

Rappaport, Alfred & Mauboussin, Michael – Expectations Investing

Harvard Business Review Press, 2001 [Equity Investing] Grade ★★★★★

A great value investor needs to be a business analyst who grasps the competitive dynamics of businesses, who knows accounting - the language of business, who can value companies and also understand the psychology of others and himself. An excellent investor needs to be a contrarian. Reading value investing books is often a rehearsal on these key themes. *Expectations Investing* by Alfred Rappaport and Michael Mauboussin is no different. What is yet distinctive is that they endorse starting the analysis with the most reliable signal of all - the price of the stock.

The reason I picked up this book was that I wanted to improve on how to filter out interesting stocks. Screening may be a quick and easy tool but it's just the first step. Multiples don't tell enough about whether a stock is cheap or not. Research shows that the market takes the long-term view and value companies based on discounted cash flows. In a recent podcast episode featuring Mauboussin, he mentioned that "*you have to earn the right to use a multiple*" and it ticked my interest. When I found out that he had co-written a book with Rappaport named *Expectations Investing* I decided to read it.

The book is structured in three parts where the first introduces the reader to the activities needed to grasp the price implied expectations (PIE) - the key theme of the book. The second, which is the most important part of the author's view (on which I agree), deals with how to implement the method. The last part focuses on corporate signals and when they should lead the investor to update the outlook. The authors recommend beginning with an analysis of what the market consensus is about future sales, margins, taxes, and investments. Knowing that leads to a free cash flow estimate. Discounted to today, it tells the investor how many years the company is expected to earn a return above the cost of capital. Believing the market is misjudging what the company should reasonably produce in the future, based on a historical analysis or through having special insights about the

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company and industry, it may be an interesting prospect.

This is where the hard work starts. Will the break from consensus come from unexpected volume growth, a better price and mix, cost efficiencies, barriers to entry or something else? Chapter nine of the book is great for the researcher as it describes the key drivers for physical-, service- and knowledge businesses. Another aid is the concept of the "turbo trigger". If growth in sales is most likely to impact the value of the company, the focus should be on the factors leading to higher sales. What if management is fraudulent? Well, to study its past actions and if the management incentives are aligned with the shareholders are always important. Lastly, and maybe most crucially, beware of psychological biases.

The best piece of the book in my view is a case study of the computer company Gateway which summarizes much of the ideas in the book and that can be used as a template for your security analysis. I have already incorporated some of it in my work as I used the example on a company I was interested in while reading the book. To test concepts of a practical book while reading, is arguably the best way to learn. There is also a website for the book with case studies and free material (www.expectationsinvesting.com).

If I were to mention something negative about *Expectations Investing* it is that the authors use a lot of technical terms that are hard for the beginner to grasp. That is no issue for the more experienced investor though. The authors' main idea is that it's better to start with the price, which is a contrarian view as most value investors highlight the risk of anchoring on the price. On the other hand, time is a scarce resource and putting a lot of effort into researching stocks that are priced for perfection seems like a waste. Both methods have their drawbacks and are both hard but having read the book, I have tilted my process a bit in favor of Rappaport and Mauboussin's approach.