

EARNINGS CALIBRATION MODEL: METHODOLOGY REPORT

Introduction

The stock selection model presented in this document is intended to provide you a simpler way to identify top-quality stocks at good prices. If you follow the unique yet sensible approach, your portfolio returns should rise and your level of risk should fall. The methodology is founded on a strong momentum-based stock selection criteria. The strength of the model lies in its simplicity and effectiveness in identifying investment opportunities without having to do extensive financial analysis. Most astute investors will arrive at the same conclusions following pure fundamentals-based analysis. The approach applies consistent rules, which demonstrate the potential in a given stock. Once understood and applied consistently, the application of the model can save investors considerable time and effort and yield good results. In short, this model will help you to:

- Identify great companies;
- Buy their stocks when they are priced low;
- Sell them when they are priced high; and,
- Repeat this process over and over again.

Earnings Calibration Model

The Earnings Calibration Model is a momentum-based stock selection model that calibrates a company's future stock price movements with the expected growth rate in the company's EPS.

The Model is an "equilibrium" model that assumes a state in which market sentiment and supply and demand are in balance and, as a result, price multiples are stabilized. This means that stock prices are set as a function of earnings and earnings growth, not multiplier expansion or contraction.

5-Step Process

The process of evaluation applied by SEENSCO is quite direct. We study each company's financial position, then its earnings strength and stability, then its size, balance sheet health, valuation levels, and value trap risk. Finally, we estimate the company's "Rate of Calibration", set a valuation range, and determine the return potential inherent in the stock.

Step #1: Quick Analysis of the Company's Financials

1. The first step in the Model, and before committing the time to analyze a company in greater detail, is to perform a quick analysis of the company's financials, paying particular attention to the company's sales, earnings, returns, and financial leverage. The SEENSCO valuation sheets present a wealth of information, including records of companies' earnings per share for several years to support this analysis. If preliminary research generally satisfies the conditions below, it is worth moving on to the second step (that is, calculating a "Rate of Calibration"). The company should have a minimum 10 year operating history. Over the past decade, there has been a trend among investors to focus more on the short-term rather than the long-term. This trend has been fueled by shorter business cycles and more frequent economic shocks. While the investment climate moves faster than in the past, the investment model presented here is intended to run counter to this thinking. The Earnings Calibration Model is based on the belief that a long-term track record reflects more accurately how a company and its management structure has been able to deal with the ups-and-downs of the business cycle. The very best companies are those that consistently outperform over the long term, and also exhibit consistency in their earnings and cash-flows over an extended period of time. SEENSCO asserts that most investors should look for a minimum of 10 years of historical operating performance to satisfy the condition of the long-term perspective of the Earnings Calibration Model. This period was selected because, in most cases, companies' management cannot distort or manipulate performance over such a long time frame. Remember the tech-bubble in 2000? Many companies that saw their stock prices fly to the moon only to crash back down did not have the benefit

of a long operating history. Also, during a 10 year period most companies will have gone through sectoral shocks and cyclical swings, which are great tests of company durability. The most outstanding companies will be able to survive any temporary economic setback.

2. The company should have strong, upward trending, and predictable EPS. This second condition is critical as earnings are the primary driver of company value. When earnings rise, stock prices are almost always soon to follow. When they drop, normally so do the stocks. Because stock prices are primarily driven by earnings, a company's earnings history provides key information in determining when a stock is fairly valued. Where the earnings move, the prices eventually follow. This is an important concept to grasp: earnings tell investors why a company's stock price has moved in the direction it has in the past as well as where a company's stock price is going to move in the future, which helps investors gauge the stock's underlying value.
3. The company should trade at a stable P/E. It is easy to waste time studying companies only to find them trading at ridiculous multiples. It is wise at the start of your evaluation to quickly look at a company's current and historical P/E to get an idea of whether the stock is likely overvalued. For example, if a company usually trades at P/E ratios of 15x-20x and is currently trading at a P/E of 50x, further analysis is probably not necessary. However, if it is trading at a P/E of 10x, it is unlikely that the stock is overvalued.
4. The company should have a market capitalization of at least \$1 billion. Market capitalization is defined as the total value of the company. This is the stock price multiplied by every outstanding share in the company. Why does size matter? Larger companies are typically more capable than smaller firms of withstanding economic shocks. That is, size contributes to business stability. Large companies aren't always fast movers, but their performance is usually fairly steady and predictable. Conversely, high-flying, small cap companies with one or two products and perhaps a few large customers, can see their stock prices rise rapidly and can oscillate from side to side in a fraction of the time that it takes a large company's stock to move. They also cannot always withstand major economic crashes or operating mistakes. They are also frequently run by small management teams and their decision making processes are less predictable. With smaller market shares, they are also far more susceptible to technological shifts and competitive forces, such as, for example, the sudden entry of a new major competitor or substitute product. The Earning Calibration Model is best suited to evaluating large companies. These companies have market capitalizations of \$1 billion or more. They offer a less exciting trajectory but they produce steady and predictable earnings that yield more predictable stock price action from which investors can profit. Their predictability is what qualifies them for investment.
5. The company should have limited financial leverage. Firms that exhibit high leverage tend to be more risky than firms with low leverage, all else equal. We assess leverage through the use of the firm's adjusted debt-to-income ratio. Firms that are over 10 on this metric, we rate as having high leverage and high financial risk. Firms that have less than 5.0, we rate as having low leverage and low financial risk.
6. The company's earnings trend should not exhibit any recent value breaks. Value breaks consist of: (1) 3 periods with 3-consecutive quarters of declining EPS (TTM) over the past 20 years and (2) recent abnormal drops, or structural breaks, in the company's earnings per share line.
7. If $P/E > 15x$, $PEG < 1$: or if $P/E < 15x$, $PEG < 1.3$. The PEG Ratio (price/earnings to growth ratio) is a valuation metric for determining the relative trade-off between the price of a stock, the earnings generated per share (EPS), and the company's expected growth. It is assumed that by dividing the P/E ratio by the earnings growth rate, the resulting ratio is a better indicator for comparing companies with different growth rates than the P/E ratio alone.

The PEG ratio is considered to be a convenient approximation of fair value. It was popularized by Peter Lynch, who wrote that "The P/E ratio of any company that's fairly priced will equal its growth rate", i.e., a fairly valued company will have its PEG equal to 1. In practice, however, the PEG ratio will be higher than 1 for most undervalued companies. As such, we set the condition that if the P/E for a company is less than 15x, a PEG of <1.3 is sufficient to signal undervaluation.

Step #2: Estimate the Company's Rate of Calibration

The key component of the Earnings Calibration Model is the calculation of the "Rate of Calibration". This is the rate at which a company's EPS, and as such its stock price, is expected to appreciate/depreciate over the next 8 quarters. Estimating the Rate of Calibration is done using linear regression and is calculated in 6 steps:

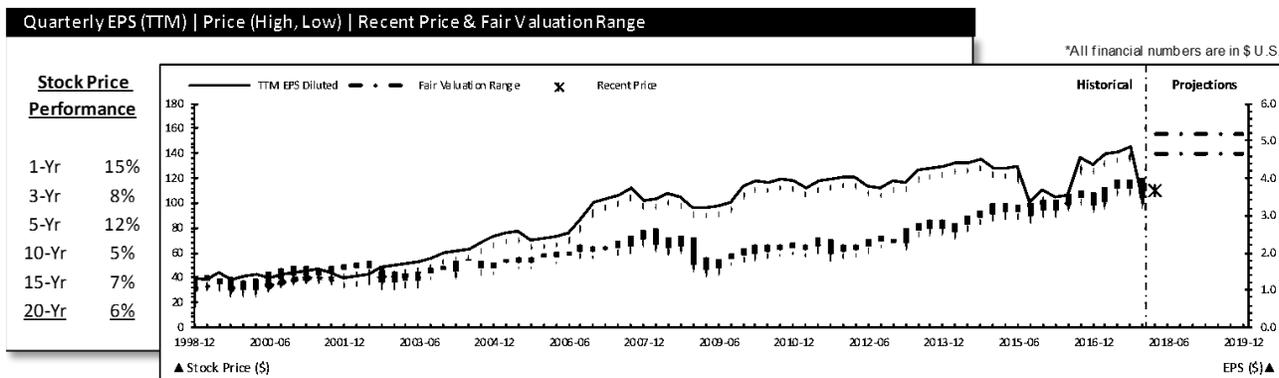
1. Build the company's 20-year historical EPS (TTM) chart;
2. Overlay the company's 20-year historical high-low stock price line;
3. Using linear regression, calculate the company's 6-quarter, 3-year, 5-year, 10-year, 15-year, and 20-year historical EPS (TTM) trend lines;
4. Extrapolate each historical EPS (TTM) trend line forward 8 quarters;
5. Using each extrapolated trend line, calculate a weighted moving average EPS trend line, applying the most weight to the 6-quarter trend line and the least weight to the 20-year trend line;
6. Calculate the growth rate implied by the company's weighted moving average EPS (TTM) trend line. This implied growth rate represents the company's "Rate of Calibration".

Step #3: Forecast the Company's Target Price

Once the Rate of Calibration is calculated, the company's stock price can be easily estimated by extrapolating the stock price forward 8 quarters at the Rate of Calibration, starting from the last reported quarter's closing price. If the business' operating performance has been stable through time, this calculation is very straightforward. For instance, consider a company trading at \$100 that has grown earnings at an average rate of 2.5% per quarter over the last 20-, 15-, 10-, 5-, and 3-year periods. Further, assume that the company has continued to grow EPS at a 2.5% rate over the last 6 quarters. This gives us a 2.5% Rate of Calibration and a forecasted stock price of \$122 over a 2 year investment horizon.

The Figure below presents the case for PepsiCo Inc (PEP), a well-known maker of drinks and snack products.

Figure: Pepsi Co Historical High-Low Stock Price Series, Trailing 12-Month EPS Series, Recent Price and Fair Value Range



Walking through this graph, it is clear that the company's long-term EPS (TTM) trend line over the full 20 year period is upward sloping with minimal volatility. The EPS (TTM) line over the previous 10 years had become less steep, however, reflecting a lower pace of EPS growth over this period relative to the 20-year period. Over the last 6 quarters, the slope of the EPS line appears to have dropped further and turned negative. When the slope of the EPS line flattens, it indicates that the operating performance of the

company is likely deteriorating and, as such, the company's stock is likely deteriorating as well. The opposite is true when the slope gets steeper; this means that the company's value is typically increasing. Another key observation that follows from this graph is that the company's stock price line has grown at a fairly comparable rate as the company's earnings per share line, implying that the market has continued to pay a similar amount for every dollar of PEP's earnings (in other words, the company has maintained a fairly stable P/E multiple). The position of the EPS line relative to the high-low line also gives insight into the risk that tends to underlie the company's valuation. In PEP's case, the high-low spread has trended narrowly and consistently through time, implying that it is a lower risk company.

Step #4: Set the Valuation Range and Determine Buy and Sell Targets and Return Potential

The last step in the valuation process involves setting an appropriate valuation range. This is important because it facilitates the comparison of the company's current stock price and return potential and tells investors whether it's a good time to buy or sell. The upper part of the valuation range signals degrees of overvaluation while the lower part signals degrees of undervaluation, and this is where investors should look for buy opportunities. To determine the valuation range, the Earnings Calibration Model bounds the price target by the 10-year average stock price trading range, representing the stock's normal volatility. The span between the upper and lower valuation lines represents the stock's fair value range and indicates where you can expect the stock to trade fairly over the next 8 quarters, given the company's earnings history and forward trajectories. In the figure above, using PepsiCo (PEP), the valuation range is between \$139.81 and \$156.01. Note that because the EPS lines will continue to evolve over time, the valuation range will follow changes in the EPS line. If the EPS line flattens (given the greater weight provided to the shorter-term trend line projections, then the valuation range will fall as well. If the EPS line continues its growing trend, then it would be expected that the fair value range would shift higher with the growing EPS. The valuation range is dynamic because it is a function of the company's stock price volatility as well as its cumulative long-term earnings trend and near term earnings trend.

Step #5: Stock Rating

Our stock ratings are guideposts to a broad audience and individuals must consider their own specific investment goals, risk tolerance, tax situation, time horizon, income needs, and complete investment portfolio, among other factors in making investment decisions.

BUY: The stock is trading significantly below the lower bound of the company's fair value range: $\text{Price} < (\text{Target Price} - 1.5x \text{ average annual trading range})$. Analysis suggests that based on the company's estimated rate of calibration, the current market price will rise to substantially higher valuation levels.

ACCUMULATE: The stock is trading modestly below the lower bound of the company's fair value range: $\text{Price} < (\text{Target Price} - 0.5x \text{ average annual trading range})$ "but" $\text{Price} > (\text{Target Price} - 1.5x \text{ average annual trading range})$. Analysis suggests that based on the company's estimated rate of calibration, the current market price will rise to modestly higher valuation levels.

HOLD: The stock is trading within the lower bound and upper bound of the company's fair value range: $(\text{Target Price} - 0.5x \text{ average annual trading range}) < \text{Price} < (\text{Target Price} + 0.5x \text{ average annual trading range})$. Analysis suggests that based on the company's estimated rate of calibration, the current market price will gravitate towards the target price and fluctuate between the upper and lower valuation bounds.

REDUCE: The stock is trading modestly above the upper bound of the company's fair value range: $\text{Price} > (\text{Target Price} + 0.5x \text{ average annual trading range})$ "but" $\text{Price} < (\text{Target Price} + 1.5x \text{ average annual trading range})$. Analysis suggests that based on the company's estimated rate of calibration, the current market price will fall to modestly lower valuation levels.

SELL: The stock is trading significantly above the upper bound of the company's fair value range: $\text{Price} > (\text{Target Price} + 1.5x \text{ average annual trading range})$. Analysis suggests that based on the company's estimated rate of calibration, the current market price will fall to substantially lower valuation levels.

INCALCULABLE: A rate of calibration, and hence, a fair value range for the company's stock cannot be calculated. This is generally due to negative current earnings or negative projected future earnings.

Additional Notes:

1. Rates of Calibration are intentionally constrained to 5% so as to not produce unrealistically high valuation targets. A 5% quarterly rate of calibration limit implies an approximate maximum upside potential of 50% over a 2 year investment horizon.
2. Valuation ranges for all companies are set based on their 10 year average annual trading ranges, unless they have been in operation (or traded publicly) for less than 10 years. In these cases, the average annual trading range for all available years is used to set the valuation range.

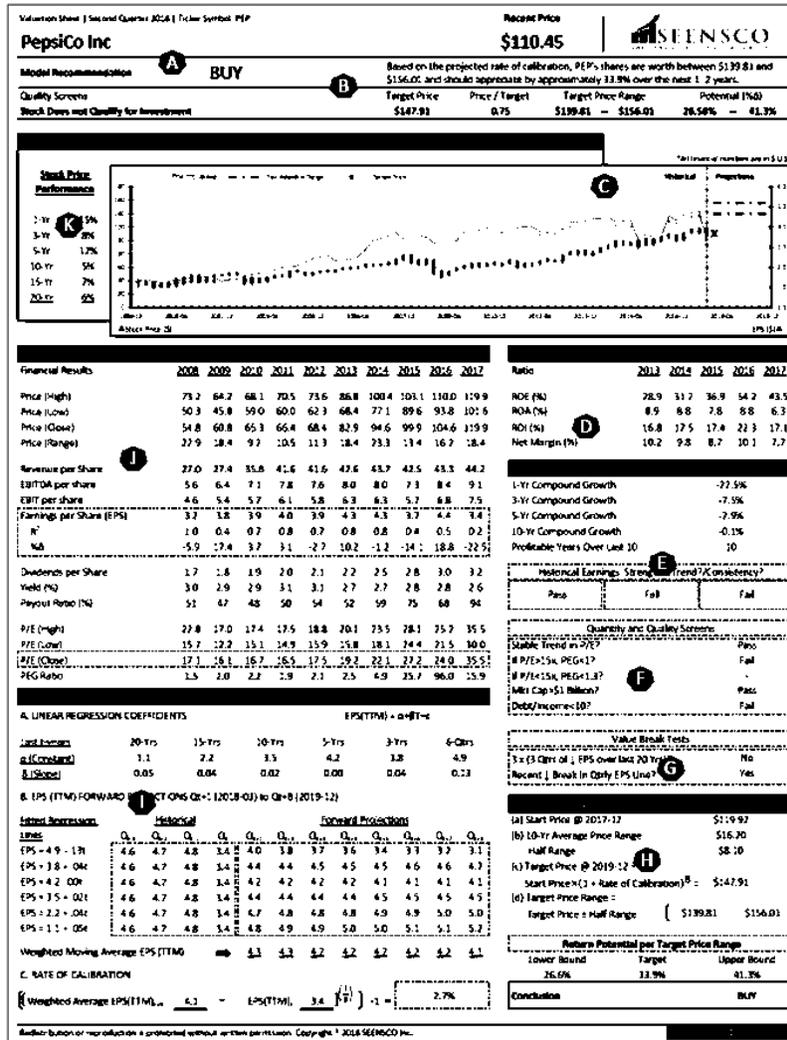
Sample Value Sheet

A Model Recommendation
Indicates whether the firm is significantly undervalued, modestly undervalued, fairly valued, modestly overvalued, or significantly overvalued based on the earnings calibration methodology.

B Target Price
Shows the company's target price and target price range derived based on the earnings calibration methodology.

C Historical EPS (TMM) Trendline, Price Series, and Fair Value Range
Displays the historical earnings and price action for the company's stock. Also displays the projected value range for the next 8 quarters in relation to the current stock price.

K Price Action
Shows the company's historical stock price performance over different periods of time.



D Key Financials
Summary of key financial ratios and earnings growth rates.

J Financial Summary
A summary of the financial performance of the company over the previous 10 year period.

E Earnings Properties
Summary of the firm's earnings power, the firm's ability to continually grow earnings, and the firm's ability to maintain consistent earnings under all economic conditions.

F Quality Screens
Investment screens specific to the Earnings Calibration Model, including size-based screens, leverage-based screens, and screens based on the level and stability of the company's P/E ratio.

I Rate of Calibration
Shows all the key components and calculations for estimating the company's "Rate of Calibration". This includes: (1) linear regression parameter estimates; (2) projected earnings lines; (3) the weighted moving average EPS estimates; and (4) the implied EPS growth rate.

H Valuation and Return Potential
Shows the calculation underlying the firm's price target, fair value range, and return potential corresponding to each price estimate.

G Value Break Test
Screens specific to the Earnings Calibration Model aimed at protecting investors from potential value traps.