Expectations Investing
Reading Stock Prices for Better Returns

Chapter 1
The Case for Expectations Investing

Excerpt from Chapter 1

Flip on CNBC or read any popular business magazine and you'll get a familiar story. The growth money manager will explain that she looks for well-managed companies that have rapidly growing earnings but that trade at reasonable price-earnings multiples. The value manager will extol the virtues of buying quality companies at low price-earnings multiples. It happens every day.

But think for a moment about what these investors are *really* saying. When the growth manager buys a stock, she's betting that the stock market isn't fully capturing the company's growth prospects. The value manager bets that the market is underestimating the company's value. In both cases, they believe that the market's current expectations are incorrect and are likely to be revised upward.

Even though investors invariably talk about expectations, in most cases they're talking about the wrong expectations. The errors fall into two camps. Either investors don't appreciate the *structure* of expectations or they do a poor job of *benchmarking* expectations.

An example of a faulty structure is a near-messianic focus on short-term earnings. As it turns out, short-term earnings are not very helpful because they are a poor proxy for how the market values stocks, making it difficult for investors to use them to quantify market expectations. Yet even those investors who do embrace an appropriate economic model often miss the mark, because they fail to benchmark their expectations against those of the market. Without knowing where expectations are today, it is hard to know where they are likely to go tomorrow.

The central theme of this book is that the ability to properly read market expectations and anticipate expectations revisions is the springboard for superior returns—long-term returns above an appropriate benchmark. Stock prices express the collective expectations of investors, and changes in these expectations determine your investment success.

Seen in this light, stock prices are gifts of information-expectations—waiting for you to unwrap and use. If you've got a fix on current expectations, then you can figure out where they are likely to go. Like the great hockey player Wayne Gretzky, you can learn to "skate to where the puck is going to be, not where it is." That's expectations investing.

Questions Addressed in Chapter 1

To make the case for expectations investing, Chapter 1 answers the following questions:

- How does expectations investing differ from a typical discounted cash flow (DCF) calculation?
- Why do we need to integrate price-implied expectations into our investments now more than ever?
- Why do most active professional managers generate returns on their investment portfolios lower than those of passive index funds?

- How does expectations investing offer active investors their best shot at achieving superior returns?
- What are the three major steps in the expectations investing process?
- Why do many investors believe that the market is short-term oriented?
- Why do many investors believe that earnings per share dictate value?
- Why do many investors believe that price-earnings multiples determine value?

Essential Ideas in Chapter 1

- Investors who can read the market's expectations and anticipate changes in those expectations will more likely generate superior investment returns.
- The expectations investing approach harnesses the powerful discounted cash flow model but starts with price and then solves for expectations.
- Investors who play the earnings expectations games are in a losing game, because short-term earnings do not reflect how the market prices stocks.