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# PRACTITIONER'S DIGEST

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The "Practitioner's Digest" emphasizes the practical significance of manuscripts featured in the "Insights" and "Articles" sections of the journal. Readers who are interested in extracting the practical value of an article, or who are simply looking for a summary, may look to this section.

## FREE CASH FLOWS, VALUATION AND GROWTH OPPORTUNITIES BIAS          PAGE 4

*Hersh Shefrin*

Analysts who use forecasts of free cash flows to establish valuations and target prices are vulnerable to a specific bias called "growth opportunities bias" (GOB). This paper explains the bias, proposes a technique for addressing the bias, and presents examples to illustrate the debiasing technique in practice. The technique involves a condition that is easy to explain, easy to describe, and can be computed on the back of an envelope.

GOB occurs when assumptions about the ratio of long term net investment to after-tax EBIT are either too low or too high relative to assumptions about long-term growth rates. The paper establishes a debiasing condition specifying the appropriate magnitude for this ratio.

Group psychology can be very important in respect to the degree to which debiasing occurs. Readers of this paper will learn about the manifestation of GOB within the community of security analysts, including the role of the CFA Institute in perpetuating or mitigating the bias.

## FOR BETTER PERFORMANCE: CONSTRAIN PORTFOLIO WEIGHTS DIFFERENTIALLY AND GLOBALLY          PAGE 27

*Haim Levy and Moshe Levy*

A central problem in portfolio optimization is the large estimation errors involved in parameter estimation. One well-known way to address this problem is to impose constraints on the portfolio weights. Typically, the same constraints are imposed for all assets. This paper suggests an extension of this method by introducing differential constraints. The logic is simple: stocks with high sample variances

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involve large estimation errors, and therefore tighter constraints are imposed on their portfolio weights. We show that the new method suggested yields improved performance relative to existing optimization methods.

## A SIMPLE DIVERSIFIED PORTFOLIO STRATEGY                                    PAGE 42

*Bernd Hanke and Garrett Quigley*

We present a simple portfolio construction approach which is a blend of market weights and equal stock and sector weights. Our approach results in a highly diversified portfolio both on a stock level and on a sector level and generates portfolio returns that are about 100–200 basis points higher per year than a for market weighted index at lower risk. The higher returns of our diversified portfolio originate both from mitigating the link with market weights and from its higher level of diversification. While diversification is most commonly analyzed in the context of risk reduction, an additional benefit of diversification is the return premium it generates for a portfolio that is rebalanced regularly.

Our diversified portfolio exhibits only slightly higher turnover than a market weighted index and is less concentrated in mega-cap stocks. Instead it assigns somewhat higher weight to smaller stocks and sectors than a market weighted index. At the same time the diversified portfolio retains the characteristics of a broad market index and is therefore highly implementable and has very high investment capacity.

Our simple diversification strategy appears to be a superior way of capturing the equity risk premium compared to a market weighted portfolio. It therefore establishes a tougher benchmark for active fund managers than market weighted indices as it results in well-diversified, high-capacity and low turnover portfolios that can be delivered very cheaply.

## SEPARATING WINNERS FROM LOSERS AMONG VALUE AND GROWTH STOCKS IN DIFFERENT US EXCHANGES: 1969–2011                        PAGE 68

*George Athanassakos*

The purpose of this paper is two-fold (a) to determine whether there is value premium in our sample of US stocks for the period May 1, 1969–April 30, 2011, and (b) to examine whether an additional screening to the first step of the value investing process can be employed to separate the outperforming value and growth stocks from the underperforming ones.

We find a consistently strong and pervasive value premium over the sample period. We show that there are distinct differences between US exchanges which means that papers that aggregate all US exchanges under one umbrella may dilute findings and bias conclusions. The stocks of AMEX firms, high business risk firms and firms that report extraordinary items experience worse returns than the rest of the US stocks in our sample. We find that P/E based sortings produce better overall results than sortings based on P/B.

We are able to construct a composite score indicator (SCORE), combining various fundamental and market metrics, which enable us not only to separate the winners from the losers among value and growth stocks, but also to predict future returns of value and growth stocks. SCORE portfolios give better results for sortings based on P/E and when we employed a cross section—time series medians approach. Results remain robust out of sample. Finally, we provide evidence that the return of a portfolio strategy that buys (sells) stocks that rank low (high) in the composite score indicator earns statistically significant positive returns.

## THE DEPENDENCE OF UPSIDE CAPTURE RATIOS AND DOWNSIDE CAPTURE RATIOS ON THE LENGTH OF THE MEASUREMENT INTERVAL, BETA, AND ALPHA                                                                    PAGE 105

*Robert Ferguson, Danny Meidan and Joel Rentzler*

Investors often approach the task of selecting investment managers, or assessing the effectiveness of their investment strategies, by analyzing backtests or live performance using various performance metrics. Two popular performance metrics are "upside capture" and "downside capture." These ratios examine the performance of a portfolio relative to a benchmark conditional on whether the benchmark return is positive (hence, "upside" capture) or negative (hence, "downside" capture) over calendar intervals such as months, quarters or years. The results depend materially on the length of the measurement interval for computing the benchmark and portfolio returns. Manager evaluation using the same measurement interval length is essential in order to ensure a fair comparison among managers.

We propose a simple theoretical model which predicts that the upside capture ratio is an increasing function of the measurement interval length and that the downside capture ratio is a decreasing function of the measurement interval length. The model also predicts that all measurement intervals' capture ratios depend strongly on betas, not just alphas, and that short measurement intervals' capture ratios are dominated by betas, hence are unreliable for assessing alphas. Consequently, capture ratios are problematic for assessing managers' skill. We illustrate this behavior both using actual data and a numerical example.