

Eureka Moment?

By Glen Bradford 6/23/2010

Ok, so I keep getting asked at what point did I start to be so successful? Well, I want to explain it in a page. I can't really pinpoint any time in particular, but I wanted to show how cognitive dissonance forced me to think for myself. Being successful comes first in the mind, second in actions, and then becomes reality. Life really is what you make it to be, so make it a good one. Following this page is 3 pages, the first of which is a 3-standard deviation below average Failing grade in a Corporate Finance course that I passed somehow. I got 45/100 and the average was in the 80's. Yeah, I went out of my way to confirm that I was the lowest grade. I was secretly full of pride. The two pages following are some of my answers that were marked wrong.

First, the EMH suggests that higher returns necessitate higher risks. Ok, lets run with that. They measure risk by relative covariance in the stock market. A long story short and about 5 pages of calculations later, you can also prove that a good company according to the EMH targets a leverage ratio. So, basically, I learned in this class I was in that in order to do so, as a company's stock price goes up, the company should buy back open shares in the market to maintain an appropriate leverage ratio.

My argument, which was apparently wrong, was that it was in the best interest of shareholders to buy back the stock at the lowest price possible. I figured that that way, they would buy back the most shares, decreasing the outstanding shares the most, given any specified value of money. Thus, the shareholders would own more. I'd rather own more, not less if I was a shareholder.

Anyway, I remember sitting in the back of class, inquiring as to how it made sense that this could possibly be, because I was getting nauseous due to the general unawareness of the actual implications of this type of logic when applied on a mass scale. I learned immediately, that if I wanted to pass the course, it was best if I blend in. I was specifically accused of financial heresy and generally looked upon as a source of misinformation and false promises. At the time, I was a 3.9 student and I this was an occurrence where I was being forced to learn something that wasn't logical to me (cognitive dissonance). I mean, the fundamental assumptions didn't make sense. How on earth does risk of owning a company come from covariance? It should come from the discrepancy between price and value.

By failing, I succeeded. I questioned the incentives of others. The teachers job is to propagate generally accepted information. Success. Unfortunately, the information being disseminated was disproven by the person that created it...

Fama and French examined 9,500 stocks between 1963 and 1990, concluding that a stock's risk, measured by beta, was not a reliable predictor of performance. Fama stated "beta as the sole variable in explaining returns on stocks ... is dead. ... What we are saying is that over the last 50 years, knowing the volatility of an equity doesn't tell you much about the stock's return."

If anything, the incorrect propagation of information in this case should make you question why you ever took the EMH seriously. Incorrect assumptions + Mathematical Proofs = Overconfidence + Uh oh?

Name Glen Bradford

(45)

MGMT 611
FINAL EXAM
Spring 2009

100 Points

(15)

(22)

(8)

INSTRUCTIONS

1. Print your name ONLY on the front of your exam.
2. The exam will end at 11:55 AM.
3. You may leave the room at any time for a break, but you are not to discuss the exam with anyone.
4. You are allowed to have one 8.5 x 11 inch pages of notes written on the front and back.
5. Please provide an audit trail for your answers as these will facilitate grading. And a higher grade for you.
6. Partial credit will be granted where appropriate.
7. Good luck!

Targets

Total Leverage Ratio = .6

Net income / EPS = Shares Outstanding

B⁺ = 1.26

Shares outstanding ≈ 1600K

Bond Rating A

Current Debt = 3,200

Current Equity = ? = Price x Shares = \$32085

$$\frac{D}{D+E} = .6 \quad \frac{D}{D+32085} = .6 \quad D^* = 4807$$

Debt to Issue = 4807 - 3200 = \$1607

Shares to buy back: $\frac{\text{Debt to Issue}}{\$27} = 1663K$

Wright is proposing to buy back the entire company by issuing new debt? The current P/E is 14.18, and the P/E of its targets are 14.2 and 14.4. Wright is proposing to pay a P/E of 19.15 to buy back his company?

Alright.

⇒ The comparable companies have an interest coverage ratio of 3.8

$$EBIT = 3997 \quad 3.8 = \frac{3997}{\text{Debt} \times .0705}$$

$$\text{Yield} = .0705 \quad \text{Debt}^* = 14919$$

Debt to Issue: 11719

I advise Wetz that ~~is~~ targeting a interest coverage ratio of 3.8 to get a Debt rating of A.

This way, he could buy back 434 shares @ \$27, ^{27% of the company}

I would recommend that the share price for this transaction to take place be as low as possible.

With a new P/E of 14.3 and 1166 shares outstanding

the EPS is \$1.939 and the PPS is \$27.7.

⇒ Page 11

The Benefit of Diversification (10 points)

~~WAP + Boston~~ Assumption

Do you agree with Wright that WAP is likely to be willing to pay a super-premium price for Top-Off because of the diversification benefits that the acquisition would provide. Why or why not? Please explain.

No, Wright only cares about shareholder returns, assuming shareholders are diversified against their risk level. ~~WAP + Boston~~ WAP does not have the synergies with Top-Off that Boston Cream has as far as I know. If WAP has the same synergies and is effectively creating a new, higher, NPV out of combining the two companies, paying a premium is an option. Odds are that because the two companies are hugely different, the same synergies do not exist.