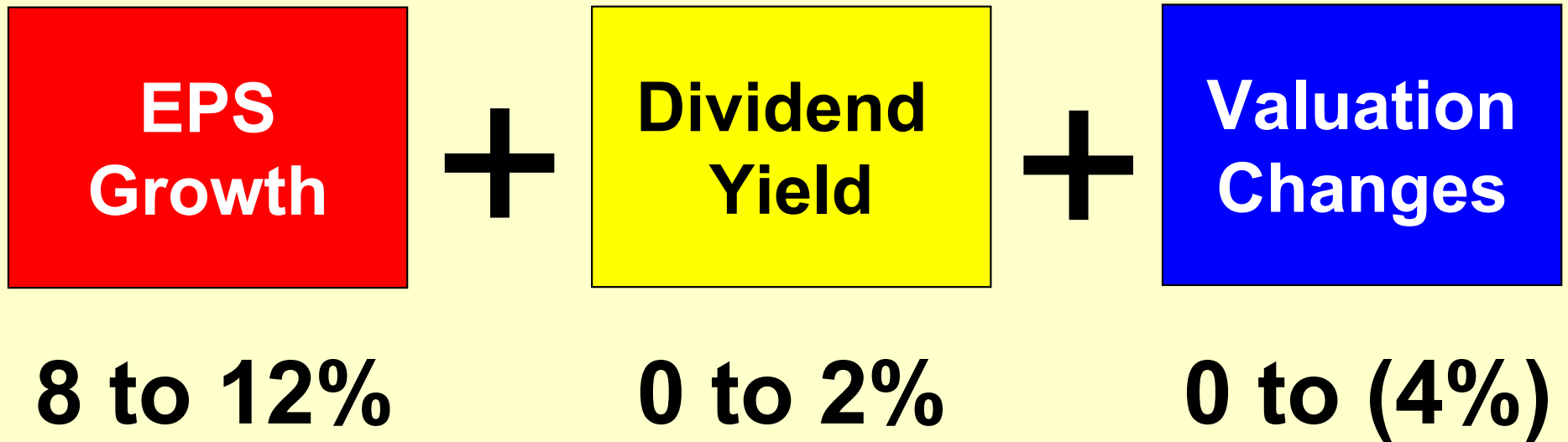
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**Company  
Valuation**

**Inflation  
Interest Rates  
GDP Growth  
Secular Trends  
World Events**

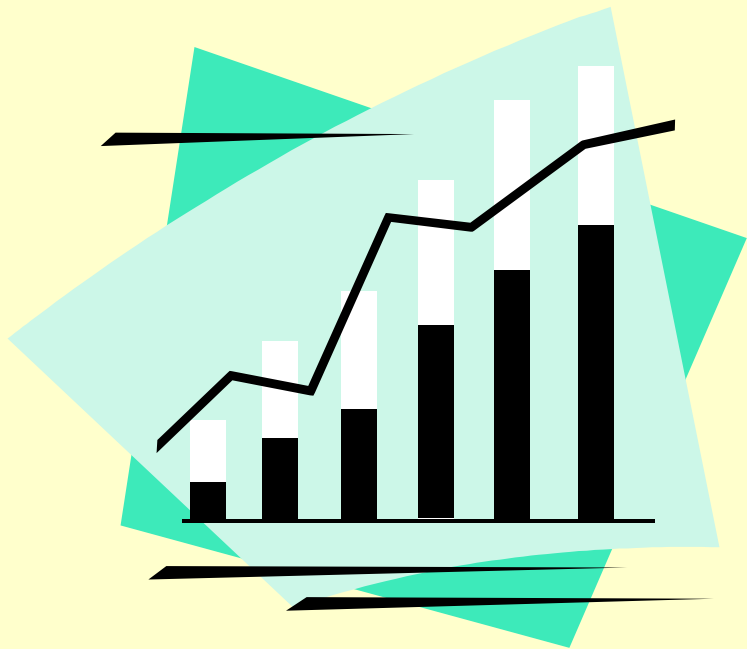
**EPS Growth  
Earnings Quality  
Management  
Economic Moat  
Financial Strength  
Industry Position**

# Return Expectations?





# Judgment matters more today than ever before



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