



## FINANCE 397.1 – INVESTMENT THEORY AND PRACTICE

SUMMER 2016

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### Course Objectives

This course is designed to teach you about the investment process. In particular, you should leave this class understanding the components used to put together a portfolio. This requires you to understand different types of securities (bonds, stocks, derivatives) and how they are combined to form a portfolio. In addition, there is background information which is necessary to understand. This information includes topics such as types of markets, how to place orders, and what stock indexes represent.

I want to tell you how this course is designed and I also want to explain why we're going to go out of order! This course is normally designed to start with an introduction to the study of Investments (Unit 1). This introductory unit includes some "personal finance" issues such as planning for retirement. After that, we normally discuss (Unit 2) the cost of capital (cost of debt, cost of preferred stock and cost of equity). We focus on the relationship between risk and return. After Unit 2 is done, we are able to focus on investment instruments.

Units 3 and 4 cover bonds. Unit 3 examines the basics of bonds (terminology, pricing relationships, etc.) and Unit 4 examines concepts and strategies used in managing bond portfolios. In Unit 4, we will focus on the concept of duration and how that translates into certain strategies (such as immunization).

Units 5 – 10 cover stocks. We will examine stock market indexes (Unit 5), the relationship between the economy and the stock market (Unit 6), valuation (Unit 7), technical analysis (Unit 8), market efficiency vs. behavioral finance (Unit 9) and placing orders (as well as using margin and selling short) in Unit 10.

Unit 11 will cover derivatives. Our focus will be on options from both an academic perspective (terminology, pricing, etc.) and a strategic perspective (how to use options to supplement your equity portfolio).

Unit 12 will allow us to study mutual funds. You can think of these as portfolios of stocks and bonds. We will also discuss hedge funds. Finally, Unit 13 will ask how we evaluate performance.

This summer, **we will proceed in a different order** and I want to explain why. We only meet eight times. The classes are long (most are six hours; two are four hours). For many of the classes, I need you to prepare for class (listening to tapes as I will describe below). Some material, however doesn't require prep work. I want to do material that doesn't require prep work when we're going to have our midterm and final. We need to have class after our midterm and final (which will each be two-hour exams) and I know that there's no way for you to prepare for the exams and for class.

In sum, we have to make a tradeoff...we need to weigh the value of proceeding in order against the value of balancing the classes out (so that one day isn't really hard and another day is really easy). I've thought about this a lot and I am completely convinced that we will be better off proceeding out of order. It will be better for everyone if we make sure that no one day is overwhelming.

This class has been designed to give us the flexibility to discuss applied topics and current events and to spend less time covering subjects that you already have seen (such as basic bond pricing and the dividend discount model). The reality, however, is that I have done this long enough to know that many members of the class (the majority) need to see this material again. As a result, I have prepared taped lectures that you will need to listen to prior to attending class. In addition, I use the taped lectures to cover material that does not lend itself to discussion.

This idea of taped lectures is best compared to a class which requires you to read ahead of the class meeting. I won't require you to read – just listen to a taped lecture. **If you choose not to do this, you will be lost in class. This would be no different than attending a case class without having read the case. Also, similar to a case class, it's obvious when someone isn't prepared.**

## Leadership and this Course

The Texas MBA program is designed to develop influential business leaders. The MBA Program has identified four fundamental and broad pillars of leadership: knowledge and understanding, communication and collaboration, responsibility and integrity, and a worldview of business and society.

In this course, you will enhance your knowledge and understanding of financial markets and investment instruments. Regardless of whether you want to be an asset manager or a marketing executive, you must understand how the capital markets work. Ultimately, the capital markets allow us to determine value. If your job as an executive is to maximize shareholder value, you must understand how this is measured. I urge you to read on your own (The Wall Street Journal, Barron's, Business Week, etc.) so that you become immersed in the language.

## Materials

### Text

*Investment Analysis and Portfolio Management*, 10<sup>th</sup> Edition by F. Reilly and K. Brown (South-Western Cengage, 2012)

### Packet

*Investments*, by Sanford J Leeds (2016) – available at the GSB copy center (3<sup>rd</sup> floor)

### Calculator

You will need a business calculator for this class. The calculator should have the following keys: IRR, n, i, PV, PMT, FV, and CF. As long as those keys are present, the calculator is fine. If you may consider taking the CFA exam in the future, I recommend the HP 12c (this calculator is the finance industry standard and one of only two calculators that may be used on the CFA exam). The other calculator which is permissible for the CFA exam is the Texas Instruments BA II Plus. **You should bring a financial calculator to every one of our class meetings.**

### Prerequisite

*BA 385T (or BOTH BA 285 and BA 286) – Financial Management* – must be successfully completed prior to taking this class. There are no exceptions to this rule.

## Course Requirements and Grading

Your grade in the course will be determined as follows:

Midterm Exam	40%
Final Exam:	45%
Project:	15%

I expect the average grade point of this class to be 3.42 +/- .05. In other words, the average grade point for the class will be between 3.37 and 3.47. The target distribution is A (25%); A- (20%); B+ (15%); B (35%); B- or lower (5%). Plus/Minus grading applies to this course. If you are in a program that does not allow for Plus/Minus grading, I will grade you with the rest of the class and the “plus” or “minus” simply falls off of your grade. In other words, a B+ or a B- will simply be a B. Please understand that I do give Cs and lower grades. This is never my goal, but it is inevitable. I do not think that it is fair for someone to work hard in order to receive a B- and then to find out that someone scored far lower and received the same B-. Finally, please realize that I lower grades based on violations of the Professionalism Policy (described below) and the Honor Code (also described below). **It is particularly important to me that you arrive on time, stay for the entire class, keep your laptops and tablets closed, do not use cellphones, don't text or email during class and respect your peers.** As the semester progresses, you will realize that I will hold you to a very high standard, but I will hold myself (and how this class is presented) to an even higher one.

## Description of Requirements

### **Midterm and Final Exam**

Your exams will be held in class. The exams will be 90 – 120 minutes long. (We will have the two **exams at the start of class on June 3<sup>rd</sup> and June 24<sup>th</sup>**. After the exams, we will have class.) My exams tend to include most of the material that I have taught (rather than just a few big questions). The typical test might have approximately 8 - 10 quantitative problems and several qualitative questions. The qualitative questions are usually short answer or multiple choice. The difficulty level of the multiple choice questions is intended to parallel the level of question that you could face on the CFA® exam. From a point perspective, the average test is 70% quantitative. (This can vary and I will tell you a week before the exam.)

You should realize that I test on what I teach. In order to prepare, you should review your packet notes (including slides), the uncollected homework problems that I have written and the uncollected problems from the back of the chapters. In addition, I will give you a slide deck to help you review for each exam. There is also a taped review lecture on Canvas. All dates are listed later in this syllabus.

I do not release old exams. I have found that releasing old exams is problematic because (1) it results in people studying “to the exam” rather than studying to learn; and (2) students inevitably feel that old exams are easier than the current exam. In addition, I do not allow students to keep their exams. This maintains the fairness of exams, since you know that no one has seen old exams. You will have ample opportunity to review your exam. If you ask any of my past students what my tests look like or what material is tested, I consider this to be a violation of the Honor Code.

## ***How to Prepare for Class and the Exams***

**Prior to class, you must listen to the taped lecture** (if one is assigned). In addition, you should read the pages in the packet that we will be covering (the taped lecture will require you to follow along with the packet). After class, you should use the text if you did not understand what we discussed or if you need more information. (Please understand: I will not hold you responsible for topics covered in the text that are not in the packet or the homework. The packet contains everything that you need to know.) Also realize that while I want you to read the entire packet, I will tell you what you are specifically responsible for when we are in class.

I will not collect homework. Homework should be done because you want to learn the material, rather than because you want to receive a check mark. Furthermore, I expect you to have discipline, rather than needing me to “force” you to do your homework.

I am a firm believer that you learn finance by working problems. If you attend class and work the problems in a timely fashion, you will do well. If you don’t work the problems in a timely fashion, this will be a very difficult class. Study the course packet consistently.

Since you won’t have time to do the homework problems again and again, let me suggest a good way to study. After you work the problems, every few days you should go back and re-read the questions. By doing this, you will trigger the thought process that you had to go through in order to answer the question. And always remember, it’s not a matter of whether you are able to answer the question the first time you see it...the issue is whether you can recognize it and answer the question in the future (and whether you can apply these concepts to the real world).

## ***Project***

This project is intended to further your Investments education and to help you to realize that you can continue to educate yourself when you graduate. For your project, I want you to read and **OUTLINE** one of the following books:

1. Margin of Safety by Seth Klarman (this book is difficult to find)
2. Value Investing From Graham to Buffett and Beyond by Greenwald, Kahn, Sonkin and van Biema
3. The Manual of Ideas by John Mihaljevic
4. Common Stocks and Uncommon Profits and Other Writings by Philip A. Fisher
5. Benjamin Graham and the Power of Growth Stocks, by Frederick K. Martin (with Nick Hansen, Scott Link, and Rob Nicoski)
6. The Essays of Warren Buffett: Lessons for Corporate America” by Warren Buffett and edited by Lawrence Cunningham

The first three books tend to be “value” oriented, while the fourth and fifth books are “growth” oriented. (There have been many more books written about value investing than growth investing.) The sixth book is more “general.”

**Your paper must be in outline form** and cannot be longer than 15 pages plus a cover page.

Fifteen pages is the total (other than the cover) regardless of whether you call something an appendix or anything else. If you want an example of an outline, look at how my packet is written.

The goal of your outline should be to allow someone who has not read this book to fully understand what it is about. A good outline clearly distinguishes thoughts. It is not simply sentences with a letter in front of it. It eliminates unnecessary words and groups ideas together.

The project is usually not a grade differentiator. The reality is that the exams will result in grade differentiation. The project is a learning exercise and the grading scale is normally pretty tight (usually 88 - 94). With that said, every so often someone turns in something that results in a significantly lower grade. The fact that the grade range is normally tight is not intended to diminish the importance of this assignment. Normally, I grade your exams (because they have the largest impact on your final grade) and I have my TA grade your outlines. This assignment is to be done alone.

Examples of times that people receive low grades include when you have clearly not read all of the book or when you do this in paragraph form. **The highest grade that you can get if you do this in paragraph form is 80 (which means that you will be in the 70s because I don't give perfect scores on this assignment). If you have not read the entire book, the highest grade you can receive is 50 (and again, that score isn't likely).** But, if you read the book and outline it and you feel like you have made a good-faith effort, you should not worry. You will know if you fall into one of the "troubled" categories.

**The project is due at the start of class on Saturday, June 24<sup>th</sup>.** I do not accept late papers. **PLEASE SUBMIT A HARD COPY OF YOUR PAPER. DO NOT SUBMIT THE PAPER ELECTRONICALLY.**

### ***Class Time***

On the next page, you will see the class schedule. All Friday classes are from 12 – 6 PM, and Saturday classes are from 8 AM – Noon.

### **Attendance Policy**

It is my belief that we all have a responsibility to make this a great class. This means that we all need to be prepared, attendance is mandatory and we all must be on time. We only have seven meetings. **If you are absent (or late) more than once, I lower your final grade by one full letter grade by each occurrence.** For example, imagine that your tests and project qualify you for a course grade of A-. But, you missed one class and were late for two others. One of those three occurrences is excused. The other two will result in your grade being dropped to C-. The point is that you should not take this class if you are unable to attend class or be on time. Again, it is never my goal to lower grades. But, I have to weigh having rules like this (which I don't like) versus having one person disrupt our class repeatedly. You can see where I come out on this...

## Schedule

Packet UNIT		Approximate # of Classes	Textbook Chapters	Uncollected Textbook Problems
3	Bond Basics	April 29	17 - 18	<b>Chap 11:</b> 1 - 2; <b>Chap 17:</b> 1 - 5; <b>Chap 18:</b> 1b, 1c, 2, 4, 8, 9, 10, 11
4	Managing Fixed Income	April 30	18 - 19	<b>Chap 18:</b> 3, 5, 6, 7, 12; <b>Chap 19:</b> 1- 4, 8
2	Cost of Capital	May 7	1; 7 - 9	<b>Chap 1:</b> 1-12; <b>Chap 1 Appendix:</b> 1 - 3; <b>Chap 3:</b> 4-5; <b>Chap 3 Appendix:</b> 1 - 2; <b>Chap 6:</b> 1- 3; <b>Chap 7:</b> 1-6, 8; <b>Chap 8:</b> 1-3, 5-9; <b>Chap 11:</b> 3; <b>Chap 25:</b> 10a, 10b
9	EMH vs Behavioral Finance	May 27	6	No HW
5	Indexes	May 27	5	<b>Chap 5:</b> 1-2, 4-6
8	Technical Analysis	May 27	15	<b>Chap 15:</b> 5-6
10	Trades and Orders	June 3	4	<b>Chap 4:</b> 1 - 7
1	Intro to Investments	June 3	1 - 3	<b>Chap 2:</b> 4 - 5
7	Valuation	June 10	11 - 14	<b>Chap 11:</b> 4 - 10, 14, 15; <b>Chap 12:</b> 4-8; <b>Chap 14:</b> 3, 8-11
11	Derivatives	June 17	20, 22 - 23	<b>Chap 22:</b> 2, 10, 11
6	Economy	June 17	12 - 13	<b>Chap 12:</b> 2
12	Mutual Funds	June 24	24	<b>Chap 24:</b> 1- 8, 10
13	Evaluating Performance	June 24	25	<b>Chap 25:</b> 1-4; 6-8

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## KEY DATES

**PLEASE NOTE: I DO NOT DO MAKE-UP EXAMS. IF YOU CAN'T MAKE THE EXAM, PLEASE DO NOT TAKE THIS CLASS.**

Friday, June 3<sup>rd</sup>: Midterm Exam

Friday, June 24<sup>th</sup>: Project Due at the Start of Class

Friday, June 24<sup>th</sup>: Final Exam

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## McCombs Classroom Professionalism Policy

**MY COMMENTS ABOUT THE PROFESSIONALISM POLICY:** I will expect you to comply with the Professionalism Policy and you should expect me to comply with it. I firmly believe that professional behavior (being on time, staying for the full class, no laptops) is crucial to a culture of learning. Additionally, this simple professionalism will do nothing to stop us from laughing in class and enjoying the learning process.

### The Policy:

The highest professional standards are expected of all members of the McCombs community. The collective class reputation and the value of the Texas MBA experience hinges on this.

Faculty are expected to be professional and prepared to deliver value for each and every class session. Students are expected to be professional in all respects.

The Texas MBA classroom experience is enhanced when:

- **Students arrive on time.** On time arrival ensures that classes are able to start and finish at the scheduled time. On time arrival shows respect for both fellow students and faculty and it enhances learning by reducing avoidable distractions.
- **Students display their name cards.** This permits fellow students and faculty to learn names, enhancing opportunities for community building and evaluation of in-class contributions.
- **Students minimize unscheduled personal breaks.** The learning environment improves when disruptions are limited.
- **Students are fully prepared for each class.** Much of the learning in the Texas MBA program takes place during classroom discussions. When students are not prepared they cannot contribute to the overall learning process. This affects not only the individual, but their peers who count on them, as well.
- **Students attend the class section to which they are registered.** Learning is enhanced when class sizes are optimized. Limits are set to ensure a quality experience. When section hopping takes place some classes become too large and it becomes difficult to contribute. When they are too small, the breadth of experience and opinion suffers.
- **Students respect the views and opinions of their colleagues.** Disagreement and debate are encouraged. Intolerance for the views of others is unacceptable.
- **Laptops are closed and put away.** When students are surfing the web, responding to e-mail, instant messaging each other, and otherwise not devoting their full attention to the topic at hand they are doing themselves and their peers a major disservice. Those around them face additional distraction. Fellow students cannot benefit from the insights of the students who are not engaged. Faculty office hours are spent going over class material with students who chose not to pay attention, rather than truly adding value by helping students who want a better understanding of the material or want to explore the issues in more depth. Students with real needs may not be able to obtain adequate help if faculty time is spent repeating what was said in class. There are often cases where learning is enhanced by the use of laptops in class. Faculty will let you know when it is appropriate to use them. In such cases, professional behavior is exhibited when misuse does not take place.
- **Phones and wireless devices are turned off.** We've all heard the annoying ringing in the middle of a meeting. Not only is it not professional, it cuts off the flow of discussion when the search for the offender begins. When a true need to communicate with someone outside of class exists (e.g., for some medical need) please inform the professor prior to class.

## **Academic Dishonesty**

I have no tolerance for acts of academic dishonesty. Such acts damage the reputation of the school and the degree and demean the honest efforts of the majority of students. The minimum penalty for an act of academic dishonesty will be a zero for that assignment or exam.

The responsibilities for both students and faculty with regard to the Honor System are described on <http://mba.mcombs.utexas.edu/students/academics/honor/index.asp> and on the final pages of this syllabus. As the instructor for this course, I agree to observe all the faculty responsibilities described therein. During Orientation, you signed the Honor Code Pledge. In doing so, you agreed to observe all of the student responsibilities of the Honor Code. If the application of the Honor System to this class and its assignments is unclear in any way, it is your responsibility to ask me for clarification.

As specific guidance for this course, you should not try to seek guidance about exams or types of questions from students who have previously taken this class. You should not do anything to aid future students in the testing process. Helping fellow students learn is an important part of our culture. I believe that it is easy to distinguish the attempt to help someone learn as opposed to the attempt to pass on information about exams.

## **Honor Code Purpose**

Academic honor, trust and integrity are fundamental to The University of Texas at Austin McCombs School of Business community. They contribute directly to the quality of your education and reach far beyond the campus to your overall standing within the business community. The University of Texas at Austin McCombs School of Business Honor System promotes academic honor, trust and integrity throughout the Graduate School of Business. The Honor System relies upon The University of Texas Student Standards of Conduct (Chapter 11 of the Institutional Rules on Student Service and Activities) for enforcement, but promotes ideals that are higher than merely enforceable standards. Every student is responsible for understanding and abiding by the provisions of the Honor System and the University of Texas Student Standards of Conduct. The University expects all students to obey the law, show respect for other members of the university community, perform contractual obligations, maintain absolute integrity and the highest standard of individual honor in scholastic work, and observe the highest standards of conduct. Ignorance of the Honor System or The University of Texas Student Standards of Conduct is not an acceptable excuse for violations under any circumstances.

The effectiveness of the Honor System results solely from the wholehearted and uncompromising support of each member of the Graduate School of Business community. Each member must abide by the Honor System and must be intolerant of any violations. The system is only as effective as you make it.

## **Faculty Involvement in the Honor System**

The University of Texas at Austin McCombs School of Business Faculty's commitment to the Honor System is critical to its success. It is imperative that faculty make their expectations clear to all students. They must also respond to accusations of cheating or other misconduct by students in a timely, discrete and fair manner. We urge faculty members to promote awareness of the importance of integrity through in-class discussions and assignments throughout the semester.

## **Expectations Under the Honor System**

### **Standards**

If a student is uncertain about the standards of conduct in a particular setting, he or she should ask the relevant faculty member for clarification to ensure his or her conduct falls within the expected scope of honor, trust and integrity as promoted by the Honor System. This applies to all tests, papers and group and individual work. Questions about appropriate behavior during the job search should be addressed to a professional member of the Career Services Office. Below are some of the specific examples of violations of the Honor System.

### **Lying**

Lying is any deliberate attempt to deceive another by stating an untruth, or by any direct form of communication to include the telling of a partial truth. Lying includes the use or omission of any information with the intent to deceive or mislead. Examples of lying include, but are not limited to, providing a false excuse for why a test was missed or presenting false information to a recruiter.

### **Stealing**

Stealing is wrongfully taking, obtaining, withholding, defacing or destroying any person's money, personal property, article or service, under any circumstances. Examples of stealing include, but are not limited to, removing course material from the library or hiding it from others, removing material from another person's mail folder, securing for one's self unattended items such as calculators, books, book bags or other personal property. Another form of stealing is the duplication of copyrighted material beyond the reasonable bounds of "fair use." Defacing (e.g., "marking up" or highlighting) library books is also considered stealing, because, through a willful act, the value of another's property is decreased. (See the appendix for a detailed explanation of "fair use.")

### **Cheating**

Cheating is wrongfully and unfairly acting out of self-interest for personal gain by seeking or accepting an unauthorized advantage over one's peers. Examples include, but are not limited to, obtaining questions or answers to tests or quizzes, and getting assistance on case write-ups or other projects beyond what is authorized by the assigning instructor. It is also cheating to accept the benefit(s) of another person's theft(s) even if not actively sought. For instance, if one continues to be attentive to an overhead conversation about a test or case write-up even if initial exposure to such information was accidental and beyond the control of the student in question, one is also cheating. If a student overhears a conversation or any information that any faculty member might reasonably wish to withhold from the student, the student should inform the faculty member(s) of the information and circumstance under which it was overheard.

## **Actions Required for Responding to Suspected and Known Violations**

As stated, everyone must abide by the Honor System and be intolerant of violations. If you suspect a violation has occurred, you should first speak to the suspected violator in an attempt to determine if an infraction has taken place. If, after doing so, you still believe that a violation has occurred, you must tell the suspected violator that he or she must report himself or herself to the course professor or Associate Dean of the Graduate School of Business. If the individual fails to report himself or herself within 48 hours, it then becomes your obligation to report the infraction to the course professor or the Associate Dean of the Graduate School of Business. Remember that although you are not required by regulation to take any action, our Honor System is only as effective as you make it. If you remain silent when you suspect or know of a violation, you are approving of such dishonorable conduct as the community standard. You are thereby precipitating a repetition of such violations.

### **The Honor Pledge**

The University of Texas at Austin McCombs School of Business requires each enrolled student to adopt the Honor System. The Honor Pledge best describes the conduct promoted by the Honor System. It is as follows:

"I affirm that I belong to the honorable community of The University of Texas at Austin Graduate School of Business. I will not lie, cheat or steal, nor will I tolerate those who do."

"I pledge my full support to the Honor System. I agree to be bound at all times by the Honor System and understand that any violation may result in my dismissal from the Graduate School of Business."

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### **Students with Disabilities**

Upon request, the University of Texas at Austin provides appropriate academic accommodations for qualified students with disabilities. Services for Students with Disabilities (SSD) is housed in the Office of the Dean of Students, located on the fourth floor of the Student Services Building. Information on how to register, downloadable forms, including guidelines for documentation, accommodation request letters, and releases of information are available online at <http://deanofstudents.utexas.edu/ssd/index.php>. Please do not hesitate to contact SSD at (512) 471-6259, 471-6441 TTY or via e-mail if you have any questions.

**The University of Texas at Austin  
McCombs School of Business**



**Sanford J. Leeds**

Distinguished Senior Lecturer  
Department of Finance

- MBA, University of Texas Graduate School of Business, 1995
- JD, University of Virginia School of Law, 1989
- B.S., University of Alabama, 1986

Sandy Leeds is a member of the Finance Department faculty at The University of Texas and President of The MBA Investment Fund, L.L.C. He teaches both graduate and undergraduate level courses, including Corporate Finance, Advanced Corporate Finance, Public Policy (Long-Term Issues in the Markets), Investments, Portfolio Management / Security Analysis and Macroeconomics. He has a J.D. from The University of Virginia School of Law, an MBA from The University of Texas at Austin and a B.S. in Investment Management from The University of Alabama. He is a member of the Texas State Bar and holds the Chartered Financial Analyst designation.

Prior to joining the faculty, Sandy managed money for a private money management firm. He was one of four portfolio managers responsible for approximately \$1.6 billion of assets. He spent the majority of his time analyzing publicly traded companies. He also has extensive experience implementing option strategies.

In addition to money management experience, Sandy also has significant legal experience. He has conducted approximately 100 jury trials and 100 bench trials. He has participated in the regulation of the securities industry, conducting the hearing against most of the principals involved in the Sterling Foster case (a \$75 million fraud). He has also advised attorneys on financial related litigation involving options, hedge funds, and other matters.

At UT, Sandy has received numerous teaching awards, including the Joe D. Beasley Teaching Award (a school-wide award for teaching in the graduate program), The CBA Foundation Advisory Council Award for Teaching Innovation (another school-wide award), the “Outstanding MBA Professor Award” (selected by the full-time MBA students in multiple years and also the Evening MBA students and the Dallas MBA students) and the “Outstanding MSF Professor Award.” In 2015, he was selected to be a Provost Teaching Fellow. Within the Austin community, he just finished a three-year term on the Investment Committee for the Austin Community Foundation (managing \$100 million) and also just finished a term as the vice-Chair for the Board of Trustees at The Girls’ School of Austin.