Practicum in Portfolio Management & Security Analysis

BFIN 2555

Statement of Purpose

The practicum is an experiential learning tool in which students manage an investment portfolio. The practicum is designed to expose students to "real world" valuation estimation and portfolio management. Through the collection of geographic, industry specific, and firm specific information, the student managed investment fund is expected to develop an informational advantage in securities with minimal or no analyst following. The students will apply valuation techniques learned in their coursework to real world companies. They will also measure and manage the risk of the portfolio and determine the risk adjusted performance of the portfolio.

Eligible Students

Eligible students include graduate students who have completed Financial Management, Investment Management, and Valuation I and undergraduate students who have completed Corporate Finance and Investments. Students must be available to attend class and complete course work during both the Fall and Spring semesters of an academic year. Regular course meetings will occur on Fridays in the financial analysis lab. The course will be three credits. Students must apply to enroll in the class and admission will be granted on a competitive basis.

Trading Decisions and Trading Procedures

The class will recommend investment decisions based on a majority vote at the investment decision meetings which should be held once each month during the school year. All students who are in good standing in the class are allowed to vote. The process leading up to the voting is as follows:

- Each analyst (either an individual student or group of students) gathers information on potential investments. A potential investment must satisfy the criteria outlined below.
- Each analyst evaluates the assigned subset of stocks.
- The analyst presents each recommended investment idea to the group.
- After the presentations the class votes by a secret ballot on which investments to make.
- The recommended investments are then evaluated by the investment committee based on the portfolio structure and investment goals. This committee then determines the final investments, reports back to the class, and executes the necessary trades.
- The investment committee is a three person committee chosen at the beginning of each semester. The committee should be representative of the distribution of MBA and undergraduate students in the class. The faculty advisor is an ex officio member of this committee.

The investment management meetings should include presentation and discussions on all relevant topics including identifying new opportunities, managing existing assets (buy, sell, hold), evaluating performance and risk and evaluating optimal portfolio holdings.

Majority rule serves to limit speculative positions and excessive trading in the portfolio. Reasoned and carefully researched cases for recommended purchase or sale will win majority approval.

Fund Management During the Semester Breaks

The faculty advisor is responsible for making any decisions which require immediate approval when the students are not available.

Investment Style and Discipline

Style

The fund follows a small- to mid-cap value investment style. The fund's objective is to identify regional stocks with limited or no analyst following whose prices do not reflect all available information. The fund should not purchase securities with active analyst following or with market capitalizations in excess of $4 billion. The fund shall be managed with the intention of obtaining the highest possible total return consistent with maintaining prudent risk. Performance evaluation will use a benchmark appropriate to the investment style. In addition, risk adjusted returns will be calculated in a variety of ways to account for the characteristics of the underlying assets such as size and liquidity.

Eligible Securities

The fund invests in a diversified portfolio of common stocks with a small percentage of assets in money market mutual funds (cash) awaiting reinvestment. Eligible securities include regional stocks with minimal analyst following and market capitalizations less than $4 billion. In certain circumstances with approval of the faculty advisor an analyst may consider a firm that is out of the region. The stock must be traded on U.S. stock exchange. If a portfolio holding is delisted from a major exchange, it needs to be reevaluated immediately. No explicit “social investment” screens restrict purchase of any security. The fund may not short sell any security. The fund may not purchase any security with borrowed money (on margin). The fund may not purchase or sell any option or futures contract.

Diversification

The fund will hold between 20-40 stocks in the portfolio. The fund limits initial positions in individual stocks to no more than 5% of the total market value of the portfolio. No new shares may be purchased if a position exceeds 7% of the portfolio. If a position exceeds 8% of the portfolio due to relative price appreciation, the fund trims its position to below 8%. The fund may not invest in industry sector or international ETFs, and invests in broadly based exchange-traded funds (ETFs), such as the iShares S&P MidCap 400/BARRA Value Index Fund®, only in unusual circumstances.

Security Selection

For each prospective investment, students calculate an intrinsic value, based on a thorough fundamental economic analysis of the company. The investment process involves several steps, which are detailed below.

Identify Promising Companies

Each student manager identifies promising companies in the region for investment from an assigned industry sector (Financials, Consumer Discretionary, etc.). An attractive candidate is a business with a stable or growing long-term sales trend. In estimating long-term sales potential for a company, we consider demographic trends, including both the age distribution and geographical distribution of the population.

We endeavor to find companies with sound fundamentals that are currently out of favor, or have growth potential not fully recognized by the market. Given the relatively small size of the fund, we can easily trade in and out of smaller companies that are "under the radar" of many large institutional investors and Wall Street analysts.

Understand the Business

Analysts learn about the business of the company by reading the latest SEC filings, press releases, brokerage reports, and industry publications. We try to understand the key economic factors that drive revenues and costs. We analyze competition in the industry and barriers to entry. After the initial investigation an on site visit to see the operation and talk with the management of the company is strongly encouraged.

Financial Statement Analysis

Students perform an extensive financial statement analysis of candidate companies. We compare key financial ratios with those of close industry competitors, both in terms of levels and trends. We look for companies with opportunities to improve profit margins and stable or improving asset turnover.

Earnings Forecasting

We create pro forma income statements and balance sheets for the company for future years. The key to value creation is the ability to earn a return on equity above the cost of equity capital. We evaluate the company's past record at creating value from its capital investment (and R&D) decisions, and develop forecasts for the future.

Forecasting sales and profit margins requires an analysis of competition and barriers to entry in the business, the potential for cost savings through use of technology, the macroeconomic outlook, and the company's operating leverage. In forecasting long-run earnings, we recognize that "no tree grows to heaven," and competition eventually drives down extraordinary economic profits.

One key element in earnings forecasting is earnings quality. Because of the reversal property of accounting, expenses that are artificially lowered now must be increased in the future. We use several diagnostics, some utilizing information from the statement of cash flows, to test for earnings manipulation.

Calculating Intrinsic Value

Intrinsic value is derived from a discounted cash flow analysis. This requires estimates of the costs of debt and equity capital for the company. The equity cost of capital is derived from the Capital Asset Pricing Model (CAPM) and related models. Because of the focus on small stocks we need to deal with issues related to size, M/B, and non-synchronous trading (e.g. 3-factor model, Scholes-Williams adjustment). Relative valuation analysis, using ratios of price to fundamentals (e.g. P/E) versus competitors, is also used.

Analysts recommend purchasing stocks if intrinsic value is well above the market price, thus providing a margin of safety. They recommend sale when the market price exceeds the current estimate of intrinsic value, either because of a change in prices or fundamentals.

Reports and Performance Evaluation

Each class is responsible for producing a monthly fund report, detailing fund holdings and investment performance. Reporting follows the Global Investment Performance Standards.

As noted above, performance evaluation uses a benchmark appropriate to the investment style and average market cap of the fund.

Ethics

Both student managers and supervising faculty have a fiduciary responsibility, and must adhere to a strict code of ethics regarding the SIF. All participants must adhere to the CFA Institute *Code of Ethics and the Standards of Professional Conduct*. Classroom discussions regarding potential purchase or sale of any security are strictly confidential. Both students and faculty are prohibited from "front-running" trades made by the fund, purchasing or selling a security when there is a reasonable expectation that the practicum will purchase or sell that security during the class.

Sell Discipline

Using our valuation model, we establish an intrinsic value for each stock, and recommend purchase of stocks trading at a significant discount to intrinsic value. We believe such stocks will provide superior total returns over the next 1-3 years. After we take a position, we monitor the company's progress against our projections, changing our forecasts and intrinsic value as needed.

If the (proportional) discount of market price to intrinsic value widens, we recommend holding or even increasing the position, as long as an increase is not detrimental to the overall risk/return profile of the portfolio. But we recommend sale of some or all of a position if:

- We observe a significant deterioration in fundamentals before the market reaches a similar conclusion
- The market price reaches or exceeds intrinsic value
- We identify another stock trading at a larger proportional discount to intrinsic value, and a rebalancing is consistent with maintaining prudent portfolio risk

- Relative price appreciation results in an excessive weighting of a stock within the portfolio
- The firm-specific (idiosyncratic) risk of the stock increases significantly, which does not affect intrinsic value but affects portfolio risk

Risk Management

The fund follows a small-to-mid cap value investing style. Thus, we can be expected to evaluate the fund's risk as they would evaluate the risk of any other small-to-mid cap value fund. To the extent that fund returns closely track the returns to unmanaged small and mid-cap value indexes, we are better able to manage its total portfolio risk. Wide return deviations from recognized style benchmarks make overall risk management difficult. Before recommending specific transactions, student analysts evaluate how the transactions affect fund risk, including looking at current fund industry sector weightings versus the benchmark.

Transitional Period

During the first few years, the fund will be in transition from its current form so the portfolio and security constraints will be relaxed until the portfolio is well diversified. In addition, currently held stocks should be evaluated based on their valuation merit and new investments should conform to the above rules.