Stephens
Investment Management Group®

BEHAVIORAL FINANCE—*FINDING INFLECTION POINTS*

As part of our investment process, we are constantly searching for inflection points in companies' fundamentals. i.e. Data that is significantly different than what Wall St. was expecting.

In our experience, investors don't do a good job of handling data that doesn't fit their prior beliefs. They are often limited by ***Overconfidence, Anchoring, Confirmation Bias and Insufficient Adjustment***.

Overconfidence – The tendency to believe that an individual's judgments are more accurate than they actually are. For example, Analysts that build earnings models for companies tend to be overconfident about their forecasts. This is evidenced by the relatively narrow bands that are created by their "best-case" and "worst-case" scenarios. Reality often lies outside of what experts think is best- or worst-case.

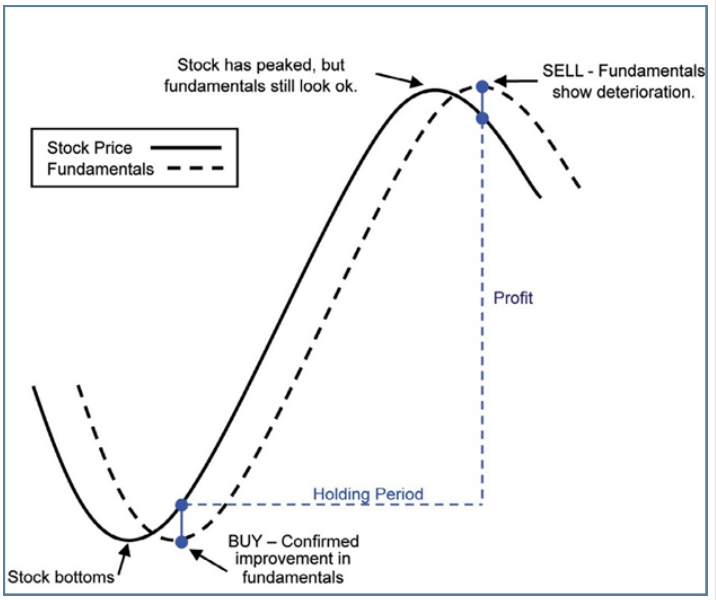
Anchoring – The tendency to rely too heavily on an initial piece of information or data point and base all future conclusions relative to the original data, even when the original data is random or uncorrelated. The anchoring bias is pervasive throughout Wall St. Investors and analysts can be anchored to an investment idea or belief.

Confirmation Bias – Looking for evidence that supports one' theory (which is sometimes easy to find, even when the theory is invalid).

Insufficient Adjustment – Adjustment (or lack of) made from the initial anchor, based on additional information.

Due to anchoring and overconfidence, Wall Street chronically underestimates the magnitude and duration of change.

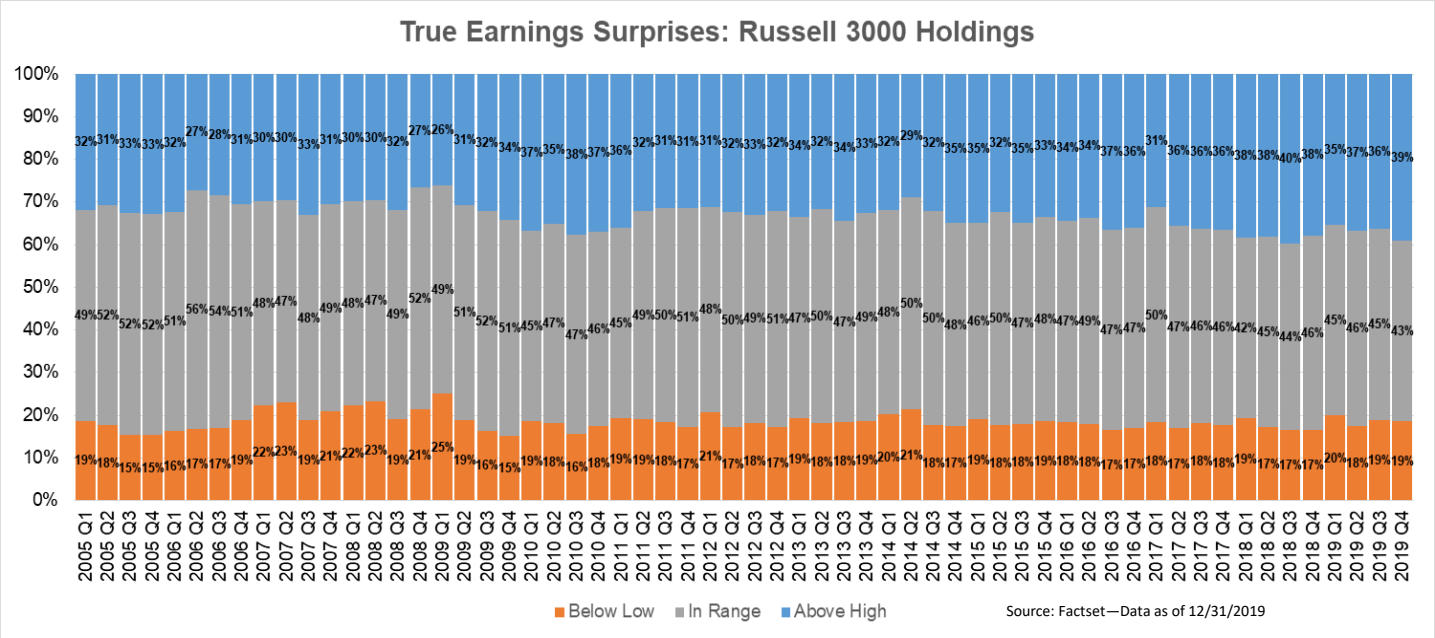
As a result of these behavioral biases, these catalysts have historically led to outperformance that exceeds expectations in both magnitude and duration. We recognize that at any given point in time, especially at major fundamental inflection points, we can't fully appreciate just how good it might get. As such, we don't set price targets. Our exit strategy depends setting fundamental targets and closely monitoring data for negative inflection points. Using this strategy, we may not buy at the absolute bottom and may not sell at the very top, but we attempt to reduce the number of false positives, and seek to capture the bulk of the return, only selling when we believe that the catalyst has run its course.



Source: Stephens Investment Management Group

TRUE EARNINGS SURPRISES: RUSSELL 3000® HOLDINGS

The following chart shows what we call a True Earnings Surprise where the actual reported quarterly earnings were either above the **highest** estimate or lower than the **lowest** estimate. The data shows that over half the time, quarter after quarter, Wall Street/Sell-Side analyst publishing research can't even define the **range** of estimates correctly. We are not talking about a miss or beat of consensus earnings; we are talking about accurately defining the range of earnings correctly for the quarter (prior 90 days).



We chose to run this data on the Russell 3000®. If you were to run the results for the Russell Midcap® or Russell 2000®, the results are even more exaggerated.

Because of the four Behavioral Biases we previously identified, we believe these biases create opportunities for our style of investing. Human nature is such that at major fundamental inflection points, most people can't fully appreciate just how different things might become. This is true at both a micro and macro level. While we believe we are better than most at making predictions, we accept the fact that even we are subject to these biases. Therefore we look for inflection points. We approach every situation with an open mind. We try to find situations where the potential outcomes are significantly above consensus and skewed positively.