Educated Investing

An Apple a Day Could Put Your Portfolio at Risk

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The Michael Price Student Investment Fund (MPSIF) is a family of funds managed directly by NYU Stern MBA students. In each issue of the Stern Opportunity, MPSIF will share a stock recommendation based on the recent work of a current MPSIF Analyst.

This edition profiles the research of MPSIF Growth Fund portfolio manager Brian Baytosh. Upon his recommendation, the Growth Fund sold its position in Apple in February, netting a 56% holding period return in the stock.

He recommends selling Apple Inc shares (NASDAQ: AAPL) at their current price of $125 (as of 2/29/2008), based on his discounted cash flow valuation of $130/share.

Baytosh is a second-year MBA student who interned over the summer in the equity research department at UBS, where he will return after graduation as an equity research associate. Prior to Stern, he worked as a production manager in the publishing industry.

Goodbye Momentum

“Triple threat – growth estimates revised downward, falling multiples, and rotation out of tech – kill momentum”

Apple was one of the biggest highflying tech stocks of 2007, but like fellow darling Google it came crashing down in recent months, as momentum investors bailed on the name.

After hitting a 52-week high of $203 at the end of last year, Apple shares fell to $125 in late February. For MPSIF Growth Fund portfolio manager Brian Baytosh, the decision to cash out of the stock was not an easy one, especially since nearly every Wall Street analyst rates the stock a buy, with a consensus price target of $194.

The MPSIF Growth Fund purchased Apple shares in December 2006, and Baytosh updated the stock with a “hold” recommendation in Fall 2007. At the end of the fall semester, the fund decided to sell a third of its position in the stock since MacWorld was coming up in January, and the stock tends to be volatile around this event.
Baytosh, for his February update on the stock, felt Apple shares were now fairly valued at $130, so he recommended the fund lock in gains and sell the rest of the position, rather than suffer even more pain.

“You always want to have the idea that, `oh it will come back,’” Baytosh says. “But you need to be disciplined about this and decide where the stock is going, not where it has been,” he says.

Baytosh decided a $200 price target (near the 52-week high price) is only justified if you assume Apple can grow revenues at a 40% compound annual growth rate over the next five years, which he didn’t think was realistic.

“A lackluster MacWorld in the middle of January and a mixed earnings report in the third week of January caused a broad downward revision in growth estimates for Apple,” Baytosh wrote in his report, which was entitled Goodbye Momentum.

“The absence of a blockbuster iPhone announcement at MacWorld called into question whether this product can continue the spectacular revenue growth contribution of the iPod,” he wrote.

Apple shares fell 10% the day after MacWorld, as Wall Street was unimpressed with the company’s super-light laptop, the MacBook Air. Shares fell another 10% after the company’s first quarter earnings release in late January.

Baytosh also points out that when Apple reported year-over-year iPod unit growth of only 5% during 1Q08, and guided to revenue of $6.8B and EPS of $0.94 versus expectation of $7.0B and $1.09 respectively, growth estimates fell further for the company.

Along with this slowing earnings growth comes the recent rotation out of tech names. This year, Apple shares have fallen 34%, while Google is down 31%.

“The current credit crunch and resulting market correction have reduced the market appetite for risk and caused a general rotation out of technology shares which has further depressed Apple share prices,” Baytosh wrote in his report.

Baytosh says Apple’s 65% share price appreciation over the second half of 2007 was driven by continued expectation of outsized upside surprises to earnings.

His analysis suggests the market is fairly pricing Apple shares. With what he grants to be “relatively optimistic assumptions” such as the iPhone taking about 16% market share in high-end handsets by 2011, Macs doubling market share to 6% by 2011, and the iPod successfully transitioning from personal music player to wireless Internet device, he arrives at a 12-month price target of $130.
Risks to his sell thesis on Apple, he says, are that outsize upside surprises resume; the market appetite for risk returns; sentiment on the name turns with the economy; or consumer spending reignites.

“Apple is a solid company that puts out a differentiated product,” he says. “They’re very smart at staying ahead of the curve on products.”

But when it comes down to what really matters, Baytosh says, you need to separate the strong strategic company and the stock—which he says is now priced fairly after having enjoyed a very rich multiple in 2007.

**About MPSIF**

The Michael Price Student Investment Fund (MPSIF) is a family of funds managed directly by NYU Stern MBA students. The fund, part of the overall NYU endowment, was established in 1999 through a generous gift from Michael Price, managing partner, MFP Investors, LLC and former chairman of Franklin Mutual Series funds.

With roughly $1.9 million currently under management, MPSIF provides Stern MBA students interested in pursuing a career in asset management with hands on experience managing a real fund with significant assets.

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