10 Years, 100 Analysts, and 2,000 Stocks: Learning from Experience

Pat Dorsey, CFA

Founder and Portfolio Manager,

Dorsey Asset Management

DORSEY ASSET MANAGEMENT

Introductions

- Pat Dorsey, CFA
  - Founder, Dorsey Asset Management
  - Former Director of Equity Research at Morningstar: Created investment philosophy, built team from 20 to 100 analysts, developed institutional research platform
  - Author of *The Five Rules for Successful Stock Investing*, and *The Little Book that Builds Wealth*

- Dorsey Asset Management
  - Single strategy, separately managed accounts
  - Long-only, all-cap, global mandate
  - Concentrated in 10-15 stocks

Agenda

- Lessons
  - 100 Analysts + 2,000 Stocks + 10 Years = many successes, many mistakes and many lessons
  - Consistent Framework
  - Wide range of companies
  - Wide range of market environments

Process Matters

- “We enjoy the process far more than the proceeds.” – Warren Buffett
  - Easy for him to say!
  - Of course, better process → more proceeds
- Think *kaizen* (continuous improvement)
  - Standardize a process, then measure the results
  - Compare measurements
  - Innovate to improve results
  - Standardize new, improved process
  - Rinse and repeat

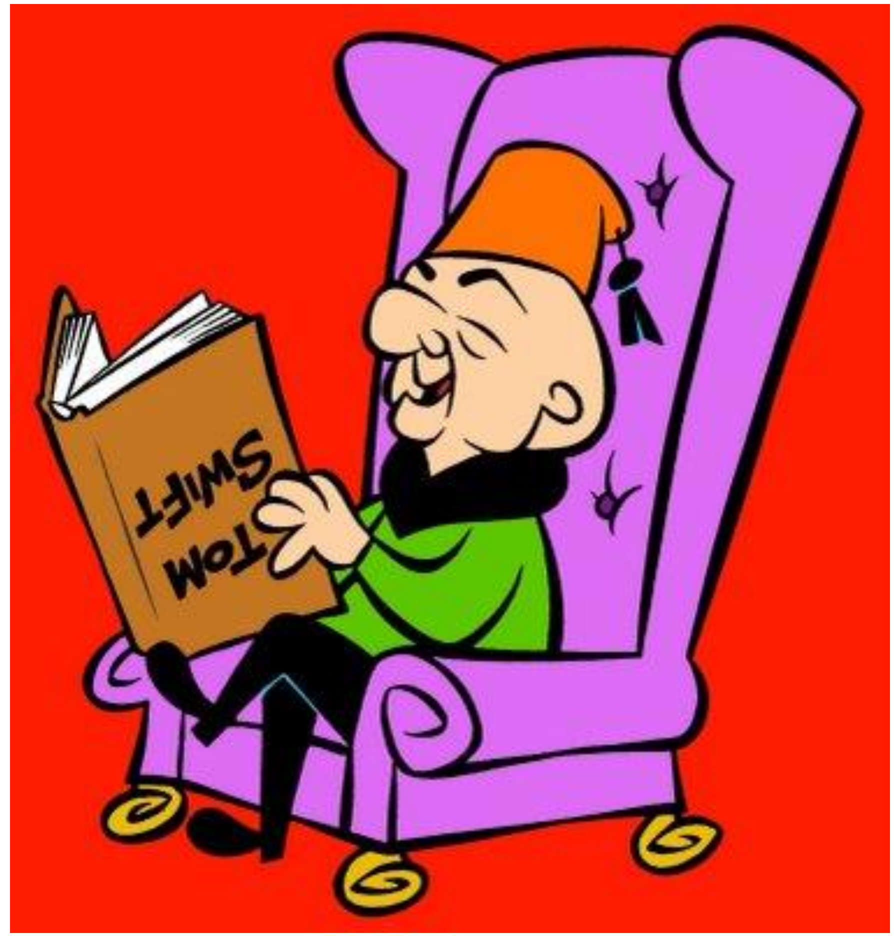
Continuous Learning

- Great investors take time to reflect
  - How can I get better?
  - Can I refine something I do well?
  - Can I improve an area in which I'm weak?
- A good investment process evolves
  - Buffett B.C. (before Charlie) vs. Buffett now
  - "Nothing has served me better in my long life than continuous learning." (Munger)

Seven Lessons

- Mr. Market has Myopia
- No Comps = Good Value
- Operating Leverage is Mispriced
- Numbers Can Lie
- Disruption Creates Value Traps, Not Values
- Use the “Too Hard Bucket” Early and Often
- Moats Are Often Mispriced

My Mental Picture of Mr. Market



#1: Mr. Market has Myopia

- The Street is abysmal at incorporating longer-term information into market prices.
- Reasons are manifold
  - Average mutual fund has ~ 120% turnover
  - Annual performance incentives
  - Increased influence of hedge funds on sell-side research revenue streams
- Absent a paradigm shift in the structure of money management, *this won't change.*

#1: Mr. Market has Myopia

- A few examples
  - KLA-Tencor
  - Ford
  - Tiffany
  - Beckman Coulter
- Takeaway: Focusing on the next few years, (vs. the next few quarters) pays off.
  - Time-horizon arbitrage is not just a fancy phrase.
  - A view on cash flow two years out is a variant view.

#1: Mr. Market has Myopia

#2: No Comps = Good Value

- The more unique a business is, the more likely it is to be mispriced.
- Chicago Merc Exchange: 1st public exchange
  - 13x trailing earnings @ time of IPO (11x fwd)
- Mastercard: 1st public credit card network
  - 17x trailing earnings @ time of IPO (6x fwd)
- Google: 1st public…whatever it is.
  - 75x trailing / 22x forward
- Moody's: Only public bond-rating agency
  - 23x trailing / 17x forward

*This is not a recommendation to buy or sell a security.
Past performance is not an indicative of future results.

I Love Lazy Analysts

- The sell-side is paid to think inside the box

#2: No Comps = Good Value

- Takeaway: Look for businesses that don't have good analogues.
  - When you find them, have greater confidence in your variant perception.
  - Odds are that you are one of the few to have actually bothered to look beneath the hood.
  - Odds are also that the results will best expectations.

#3: Operating Leverage is Mispriced

- Anchoring
  - Hard not to be biased by past margins
- Linear thinking
  - We don’t naturally think in terms of step changes or power laws
- Social proof
  - What’s the payoff in showing your boss (or your clients) projections that look “nuts”?

#3: Operating Leverage is Mispriced

- Company “A” went public in 2006. Pretty hard to make an earnings / cash flow forecast based on 30% operating margin when the company had never printed better than 13%.

Margins % of Sales	2004	2005	2006	2007	2008	2009	2010
Revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0
SG&A	81.0	80.3	76.9	69.8	58.7	52.8	47.6
Other	5.6	6.3	16.2	3.0	2.3	2.9	2.8
Operating Margin	**13.4**	**13.4**	**6.9**	**27.2**	**39.5**	**44.3**	**49.7**

Pro-Forma

*This is not a recommendation to buy or sell a security.
Past performance is not an indicative of future results.

#3: Operating Leverage is Mispriced

- A few examples:
- SuperMedia / Dex / Newspapers
- Chico's
- CME
- Ford
- Mastercard

#3: Operating Leverage is Mispriced

- Takeaways:

- Forecast in *dollars*, not percentages
  - Removes some of the anchoring bias, keeps you focused on what matters: Fixed vs. variable costs.

- Don't fear projections that look "silly."
  - How many analysts forecasted Mastercard's operating margins increasing from 13% to 44% in three years? Or forecasted the New York Times' margins shrinking from 16% to zero in two years?

*This is not a recommendation to buy or sell a security.
Past performance is not an indicative of future results.

#4: Numbers Can Lie

- The Excel Fallacy
  - Just because you can chart something doesn't mean it's necessarily useful for forecasting.

- Inflection points often show up in scuttlebutt before they show up in data.
  - Housing Bubble
  - Cost-cutting during the Great Recession: "We've done five years of restructuring in five months."
  - Dell

#4: Numbers Can Lie

- Takeaway: Forward-looking anecdotal evidence may trump backward-looking quantitative evidence.
  - When everyone points to history to justify a thesis, trouble may be brewing
  - "All of the data is in the past, but all of the value is in the future." (Bill Miller)
- Caveat: Sometimes "the math is the math is the math."

#5: Disruption Creates Value Traps

- If a business is being disrupted, it's a value trap, not a value.
  - "Disruption and commoditization are the long story arc of technology."

Dell	Avid
Nokia	Best Buy
Eastman Kodak	Newspapers
Garmin	Encyclopedias

#5: Disruption Creates Value Traps

- Current example: Research in Motion RIMM
  - 9x earnings and an 11% cash return…
    - Whatta deal!
  - Or maybe not…
    - Consumer push has flopped (Storm? Torch?)
    - Multiple OS platforms are a pain for developers. Why develop for BB OS and QNX when you can just write for iOS and have a bigger market?
    - Shipped tablet *without an email app.*
    - Company is trying to do too much, rather than focusing on core strengths.

#5: Disruption Creates Value Traps

- Classic "regression to the mean" investing may not work *if the mean is shifting.*

- Technological change + competitive evolution create non-stationary data series

- <u>Takeaway:</u> Be careful when a business in a changing industry is "statistically cheap".

#6: Use the "Too Hard" Bucket

- You can't reliably forecast commodity prices.

Commodity	Expected 2007 % Change (as of 12/06)	Actual Year to Date Change	Current Expected 2007 % Chg
Uranium	-6.41	56.94	-23.50
Nickel	-38.91	45.24	-39.42
Tin	-30.40	30.32	-35.55
Copper	-15.63	28.73	-27.03
Lead	-39.31	21.02	-30.98
Platinum	-6.84	12.81	-9.01
Natural Gas	1.96	11.08	-0.08
Gold	7.19	7.90	-2.51
Silver	-10.92	7.79	-3.06
Aluminum	-13.70	3.08	-9.55
Oil	2.84	-1.03	-3.68
Zinc	-30.49	-12.06	-1.41

*This is not a recommendation to buy or sell a security.
Past performance is not an indicative of future results.

DORSEY ASSET MANAGEMENT

#6: Use the “Too Hard” Bucket

- Political / regulatory risk isn’t much easier
  - True, the initial nasty regulatory proposal is often watered down by well-heeled lobbyists.
  - But sometimes messianic zeal (or ignorance) trumps the politico’s need for campaign cash.

- What’s your edge in reliably forecasting the outcome of a regulatory / political decision?

#6: Use the "Too Hard" Bucket

- Political risk is <u>worse</u> than legal risk. Juries may be even less rational than politicians, but at least their decisions can be appealed.
  - For-profit education
  - Sallie Mae
  - Tier-1 capital ratios
  - Interchange fees for debit cards

#7: Moats are Mispriced

- Competitive advantage is not part of the modal investor's mental framework.
  - Recency bias looms large.
  - "Spreads" on time-horizon arbitrage are material.
  - Inefficiencies abound, even in larger cap stocks.

- Fuller's three sources of alpha
  - Informational, analytical, and behavioral
  - Thinking about moats gets you two out of the three

#7: Moats are Mispriced

- Competitive advantage is not part of the modal investor’s mental framework.
  - Recency bias looms large.
  - “Spreads” on time-horizon arbitrage are material.
  - Inefficiencies abound, even in larger cap stocks.

- Fuller’s three sources of alpha
  - Informational, analytical, and behavioral
  - Thinking about moats gets you two out of the three

#7: Moats are Mispriced

- Competitive advantage is not part of the modal investor’s mental framework.
  - Recency bias looms large.
  - “Spreads” on time-horizon arbitrage are material.
  - Inefficiencies abound, even in larger cap stocks.

- Fuller’s three sources of alpha
  - Informational, analytical, and behavioral
  - Thinking about moats gets you two out of the three

An Idea

- Thesis centers on AMD's "Bulldozer" server chip, shipping in mid-2011
  - More cores per server = more efficient usage of physical space and power consumption, vs Intel
  - Should be very attractive to virtualized datacenters
- However, notebook and desktop chips have potential as well
  - ATI acquisition puts GPU and CPU on the same chip
  - Much better metrics than Intel's Atom

An Idea

- Advanced Micro Devices (AMD)
  - Huh?
  - No moat, but low expectations
  - Less capital intensive after foundry spinoff
  - New chip architecture gives opportunity to capture market share from Intel, which would drive sales and substantial margin expansion
    - Intel has 95% share in servers – little left for AMD to lose
    - New AMD chips should have an advantage in datacenters
    - Gaining 10 percentage points of server share would double AMD's operating income @ 65% gross margin

Thanks

- Questions?

- Contact info: pat@dorseyasset.com
- 312-233-2544

Disclosures

This presentation is furnished on a confidential basis to the recipient for informational purposes only and does not constitute investment advice. This presentation does not constitute an offer to sell, or a solicitation of an offer to buy, any interest in any investment vehicle. Any securities mentioned are provided as examples and are not recommendations to buy or sell.

Dorsey Asset Management, LLC (“Dorsey” or the “firm”) does not accept any responsibility or liability arising from the use of this presentation. No representation or warranty, express or implied, is being given or made that the information presented herein is accurate, current or complete, and such information is at all times subject to change without notice. This presentation may not be copied, reproduced or distributed without prior written consent of Dorsey. By accepting this presentation, you acknowledge that all of the information contained in this presentation shall be kept strictly confidential by you.

This document contains information about Dorsey’s strategy and investment philosophy. It includes statements that are based upon current assumptions, beliefs and expectations of Dorsey. Forward-looking statements are speculative in nature, and it can be expected that some or all of the assumptions or beliefs underlying the forward-looking statements will not materialize or will vary significantly from actual results or outcomes.

Dorsey reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. There is no assurance that any securities, sectors, or industries discussed herein will be included or excluded from an account’s portfolio. Investing involves the risk of loss of principal.

Dorsey is a registered investment advisor. Registration does not imply a certain level of skills or training. More information about the firm, including its investment strategies and objectives, can be found in our ADV Part 2, which is available, without charge, upon request. Our Form ADV contains information regarding Dorsey’s business practices and the backgrounds of our key personnel. DAM 16-18