



CFAA Event 9/18/2012

“DCF Intrinsic Value Accuracy and Back Test Predictive Capability of Excess Returns” Measuring the Price Formation Process and Risk

In a financial World that is seeing a large amount of investments, there is no doubt that the need exists for individuals and companies who possess the skills needed to make sound investments decisions. Being able to calculate an accurate intrinsic value for a company must consist of a deeper analysis through an advanced DCF model. HOLT Co-Founder and President of LifeCycle Returns, Inc. (LCRT), Mr. Thomas is an expert at valuation techniques and the use of value management principles. Three key areas that Mr. Thomas covered in his presentation to the CFAA audience on September 18th 2012 were the methodology of creating advanced automated DCF valuation models, DCF intrinsic value accuracy, and measuring the fat-tailed risk of the price formation process.

During his presentation, Mr. Thomas engaged the audience with detailed charts and graphs. These charts and graphs showed the steps to assess the reliability of a DCF model and apply a pragmatic research process to test and improve DCF-based valuation. Through the use of “Value Charts,” initially created by Value Line, an analyst can expect to use this tool containing data solely on the history of the movement of price against the historical tracking of valuation models. The end result, as observed by Robert Shiller, an American economist, was a chart depicting prices as more volatile than the intrinsic values because the price dispersion is so wide. This was critical because it formed the basis of most of the work in behavioral finance and economics.



Another way to determine accuracy was to compare the price level absolute tracking error of your DCF model to others. This absolute tracking error took the geometric mean difference of the % under/over valuation of the intrinsic value compared to the stock price. Based upon a single company’s historical data, Mr. Thomas compared three common valuation models: DCF Model, EV/EBITDA, and Net Free Cash Flow (NFCF),



with tracking errors of 18.0%, 30.7%, and 37.4%, respectively. But, when testing this error against 3,560 firms, the NCF method was at 167%, the EV/EBITDA method at 72%, and the LCRT Model at 47% based on data from 2001-2007. He then went on to say that while the EV/EBITDA method was simpler and pretty accurate, the problem was that it did not contain the balance sheet. By including the balance sheet and having more accurate data, these models can become more predictive. It was important to have an unbiased, detailed and accurate model. And as Mr. Thomas put it, “The problem with analyst forecasts is that they control the dials which go into the terminal value. Since the Terminal Value is about 85%-95% of total evaluation, they can come up with any recommendation they wanted to make anyway.” Using these comparisons allowed for a practical research process to improve DCF valuations and test models’ accuracy using large samples.



Upon further analysis of these charts, Mr. Thomas stated that we need to break away from the traditional thinking of assigning risk. This typical way says that if a company is under or overvalued, it’s higher risk; it has a higher standard deviation. “Actually, the overvalued and undervalued firms are the least risky. And everything in the middle is the most risky. It’s a very simple answer; if a company is really over/under valued, you know where the price is likely headed. That’s what makes it less risky. And if it’s fairly valued, you don’t know where the price is going.”

The event moderator and CFAA Director Ms. Dandan Yang expressed CFAA’s appreciation to Mr. Thomas for giving the attendees a very informative and fun presentation. For anyone who was not able to attend the event on September 18th, but would like to get a copy of the Advanced DCF Models presentation, Mr. Thomas is more than happy to send you a copy or answer any questions you may have. He may be reached at his e-mail address, Rawley@LCRT.com. In addition, please make sure to check back with our website, www.chinesefinanceassociation.org for upcoming, monthly events.

About CFAA

Chinese Finance Association of America (CFAA) is an independent not-for-profit, non-partisan organization committed to promoting educational and cultural exchange among finance professionals between the United States and Greater China through facilitating communication and the exchange of ideas in the financial industry. Incorporated and headquartered in Chicago, Illinois, CFAA is



Chinese Finance Association of America

美国华人金融协会

aimed to serve Chinese finance professionals and others who are interested in the financial industry of Greater China. Please visit our website www.ChineseFinanceAssociation.org for more information about CFAA. To become a CFAA member, or to renew your CFAA membership and make your membership payment, please go to the [membership section](#) on our website. If you are interested in the volunteering opportunities at CFAA, please submit the [volunteer and staff application form](#). For global career opportunities in finance, please visit our newly launched [Online Job Center](#) through our partnership with one of the leading global career placement companies eFinancialCareers.com.