

**Course Description:****Investment Topics
with a focus on Global Investment Strategy**

C15.0042 3 credits. Spring

*Prerequisites: C15.0002, C15.0007,
and senior standing.*

Investment Strategists play a key role in the investment process. Course acquaints students with the process of developing a macro view of the financial markets that can guide asset allocation, stock selection, and other investment policies. Key topics include asset allocation, equity valuation and thematic investing—i.e. determining how demographic, technological and political trends will affect financial markets. The course will also examine other issues, including corporate profits, the fixed income markets, inflation and deflation, and panics and manias. Knowledge of basic finance, macroeconomics, economic history is helpful. Readings, group discussions employed.

Course Instructors:

Mr. Edward M. Kerschner, Chief Global Strategist for UBS Warburg.
Professors Keenan, Mei, and others from the Department of Finance

Mr. Kerschner will meet the class on Mondays from 11:00-12:15p. The topics he will cover are indicated in the Syllabus below. There may be Mondays when the class runs longer. On Wednesdays various finance faculty will discuss related research that relates to analytical procedures for valuation and portfolio analysis. Most class sessions will focus on equity markets and analysis. Grading will be based primarily on class discussion and written reports.

Spring 2002

Syllabus

Week 1:

*** *Investment Strategy—An Overview***

Readings:

- * “2002 Global Outlook” (Kerschner)

A broad overview of one Wall Street firm’s investment strategy, focusing on stock market valuations and current thematics. Note that all of the issues addressed in this overview will be explored in detail in subsequent lectures.

Week 2:

Asset Allocation Relationships—Theory and Practice

Readings:

- * “Does Asset Allocation Matter Anymore?” (Kerschner)
- “Advanced Theory and Methodology of Tactical Asset Allocation” (Lee)
- “Determinants of Portfolio Performance” (Brinson, Hood, Beebower)
- * “Asset Allocation—Explanation of the Model” (Kerschner);
- “Asset Allocation—Monthly Update: October 1987, October 1988, * December 2001” (Kerschner)

What is asset allocation? Why does it matter? We will discuss the financial theory behind asset allocation, and review the factors that led to the adoption of an asset allocation framework by the investment community. An Asset Allocation model that has been successfully used on Wall Street for over 25 years will be examined. Finally, we will discuss the challenges that face Asset Allocation practitioners today.

Topic for Discussion: So, does Asset Allocation matter anymore?

* Indicates “core reading”

Week 3:

Thematic Investing—Demographic Dynamics

Readings:

“Consumer Comeback, Chapter Five: The Payoff” (Kerschner)

* “Consumer Comeback” (Kerschner)

* “The New Millennium American” (Kerschner)

“The American Age of Affluence” (Kerschner)

“The All American Shopping List” (Kerschner)

“Consumer Myths” (Kerschner)

“Consumer Myths Appendix” (Kerschner)

Thematic investing seeks to identify multi-year trends that will have significant investment implications. A key force that determines multi-year investment themes: demographics. We discuss why a “Consumer Comeback” got under way in 1995, how the attitudes of the “New Millennium American” have changed, and the factors that led to an “American Age of Affluence.”

Topic for Discussion: Is the “Consumer Comeback” over?

Week 4:

Thematic Investing—Technological Trends

Readings:

“Converging Technologies” (Kerschner)

* “Net for Naught” (Kerschner)

* “The Information Revolution Wars” (Kerschner)

“GiganTechs” (Kerschner)

Continuing our discussion of thematic investing, we turn to technology. Technology, by definition, involves tremendous potential for growth. However, the sector is notoriously cyclical and, on top of that, there is always the threat of obsolescence. We discuss the boom and bust in Personal Computing stocks in the early 1980s, the “Information Revolution” of the 1990s, and the rise of “GiganTechs” in the first decade of the new millennium.

Topic for Discussion: Are tech stocks dead?

Week 5:

Thematic Investing—Corporate Restructuring

Readings:

“Back to the Future: America’s Second Great Restructuring” (Kerschner)

“Destructuring” (Kerschner)

“Strategic Action” (Kerschner)

* “Transformers” (Kerschner)

“Global Transformers” (Kerschner)

An ongoing theme in the financial markets has been corporate restructuring. In this session we discuss the factors that have driven—and continue to drive—corporate transformation. We discuss how the restructuring of the mid-1980s was a natural and necessary reaction to the disinflation of the 1980s. We analyze how, in the early 1990s, anemic revenue growth and poor profitability led to “Destructuring”—the disassembly and restructuring of corporations—in order to maximize shareholder values.

“Destructuring” was followed in the mid-1990s by strategic acquisitions aimed at boosting corporate revenues. Finally we examine why, in the Information Economy, “transformers” are outsourcing all functions except their core competency.

Topic for Discussion: What’s the next phase of corporate restructuring?

Week 6:

Thematic Investing—The Death of a Theme

Readings:

* “Branded” (Kerschner)

“Brand Breakdown” (Kerschner)

* “BuBa Boom and America’s Euro-industrials” (Kerschner)

“More of America’s Euro-Industrials” (Kerschner)

“Euro-Trough” (Kerschner)

“Euro-Peak” (Kerschner)

* “Drug stocks: a healthy opportunity” (Kerschner)

“Operating Profits” (Kerschner)

“Medical Megamorphosis (Kerschner)

Themes that have been successful for several years can suddenly be adversely affected by a change in the economic or investment environment. What are some of the factors to watch for when determining whether a theme that has been successful for some time is at risk? We discuss these issues in the context of three thematics: (i) consumer branded goods (ii) “Euro-industrials”—U.S. industrial companies with a significant exposure to Europe (iii) Healthcare companies

Topic for Discussion: Which of today’s investment themes is most at risk?

Week 7:

Equity Valuation

Readings:

“Equity Valuation—Explanation of the Model” (Kerschner);

“Equity Valuation—Monthly Update: December 2001” (Kerschner)

* “There Are No High-P/E Growth Stocks” (Kerschner)

* “Growth versus value—Still No Contest” (Kerschner)

“Global Tech Strategy Special Edition: Valuation” (UBS Warburg Global Tech Strategy)

After identifying key investment themes, the next challenge is to identify the stocks that benefit from those themes. But how much should you pay for those stocks? We review the standard Dividend Discount Model, and learn how it can be used to calculate a “fair” P/E for the market as a whole. Given this “fair” P/E for the S&P 500, we then extend our analysis to calculate “fair” P/E multiples for individual stocks. We introduce the concept of “normal” earnings.

Topic for Discussion: How much would you pay for a share of the common stock of (a.) Caterpillar? (b.) Cisco?

Week 8:

Profits, the Economy and Stock Prices

Readings:

* “The Profit Picture Monthly: December 2001” (Doerflinger)

“Does Anyone Ever Know What Time It Is?” (Kerschner)

* “What is the S&P 500?” (Kerschner)

“Growing Up” (Kerschner)

“The Good, the Bad, And the Ugly” (Kerschner)

“It’s Not Over Yet” (Kerschner)

Thanks to earlier classes, we now know the “fair” P/E for stocks and the stock market. But what’s the “E”? We discuss various measures of corporate profits and ask “What are S&P 500 EPS?” We analyze the behavior of profits relative to the economy, explaining why profits are more volatile than the economy.

Although stock prices tend to reflect corporate earnings, the relationship between the two is far from straightforward. Indeed, it is not uncommon for stock prices to be weak when corporate earnings are strong, and to rise while earnings are weak. We explore the interplay between the business cycle, actions of the Federal reserve, profit growth, and stock prices.

Topic for Discussion: By how much will S&P 500 operating EPS grow in 2002?

Week 9:

The Fixed Income Markets

Readings:

- * “Another Tight Squeeze?” (Kerschner)
- “The New Bond Market Vigilantes” (Kerschner)
- “6 in ’96” (Kerschner)
- “Fours Before Long (Kerschner)
- * “5 at the Turn” (Kerschner)
- “Home on the Range” (Kerschner)

We now turn our discussion from stocks to assets in the fixed income markets i.e., bonds and cash. We discuss the two key determinants of nominal interest rates—inflation and real interest rates. We analyze why interest rates have fallen steadily since the 1980s. We also discuss the influence of the Federal Reserve on the fixed income markets.

Topic for Discussion: What will the yield on the 10 year Treasury bond be on January 1, 2003?

Week 10:

Flations: Inflation and Deflation

Readings:

- * “Inflated Fears” (Kerschner)
- * “Benign Deflation?” (Kerschner)

Nothing is more important to formulating a correct investment strategy than understanding whether the underlying economic trend is inflationary or deflationary. We define the terms and examine the underlying political / social / economic forces at work. We examine which asset classes perform best in inflationary and deflationary periods. We discuss why stocks are not an effective hedge against inflation?

Topic for Discussion: In the next 10 years, is the U.S. economy more likely to experience inflation or deflation?

Week 11:

The Individual Investor and the Stock and Bond Markets

Readings:

- * “The Big Shift” (Kerschner)
- “The Ozzie and Harriet Market” (Kerschner)
- * “The Big Shift—Barely Begun” (Kerschner)
- “The American Age of Affluence” (Kerschner)

We now have a good understanding of Asset Allocation and Equity Valuation techniques, as well as the Fixed Income markets. But what has motivated flows by the individual investor into the capital markets? We review the “Ozzie and Harriet” market of the 1950s, the avoidance of stocks by public investors in the 1980s, the “Big Shift” of the 1990s, and the behavior of individual investors in the 21st century.

Topic for Discussion: Is the “Big Shift” likely to continue?

Week 12:

Manias, Panics and Walls of Worry

Readings:

- * “New Economy: Yes, New Metrics: No” (Kerschner)
- “New Metrics: Still Sliding” (Kerschner)
- “How Much Is a Tulip Worth?” (Hirschey)
- * “Climbing the Wall of Worry—Again” (Kerschner)
- * “Still Climbing the Wall of Worry” (Kerschner)
- “Happy Anniversary” (Kerschner)
- “Asset Allocation—Monthly Update: October 1987” (Kerschner)
- “Revisiting the October 1987 Crash” (Wigmore)

In the long run capital markets are remarkably efficient. But in the short run, inefficiencies can develop, sometimes fueled by manias (which lead to excessive overvaluation). We review three prior manias: the mania for conglomerates in the 1960s, the LBO mania of the 1980s, and the Internet mania of the 1990s.

Anticipating and responding to financial panics is a necessary element of an investment strategy. We define the term, note and analyze the causes of panics, which include excessive speculation, ineffective regulation of financial markets and institutions, and underlying macroeconomic weaknesses. We discuss how bull markets typically climb a “Wall of Worry.”

Topic for Discussion: Are we climbing a Wall of Worry today?

Week 13:

Big Mistake!

Readings:

“Sell now, or pay later” (Kerschner)

* “Asset Allocation—Monthly Update: October 1988” (Kerschner)

“DJIA could rise 1000 points over the next 18 months” (Kerschner)

* “Two Strategists Expect 1,000-Point Move In the Market, but in Different Directions”
(Wall Street Journal)

“Submerging Economies” (Kerschner)

* “The dreaded D word” (Forbes)

“Y2K OK” (Kerschner)

* “Could Y2K Cause a Global Recession?” (Fortune)

It's so easy! Thirteen weeks later and this Investment Strategy stuff seems a piece of cake. How could you go wrong? We discuss some big mistakes some Wall Street strategists have made in recent years, including a bad asset allocation call in 1988, the “bull market bears” of the late 1990s, the “extended global deflation” call of 1998, and the “Y2K” call of 1999. We analyze why these calls were made, and discuss how to avoid making bad calls.

Topic for Discussion: What mistakes could we be making today (apart from attending this course)?
