Equity Valuation Primer
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Agenda

I. Introduction to Firm / Equity Valuation
II. Relative Valuations Techniques
III. Cash Flow Techniques
IV. Discussion of Best Practices
V. How To Value Equities On Your Own
Introduction to Firm / Equity Valuation

SECTION I
What Value is There in Understanding Valuation

Why Is It Good To Know How To Value a Firm / Equity?

- Good to know how to value an enterprise (Total Enterprise Vale = TEV) and equity (i.e. common stock) for many reasons:
  - Takeovers / Acquisitions
  - Mergers
  - Divestitures (selling off part of a business)
  - Offerings of common stock (Initial Public Offerings (IPOs) and Secondary Offerings)
  - Identifying good “bargain” stocks that trade on the market below “intrinsic value” (i.e. under-valued stocks)

- It is good to know a wide variety of valuation techniques. Always good to take an average of all valuation technique results. Also good to understand untraditional valuation methods in untraditional instances (example: how do you value a start-up company with no revenue, such as Facebook once was? – not easy to answer!)

You don’t want to be like this guy – you want to have understanding of sound valuation techniques to properly price stocks.
Why Not Use Book Value?

- All public companies publish financial statements in their annual reports, which are made public on SEDAR or EDGAR, so why can’t I just look at the “Book Value” = Total Assets? (After all, I am just buying part ownership of those assets!)
  - Question: Does Total Assets = Fair Market Value of a Firm?
    - Answer: 99% of the time, NO!

- Book Value:
  - Is based on historical cost of assets
  - Ignores the value created by management with these assets
  - May include redundant assets
  - May grossly underestimate certain assets (such as real estate that almost never depreciate, even though it is recorded as a depreciating asset on companies’ balance sheet)

Two Main Types of Valuation Techniques

- Relative Valuation Techniques:
  - Precedent Transactions Valuation
  - Comparable Companies (“Comps”) Multiples Valuation

- Cash Flow Techniques:
  - Dividend Discount Valuation
  - Discounted Cash Flows (DCF) (Markus’ Favourite – more on this topic at tomorrow’s Associate Meeting!)
TEV vs. Equity Value

- TEV is **NOT** the same thing as equity
  - TEV represents the total value of the firm (which includes equity)
- When we value equity, we either:
  - Use valuation techniques that value equity as a stand-alone measure – relative valuation techniques
  - Or we measure TEV, and then subtract all other forms of capital (such as debt, preferred shares, etc.) to find the value of the equity part – DCF technique

\[
\text{FMV of Assets} = \text{FMV of (Liabil. + Owner’s Equity)}
\]

**TEV**

- **Fair Market Value (FMV) Adjustment Over Book Value**
- **Book Value of Total Assets** (Recorded on Balance Sheet)
- **Liabilities (@ FMV) (i.e. Debt)**
- **Equity** (What we are trying to value / get FMV of!)
Trading Price Is Not Necessarily The Intrinsic Value!

- Large debate over whether the markets are “efficient” (all trading prices on the stock market are correct, true values of financial securities given all publically available information) or not
  - To some extent markets are efficient because if they weren't, buying stocks at “bargain” prices makes no sense because implicitly we buy them at below-intrinsic value prices with philosophy that eventually market will properly price it (and when it does, we can sell and make a lot of money)
  - But because a lot of market data is lagging and there are a lot of dumb investors out there, prices are not always reflective of true, intrinsic value
  - In this sense, the market trends towards efficiency in the long-run, but there are often opportunities for capitalizing off of shorter-term inefficiencies

### Takeover Example To Illustrate

<table>
<thead>
<tr>
<th>Potential Takeover Premium</th>
<th>Defence Cost</th>
<th>Potential cost if competitor gets target</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Outlook</td>
<td>Acquirer has different outlook than the market</td>
</tr>
<tr>
<td></td>
<td>Synergies</td>
<td>Cost savings / increased revenue</td>
</tr>
<tr>
<td></td>
<td>Re-finance</td>
<td>Sub-Optimal capital structure</td>
</tr>
<tr>
<td></td>
<td>Under-valuation</td>
<td>Under-valuation in market pricing</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Current Public Market Trading Price</th>
</tr>
</thead>
</table>

**Other...**
Relative Valuations Techniques

SECTION II
Comparable Transactions

Using Past Transactions As a Guideline

- Idea: If Markus just bought a dozen bagels for $12, we could approximate market value as $1 per bagel – therefore, when Tansik goes to buy 7 bagels, he knows that he should be paying roughly ($1/bagel)x(7 bagels) = $7 total
  - Now, instead of valuing bagels, we can value both firms and equity on its own
  - This method is applied in multiple areas of finance – especially real estate (best predictor of the price of your house on the market is the price that your neighbour just sold their house for!)

- Problem: very few companies are comparable, and none are absolutely comparable

- When using this technique, you need to pay attention to when the transactions took place because the market changes (a transaction a month before the collapse of Lehman Brothers would occur at a much higher price than one after the collapse!)

- Premiums and multiples can be analyzed to apply similar relative premiums to other equity securities
Comps – Fun With Multiples

Using Other’s Firms’ Trading Multiples to Extrapolate Our Firm’s Value

- Idea: If there is a ratio (i.e. Price per Share / Earnings per Share) for a mining company in Alberta called **MARKUS CO.**
  - Can multiply this ratio by the Earnings per Share (“EPS”) at another mining company in Ontario, called **TANSIK CO.** to get the Price per Share at Tansik Co.
  - Assumes the P/E multiple at Markus Co. is an accurate one that well describes the multiple one would expect from Tansik Co.

\[
\text{Markus Co. Share Price (Mar)} \times \frac{\text{EPS (Mar)}}{\text{EPS (Tan)}} = \text{Tansik Co. Share Price (Tan)}
\]

- To find good valuation multiples, you must find well-suited comparable companies - multiples are driven by 2 things: risk and growth (which translates into return):
  - Therefore, similarity based on things that drive both risk (Weighted Average Cost of Capital (“WACC”)) and growth:
    - Size of company
    - Capital structure (debt-to-equity mix)
    - Growth prospects
    - Industry / geographic location
    - Margins
Commonly Used Multiples

Price / Earnings ("P/E")

- Most commonly used / popular multiple – applied to many industries (often even ones where it shouldn’t be!)
- Measure of the price paid for a share relative to the annual net income or profit earned by the firm per share
  - A higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio
- The reciprocal of the PE ratio is known as the “Earnings Yield”
  - The earnings yield is an estimate of expected return to be earned from holding the stock if we accept certain restrictive assumptions
- The price per share the numerator is the market price of a single share of the stock. The earnings per share in the denominator depends on the type of P/E:
  - “Trailing P/E” – EPS is based on the net income of the company for the most recent 12 month period
  - “Forward P/E” – EPS is based on estimated net earnings per share over next 12 months
- The essential problem with the earnings-multiple valuation approach is that it does not value directly what matters to investors. Only the cash flow generated by the business can be used for consumption or additional investment

\[ P/E \text{ ratio} = \frac{\text{Price per Share}}{\text{Annual Earnings per Share}} \]
Commonly Used Multiples (Cont’d)

Historical Average P/E Rates for S&P 500 Companies…

[Graph showing S&P 500 P/E ratio and US interest rates, 1881-2008, with notable years marked on the graph.]
Commonly Used Multiples (Cont’d)

P/E Valuation Guideline (Not In Any Way Always True…Just A Guideline)

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>N/A</td>
<td>A company with no earnings has an undefined P/E ratio. By convention, companies with losses (negative earnings) are usually treated as having an undefined P/E ratio, although a negative P/E ratio can be mathematically determined.</td>
</tr>
<tr>
<td>0–10</td>
<td>Either the stock is undervalued or the company's earnings are thought to be in decline. Alternatively, current earnings may be substantially above historic trends or the company may have profited from selling assets.</td>
</tr>
<tr>
<td>10–17</td>
<td>For many companies a P/E ratio in this range may be considered fair value.</td>
</tr>
<tr>
<td>17–25</td>
<td>Either the stock is overvalued or the company's earnings have increased since the last earnings figure was published. The stock may also be a growth stock with earnings expected to increase substantially in future.</td>
</tr>
<tr>
<td>25+</td>
<td>A company whose shares have a very high P/E may have high expected future growth in earnings or the stock may be the subject of a speculative bubble.</td>
</tr>
</tbody>
</table>

TEV / EBITDA

- Question: Why is EBITDA used in the TEV ratio?
  - Answer: It is applicable to all capital holders (i.e. “above the line” – before interest payments on debt)

- An advantage of this multiple is that it is capital structure-neutral. Therefore, this multiple can be used for direct cross-companies application.

- The reciprocate multiple EBITDA/EV is used as a cash return on investment.

Other Multiples

- Other multiples include: Price / Cash Flows (“P/CF”), Price / Book Value (“P/B”), Price / Sales (“P/S”), etc.
Cash Flow Techniques

SECTION III
Recall: Time Value of Money

(Slide from Presentation 1 – Introduction to Capital Markets)

- Question: Why did a box of matches cost $0.01 thirty years ago, when a box of matches costs $0.50 now?
  - Answer: The “Time Value of Money”
- Put simply, $1 today is worth more than $1 tomorrow
- Can be illustrated with the following example:
  - Peter and Brian both thirsty for a pint, and beer costs $5/pint
  - Peter has $5 and Brian has no money (sharing is not an option)
  - If Brian asks Peter for his $5 with a promise to return the money the next month, Peter would naturally prefer to enjoy the beer himself
  - If however, Brian agreed to pay Peter back an additional “fair amount” on top of the $5 principal loan value owed, Peter may prefer to wait for a beer another day
- If Peter loaned the $5 to Brian today, why would he want to collect interest for Brian to pay him back the next month?
  1. Delayed Gratification – Peter cannot enjoy the refreshing pint of beer today (he will have to wait)
  2. Default Risk – Maybe Brian won’t be able to pay Peter back
  3. Inflation – Brian might pay Peter back next month, but the price of beer may have gone up in that time
- The “fair additional cost” to Brian associated with borrowing the money is called an “opportunity cost”

The value of a company / enterprise if the present value of all the future free cash flows: since a dollar tomorrow is less than a dollar today, we must discount these future cash flows using the Weighted Average Cost of Capital (“WACC”)
## Brief Introduction to Discounted Cash Flows (DCF)

### Weighted Average Cost of Capital

- **WACC** = measure of the weighted average expected return to **all** stakeholders (debt-holders, shareholders, etc.)

### DCF Valuation of "ABC Co."

**As at May 1, 1998**

#### Step 1: Calculating the Firm's WACC

<table>
<thead>
<tr>
<th><strong>Weights</strong></th>
<th><strong>Cost of Debt</strong></th>
<th><strong>Cost of Equity</strong></th>
<th><strong>WACC</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Weight of debt ($w_d$)</td>
<td>Weight of equity ($w_e$)</td>
<td>Before Tax Cost of debt</td>
<td>Tax rate ($t$)</td>
</tr>
<tr>
<td>29.69%</td>
<td>70.31%</td>
<td>10.50%</td>
<td>44.00%</td>
</tr>
</tbody>
</table>

#### Assumptions

- *(From Exhibit 7(a), Step 1)*
- *(From Exhibit 7(a), Step 1)*
- *(Canadian prime rate of 6.5% (Exhibit 2) + 400 bp (4%) spread)*
- *(Given - Exhibit 6.6 (Income Taxes))*
- *(Canada bond yield (Exhibit 2) - assume long-term)*
- *(Usually 5% from "Best Practices," but market currently BOOMING!)*

#### Step 2: Stating Cash Flow Assumptions

<table>
<thead>
<tr>
<th><strong>Assumptions</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>FCF terminal growth ($g$)</td>
</tr>
<tr>
<td>Tax Rate</td>
</tr>
</tbody>
</table>

- $g = GDP + CPI = 3.4% + 0.9%$ (Exhibit 2)
- *(Given - Exhibit 6.6 (Income Taxes))*
Discounted Cash Flows Analysis → Share Price

- Project out “Unlevered Free Cash Flows” and then discount them at using the WACC (with terminal cash flow in last year).
- Sum up the discounted unlevered free cash flows to get TEV, then subtract other forms of financing (debt, pref. shares).
- Result = FMV of Equity Value → divide by # of outstanding (diluted) shares to get FMV Share Price.

(All figures in thousands, except equity value/share)

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>1.688,200.0</td>
<td>1.822,000.0</td>
<td>1.966,404.5</td>
<td>2.122,253.8</td>
<td>2.290,455.2</td>
<td>2.388,944.8</td>
<td></td>
</tr>
</tbody>
</table>

**Unlevered Free Cash Flows**

- **Revenue**: $1,688,200.0
- **EBIT**: 47,000.0, 53,182.0, 59,853.9, 67,054.6, 74,826.0, 78,043.6
- **Tax Pool**: 213,000.0, 192,320.0, 147,520.0, 97,920.0, 68,416.0
- **Cash Taxes Due (44%)**: (20,680.0), (23,400.1), (26,335.7), (29,504.0), (32,923.5)
- **Actual Taxes Paid**: 0.0, 0.0, 0.0, 0.0, 0.0, 0.0
- **Tax-Effective EBIT**: $47,000.0, $53,182.0, $59,853.9, $67,054.6, $74,826.0, $43,704.4
- **Add: Depreciation**: 31,000.0, 31,000.0, 31,000.0, 31,000.0, 31,000.0, 31,000.0
- **Less: Capital Expenditures**: (100,000.0), (32,377.7), (23,295.9), (12,571.1), (13,567.4), (14,150.8)
- **Less: Incremental Working Capital**: (96,026.0), (7,610.6), (15,824.5), (24,689.3), (34,256.7), (39,858.9)
- **Unlevered Free Cash Flow**: ($118,026.0), $44,193.7, $51,733.6, $60,794.2, $58,001.9, $20,694.7
- **Present Value of Unlevered FCF**: ($111,368.6), $37,750.2, $40,004.3, $42,557.0, $36,755.7, $13,114.2

**Value Summary**

- **PV of Unlev. Free Cash Flows**: $45,698.5
- **PV of Terminal Value**: $212,712.0
- **Enterprise Value**: $258,410.5
- **Less: Debt**: $76,726.0
- **Add: Excess Cash**: 0
- **Equity Value**: $181,684.52
- **FD Shares Outstanding**: 9,888.733
- **Equity Value per Share**: $18.37
- **Issue Price (20% Discount)**: $14.70

**DCF Assumptions (from Steps 1 & 2)**

- **WACC**: 10.47%
- **Terminal Growth Rate**: 4.30%
- **Implied Terminal EBITDA Multiple**: 4.5x

**Amount of Capital Needed**: $175,000,000
**# of Shares to Issue (@ Discount)**: 11,906,135
### Sensitivity Analysis (Key Measure of Exposure)

#### Discount Rate (WACC)

<table>
<thead>
<tr>
<th>Terminal Growth Rate</th>
<th>2.00%</th>
<th>2.50%</th>
<th>3.00%</th>
<th>3.50%</th>
<th>4.00%</th>
</tr>
</thead>
<tbody>
<tr>
<td>9.0%</td>
<td>$273,180</td>
<td>$284,954</td>
<td>$298,689</td>
<td>$314,922</td>
<td>$334,402</td>
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<tr>
<td>9.5%</td>
<td>$252,099</td>
<td>$261,770</td>
<td>$272,930</td>
<td>$285,949</td>
<td>$301,336</td>
</tr>
<tr>
<td>10.0%</td>
<td>$233,548</td>
<td>$241,561</td>
<td>$250,719</td>
<td>$261,286</td>
<td>$273,614</td>
</tr>
<tr>
<td>10.5%</td>
<td>$217,085</td>
<td>$223,773</td>
<td>$231,353</td>
<td>$240,155</td>
<td>$250,010</td>
</tr>
<tr>
<td>11.0%</td>
<td>$202,365</td>
<td>$207,982</td>
<td>$214,301</td>
<td>$221,462</td>
<td>$229,646</td>
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<tr>
<td>11.5%</td>
<td>$189,117</td>
<td>$193,859</td>
<td>$199,159</td>
<td>$205,121</td>
<td>$211,879</td>
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<tr>
<td>12.0%</td>
<td>$177,123</td>
<td>$181,144</td>
<td>$185,613</td>
<td>$190,607</td>
<td>$196,225</td>
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<tr>
<td>12.5%</td>
<td>$166,205</td>
<td>$169,629</td>
<td>$173,413</td>
<td>$177,617</td>
<td>$182,316</td>
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<tr>
<td>13.0%</td>
<td>$156,221</td>
<td>$159,144</td>
<td>$162,360</td>
<td>$165,915</td>
<td>$169,864</td>
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<tr>
<td>13.5%</td>
<td>$147,050</td>
<td>$149,553</td>
<td>$152,294</td>
<td>$155,310</td>
<td>$158,643</td>
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<tr>
<td>14.0%</td>
<td>$138,592</td>
<td>$140,740</td>
<td>$143,083</td>
<td>$145,648</td>
<td>$148,471</td>
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<tr>
<td>14.5%</td>
<td>$130,765</td>
<td>$132,610</td>
<td>$134,616</td>
<td>$136,804</td>
<td>$139,200</td>
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<tr>
<td>15.0%</td>
<td>$123,497</td>
<td>$125,084</td>
<td>$126,803</td>
<td>$128,672</td>
<td>$130,710</td>
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</tbody>
</table>

#### Sensitivity on Equity Value per Share

<table>
<thead>
<tr>
<th>Terminal Growth Rate</th>
<th>2.00%</th>
<th>2.50%</th>
<th>3.00%</th>
<th>3.50%</th>
<th>4.00%</th>
</tr>
</thead>
<tbody>
<tr>
<td>9.0%</td>
<td>$15.54</td>
<td>$16.21</td>
<td>$16.99</td>
<td>$17.91</td>
<td>$19.02</td>
</tr>
<tr>
<td>9.5%</td>
<td>$14.34</td>
<td>$14.89</td>
<td>$15.52</td>
<td>$16.26</td>
<td>$17.14</td>
</tr>
<tr>
<td>10.0%</td>
<td>$13.28</td>
<td>$13.74</td>
<td>$14.26</td>
<td>$14.86</td>
<td>$15.56</td>
</tr>
<tr>
<td>10.5%</td>
<td>$12.35</td>
<td>$12.73</td>
<td>$13.16</td>
<td>$13.65</td>
<td>$14.22</td>
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<tr>
<td>11.0%</td>
<td>$11.51</td>
<td>$11.83</td>
<td>$12.19</td>
<td>$12.60</td>
<td>$13.06</td>
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<td>11.5%</td>
<td>$10.76</td>
<td>$11.03</td>
<td>$11.33</td>
<td>$11.67</td>
<td>$12.05</td>
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<tr>
<td>12.0%</td>
<td>$10.07</td>
<td>$10.30</td>
<td>$10.56</td>
<td>$10.84</td>
<td>$11.16</td>
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<tr>
<td>12.5%</td>
<td>$9.45</td>
<td>$9.65</td>
<td>$9.86</td>
<td>$10.10</td>
<td>$10.37</td>
</tr>
<tr>
<td>13.0%</td>
<td>$8.89</td>
<td>$9.05</td>
<td>$9.24</td>
<td>$9.44</td>
<td>$9.66</td>
</tr>
<tr>
<td>13.5%</td>
<td>$8.36</td>
<td>$8.51</td>
<td>$8.66</td>
<td>$8.83</td>
<td>$9.02</td>
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<td>14.0%</td>
<td>$7.88</td>
<td>$8.01</td>
<td>$8.14</td>
<td>$8.28</td>
<td>$8.44</td>
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<tr>
<td>14.5%</td>
<td>$7.44</td>
<td>$7.54</td>
<td>$7.66</td>
<td>$7.78</td>
<td>$7.92</td>
</tr>
<tr>
<td>15.0%</td>
<td>$7.02</td>
<td>$7.11</td>
<td>$7.21</td>
<td>$7.32</td>
<td>$7.43</td>
</tr>
</tbody>
</table>
Discussion of Best Practices

SECTION IV
### Transaction Range Analysis (Football Field)

#### Step 1: Summarizing ranges from all valuation methods

<table>
<thead>
<tr>
<th>Valuation Metric</th>
<th>Value of Equity Low</th>
<th>Value of Equity High</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stand-Alone DCF Analysis</td>
<td>$15.0</td>
<td>$32.0</td>
</tr>
<tr>
<td>Merger DCF (Synergies) - TPG</td>
<td>$26.7</td>
<td>$38.0</td>
</tr>
<tr>
<td>Merger DCF (Synergies) - IND</td>
<td>$25.2</td>
<td>$28.1</td>
</tr>
<tr>
<td>TEV/EBITDA (LTM)</td>
<td>$19.7</td>
<td>$27.8</td>
</tr>
<tr>
<td>Price/Net Income (LTM)</td>
<td>$27.3</td>
<td>$41.3</td>
</tr>
<tr>
<td>TEV/EBITDA (2008E)</td>
<td>$17.3</td>
<td>$31.7</td>
</tr>
<tr>
<td>Price/Net Income (2008E)</td>
<td>$24.4</td>
<td>$27.1</td>
</tr>
</tbody>
</table>

#### Step 2: Football Field Creation

- There is no one valuation method that is better than the rest.
- The best practice in the finance industry is to price equity using all of the valuation techniques, charting out the ranges (based on sensitivity of inputs) using a “Football Field” (see left chart), and then taking an average.
- This chart can also be used to identify where bids for the stock currently stand (if it is an acquisition / merger, for example).
How To Value Equities On Your Own

SECTION V
1. Overview

2. Free Cash Flows

3. Weighted Average Cost of Capital (WACC)
   • Cost of Debt
   • Cost of Equity (CAPM)

4. Terminal Value

5. Enterprise Value
   • Treasury Stock Method

6. Questions
Valuing Equity on Your Own (Website Resources)

Valuation Websites

- Magic Formula Investing (from Joel Greenblatt’s “Little Book That Beats the Market”):
  [www.magicformulainvesting.com](http://www.magicformulainvesting.com)
- ValuPro Investing (DCF stock valuations using live Google Finance data from “Streetsmart Guide to Valuing a Stock”):
  [www.valuepro.net](http://www.valuepro.net)

Other Useful Websites

- Investopedia:
  [www.invesopedia.com](http://www.invesopedia.com)
- Wikinvest:
  [www.wikinvest.com](http://www.wikinvest.com)
- The Economist:
  [www.economist.com](http://www.economist.com)
- MSN Money Central:
  [www.moneycentral.msn.com](http://www.moneycentral.msn.com)
- Bankers Ball:
  [www.bankersball.com](http://www.bankersball.com)
- NY Times Dealbook:
- Bloomberg:
  [www.bloomberg.com](http://www.bloomberg.com)
- Google Finance:
  [www.google.ca/finance](http://www.google.ca/finance)
- Yahoo! Finance:
  [www.finance.yahoo.com](http://www.finance.yahoo.com)
- Bank of Canada:
  [www.bankofcanada.ca](http://www.bankofcanada.ca)
Suggested Reading Materials (Same as Pres. # 1)

For Starters – Introduction to Investing Concepts
Suggested Reading Materials (Same as Pres. # 1)

For More Experienced – Informative & Classic Finance Humour Books

- *Security Analysis* by Benjamin Graham and David L. Dodd
- *A Random Walk Down Wall Street* by Burton G. Malkiel
- *The Intelligent Investor* by Benjamin Graham
- *The Theory of Investment Value* by John B. M. Keynes
- *Your Money & Your Brain* by Jason Zweig
- *Financial Shock* by Mark Zandi
- *The Black Swan* by Nassim Nicholas Taleb
- *Monkey Business* by John Rolfe and Peter Troob
- *Liar’s Poker* by Michael Lewis