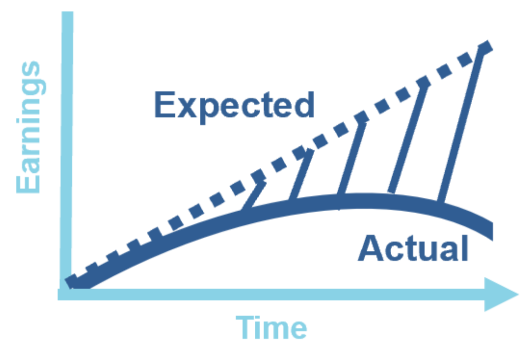
CastleArk Investment Process: Capitalizing on Inefficiencies

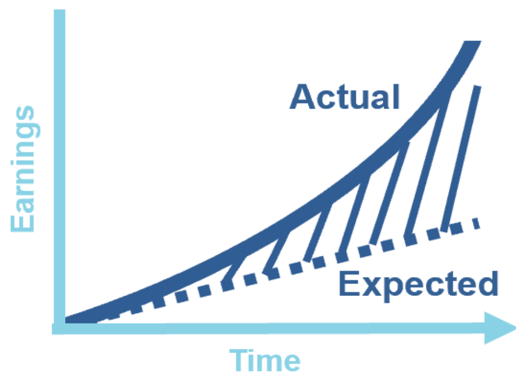
Discovering Biases in a Company's Earnings Outlook

As investors, we search for companies whose stocks are mispriced relative to their forward earnings paths. We believe the potential for success is greatest when investors expect an impractical pace of earnings growth, creating an opportunity to own or exit the stock. Identifying investor **overconfidence** that a business can sustain rapid growth or **fear** that one cannot, underlies our investment process.

Built on the premise that emotional influences can impact market outcomes, Behavioral Finance theory identifies human tendencies like *herd mentality*, *loss aversion* and *anchoring* as non-fundamental drivers of financial market returns. We apply these concepts in our analysis to identify anomalies between a stock's current valuation and its likely trajectory. Our investment process begins by comparing our bottom-up assessment of a company's forward earnings trend with market expectations. When a stock's price reflects a sharper forward earnings path than is unsupported by fundamentals, we then look for behavioral biases to explain the difference. Depending on the bias, the potential for disappointment can be substantial. Conversely, a stock whose price indicates a mediocre growth path despite exceptional business prospects, presents an investment opportunity driven in part by behavioral biases. Combining fundamental analysis with behavioral finance elements informs our unique perspective that applies to all markets and strategies.



For example, investors in large, well-established companies tend to project longer or more sustainable earnings paths than those businesses can support. Due to consistent historical success by these companies' investors can rationalize their forward projections--and the value placed on them—reflecting a false sense of security. This *anchoring* to past performance leads to earnings expectations that are unsupported by the size of the market or the competitive landscape the company is facing. Understanding these behavioral nuances allows us to avoid stocks whose earnings are destined to disappoint, while focusing on stocks with more durable outlooks to match or exceed expectations.



Among investors in smaller, newer companies, we often find the opposite tendency, that is investors take a more guarded view of a business in the early phase of a new product or market introduction. Because these firms have shorter, more volatile histories, investors are often biased towards caution and avoiding losses takes higher priority than making investment gains. This tendency toward *loss aversion* delays investing or causes early investors to sell too soon. Because of this bias, the expected earnings growth potential can be priced well below the actual outcome. Identifying these companies with solid earnings prospects that are overlooked by cautious investors provides us the opportunity for higher-than-expected returns.

Discovering bias in a company's forward outlook is key to distinguishing between an investment with a downside or an upside opportunity. By means of sound, fundamental assessment of the forward earnings compared to expectations embedded in the stock price, we can uncover behavioral bias to earn higher returns for our clients.