Investment Philosophy

How to make investment decisions

TBC New Member Education 2020 – Week 6

Agenda

- Value Investing

- Reflexivity

- Breaking down Expected Return

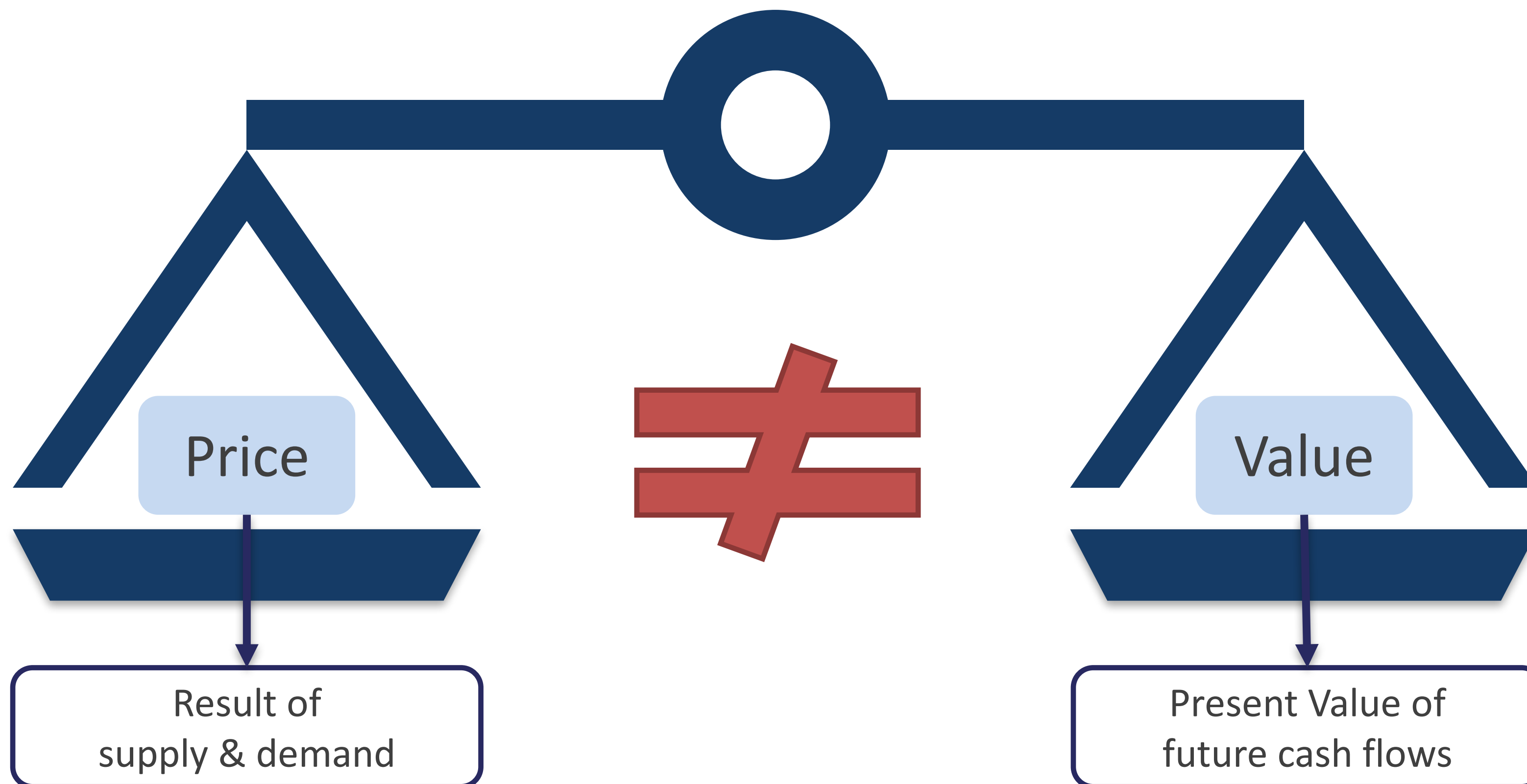
- Dealing with Risk

- ~~Investment Archetypes~~ **(Not on Exam)**

- Investment Checklist

Value Investing

Price = Value?



"Price is what you pay, but value is what you get" – Warren Buffet

But why?

Overvalued	Undervalued
Price > Value	Price < Value

Overvalued

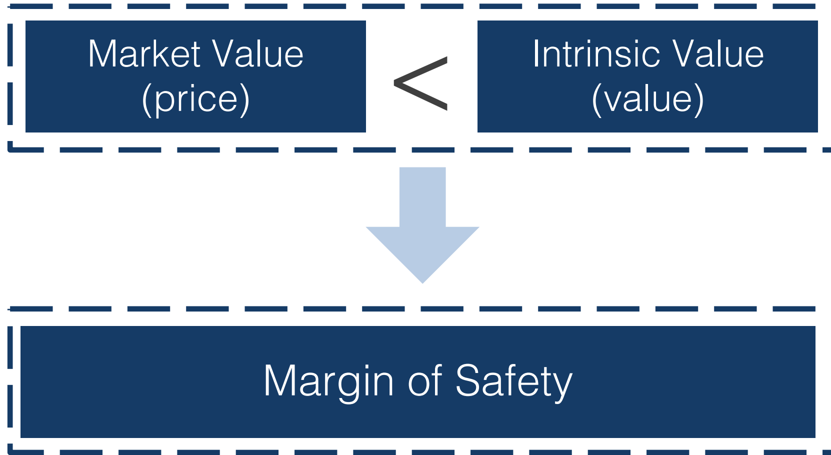
- Trendy, popular, exciting, hyped
- Unreasonable growth expectations
- Market overreaction to good news
- Large analyst coverage
  - Typically larger companies

Undervalued

- Unpopular, boring, neglected, overlooked
- Market too focused on short-term hurdles, and not the long-term business value
- Market overreaction to bad news
- Little analyst coverage
  - Typically smaller companies

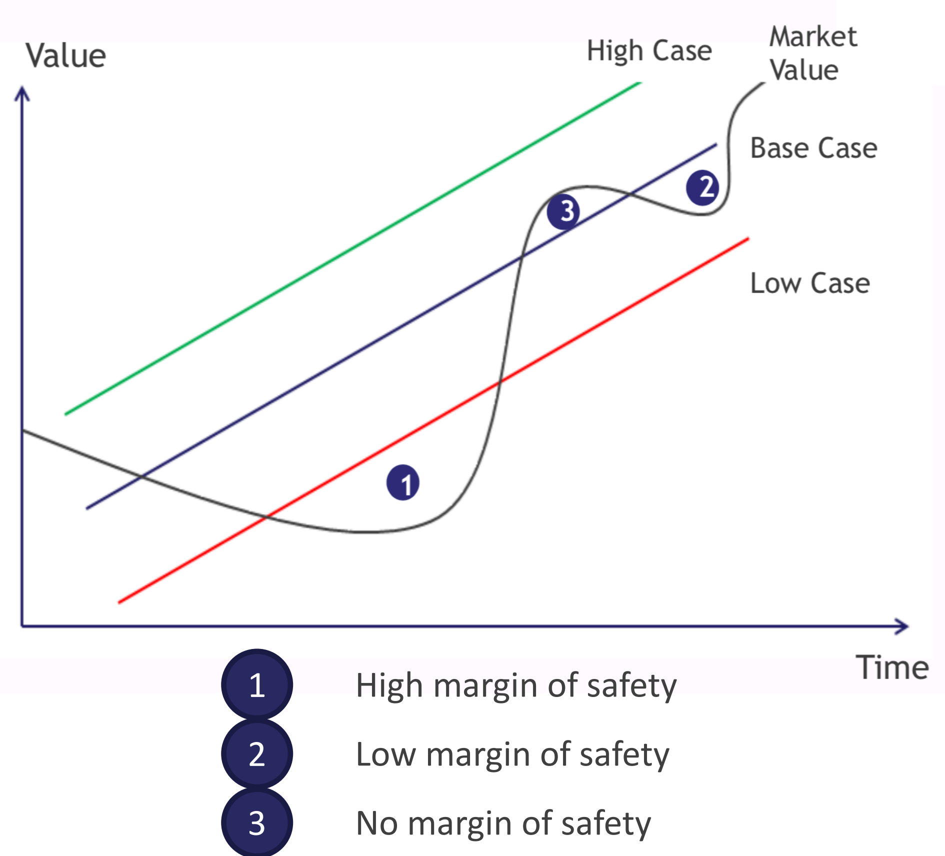
"Security prices reflect investors' perception of reality and not necessarily reality itself" – Seth Klarman

Margin of Safety



"The problem is that with so much attention being paid to the upside, it is easy to lose sight of the risk…Greater risk does not guarantee greater return. To the contrary, risk erodes return by causing losses."

– Seth Klarman



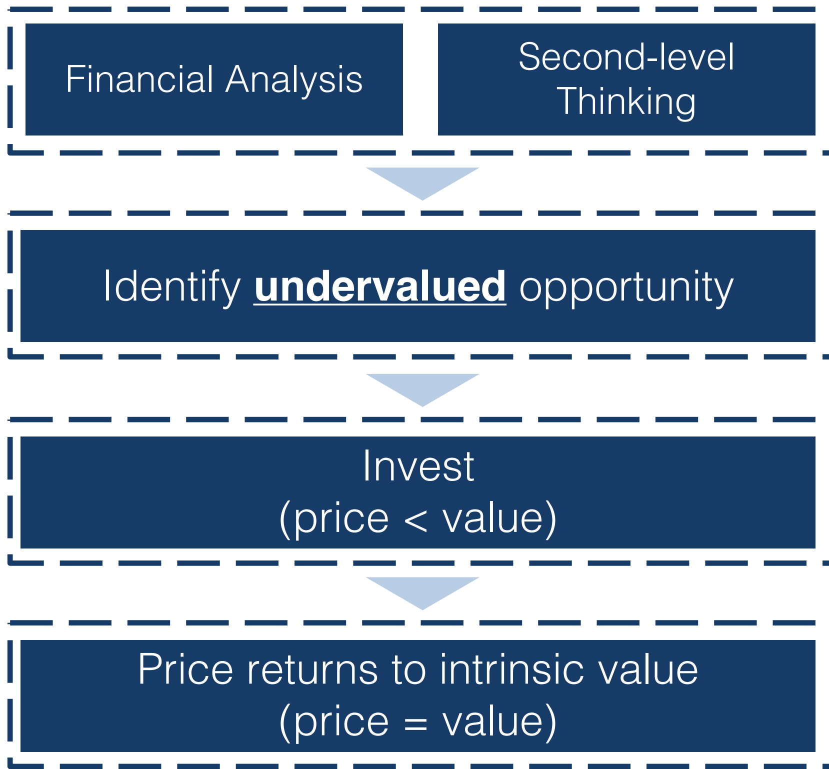
1. High margin of safety
2. Low margin of safety
3. No margin of safety

Margin of Safety measures the degree of downside protection

Value Investing

Definition

An investing philosophy that **focuses** on buying stocks currently traded below their intrinsic value



"A margin of safety is necessary because valuation is an **imprecise art**, the future is unpredictable, and investors are human and do make mistakes. It is adherence to the concept of a margin of safety that best distinguishes value investors from all others, who are not as **concerned about loss**"

– Margin of safety

Risk-adjusted returns

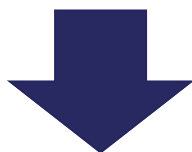
Reflexivity

Reflexivity is the idea that a company's price can affect its fundamentals

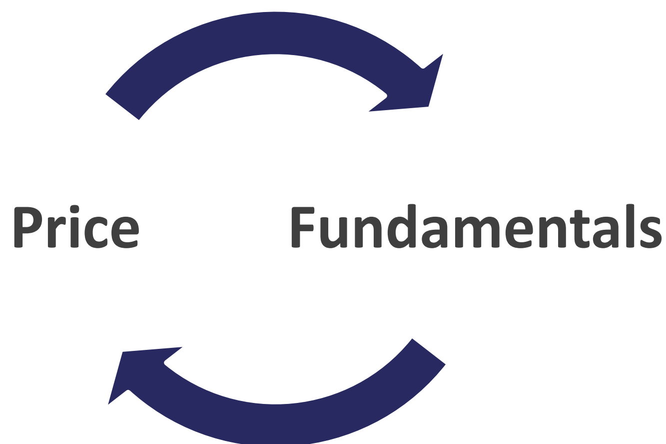
- Economic equivalent of the phrase "self-fulfilling prophecy"
- Humans are active participants in the world, not just passive observers -> their perception of reality can become reality

"Traditional" Value (e.g. Buffett)	Reflexivity (e.g. Soros)

Fundamentals

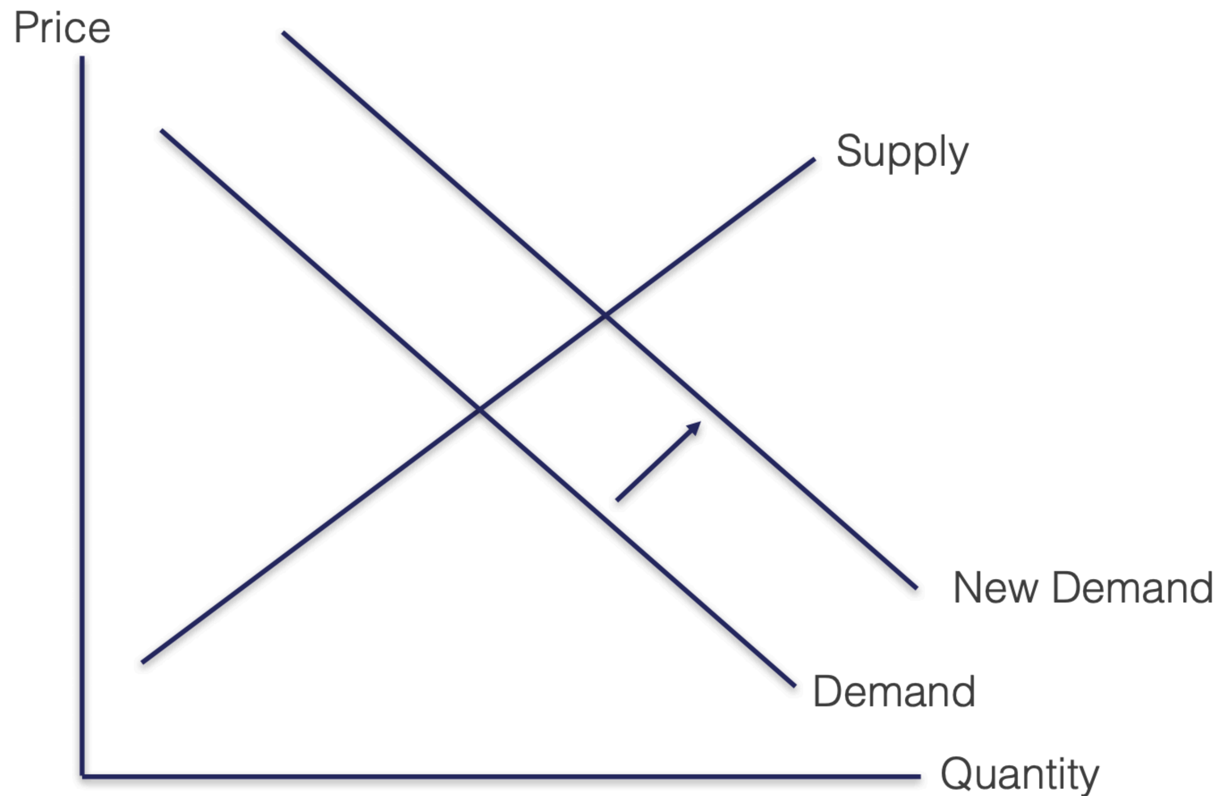


Price



Econ 101

Higher demand -> Higher price -> New equilibrium



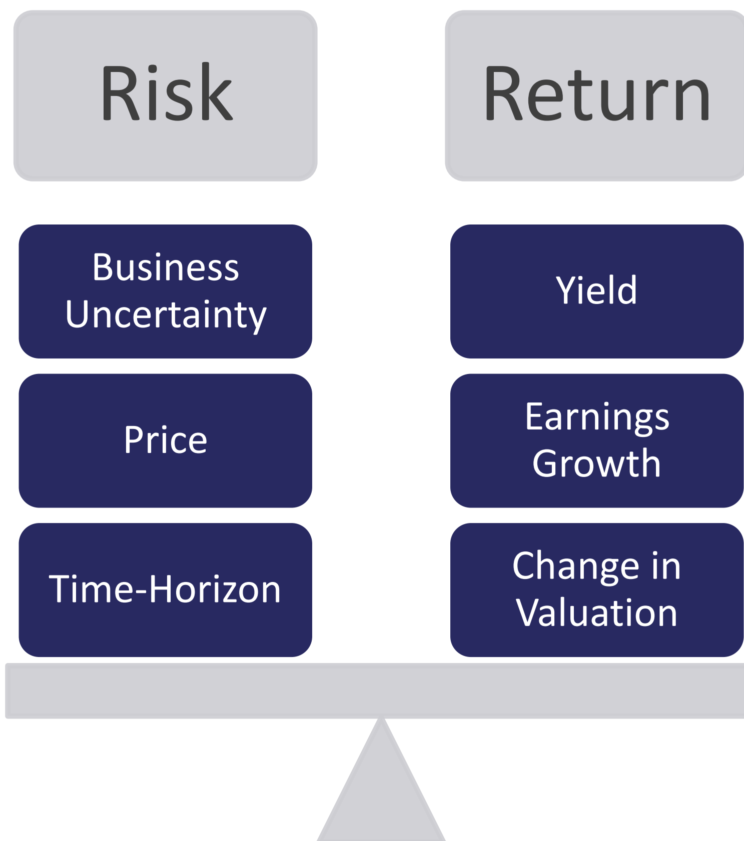
Reality ≠ Econ 101

- Financial markets are different than other markets and this static model does not apply as well to them
- In the financial markets, rising prices often attract buyers
  - If the price of beer goes up, most people would buy less beer
  - However, if the price of a beer stock goes up, most people would buy more stock
- As a result, sometimes higher demand leads to higher prices which leads to even more demand, thus preventing an equilibrium from forming and eventually creating a bubble

Risk and Return

Risk and Return

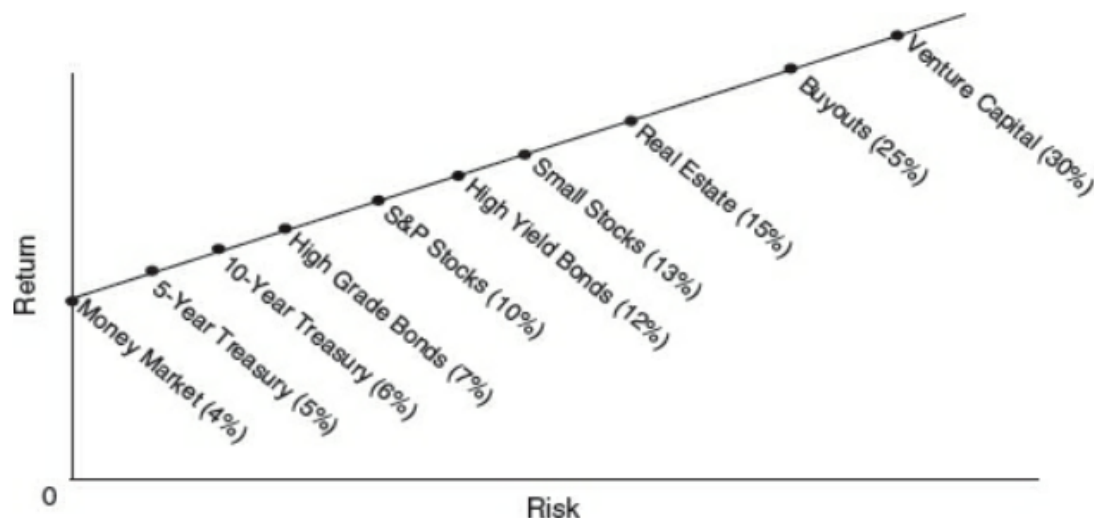
All investment decisions hinge on the balance between risk and return



Risk and Return

Risk and return are the twin pillars of investing – each is just as important as the other

- Rational people are (generally) risk averse
- Investors should demand higher rates of return in exchange for taking on more risk
- If markets are efficient, the only way to increase your expected return is to take on more risk



"So, going beyond determining whether he or she can bear the absolute amount of risk that is attendant, **the investor's second job is to determine whether the return on a given investment justifies taking the risk.** Clearly, return tells just half of the story, and risk assessment is required."

– Howard Marks

Sources: The Most Important Thing Illuminated
* Likely not an actual capital market line because investing in any single asset class won't lie on the efficient frontier

Breaking Down Expected Return

Expected Return

$$\text{Total Return} \approx \underbrace{\text{Dividend Yield}}_{\text{Yield}} + \underbrace{\Delta\text{EPS}}_{\text{Growth}} + \underbrace{\Delta\text{P/E Ratio}}_{\text{Valuation}}$$

Can break down return over a given time period into…

1. **Dividend Yield**
2. **Growth in Earnings per Share**
   – Change in revenue
   – Change in margin
   – Change in shares outstanding (due to buybacks/share issuances)
3. **Change in Valuation**
   – Change in implied earnings growth
   – Change in bond yields (risk-free rate)
   – Change in risk premium
     - ERP (due to market price of risk) and riskiness of company

Back of the Envelope Valuation

When it comes to investing, simple is often better

“There's a clarity that comes with great ideas: **You can** [easily and simply] **explain why something's a great business**, how **and why it's cheap**, why it's cheap for temporary reasons and how, on a normal basis, it should be trading at a much higher level. **You're never sitting there on the 40th page of your spreadsheet, as Buffett would say, agonizing over whether you should buy or not.**”

— Joel Greenblatt

Back of the Envelope Valuation

1. **Estimate earnings growth** over the next 3-5 years (or whatever time period is convenient)
   - ROIC*Reinvestment Rate
   - Revenue Growth and Margin expansion/contraction: Will they gain market share or is the market growing? Is there operating leverage? What are unit-level margins? Is the cost structure primarily fixed or variable?
   - Share buybacks (if using a multiple based on EPS)
2. Apply a **terminal multiple**
   - Remember even if you are growing really fast now it's likely your terminal multiple will be converge to the market multiple to reflect your less super-normal growth in the future
3. Use your estimated market cap 5 years from now to calculate your **annualized return**
   - Have to also account for any capital returned to shareholders (e.g. dividends)
   - Annual return comes from **growth in share price** (converted into an CAGR) and **annual dividend yield**
4. Compare your **expected return to the perceived risk** of the investment and decide if it's worth it

Simple Example Valuation

- Company A Now
  - $100 in earnings
  - Trades at 20x Earnings, so market cap is $2000 dollars
  - Expects to grow earnings 10% this year
  - Will pay a 2% dividend yield
  - Multiple after next year will be 25x
- Company A Next Year
  - $110 in earnings
  - Market Cap is now $2750 dollars
  - Stock Price is therefore 37.5% greater
  - Dividend Yield was 2%
  - Total Actual Return is 39.5%

Approximate Return

2% Dividend Yield + 10% EPS growth + 25% annual multiple expansion = 37% approx. annualized return

Real Example Valuation

O'Reilly Auto Parts (currently 19x forward P/E)

1. **Dividend**
   - Does not pay a dividend
2. **Earnings Growth**
   - Approximate revenue growth at 6% annually (3% SSS and 3% from new stores)
   - Experiencing margin expansion so say that increases earnings growth to 8%
   - Reduce share count 15% over 5 years (in-line with historical buyback activity), which increases earnings growth to 11% per year
3. **Multiple expansion/contraction**
   - Above-average growth, recession-resilient business, shareholder friendly management team, so slight premium to the market seems reasonable
   - Market historically trades at 16x, so an 18x forward multiple seems appropriate

Approximate Return

0% Dividend Yield + 11% EPS growth - 1% annually from multiple contraction = 10% approx. annualized return

Extensions of Example Valuation

This basic framework can be extended to do back of the envelope for all sorts of companies:

Total Return = Annual Dividend Yield + Annual Change in Stock Price

1. **Dividend Yield**
   - Generally, companies give fairly accurate guidance as to what to expect from dividends
   - Be careful when dealing with companies which have historically paid a dividend but may have to cut
     - Cutting the dividend will lead to decline in yield as well as (generally) a contraction in the multiple
2. **Change in stock price**
   - Can use whatever measure of earnings + multiple you think best represents the company/is easiest to project with
     - EV/Sales, EV/EBITDA, P/E, etc.
   - Always remember that multiples tend to revert to the mean over longer periods of time (because growth in percentage terms will tend to mean-revert over longer periods of time)
   - Be careful if using EV/Sales, because a company has to be valued based on earnings eventually

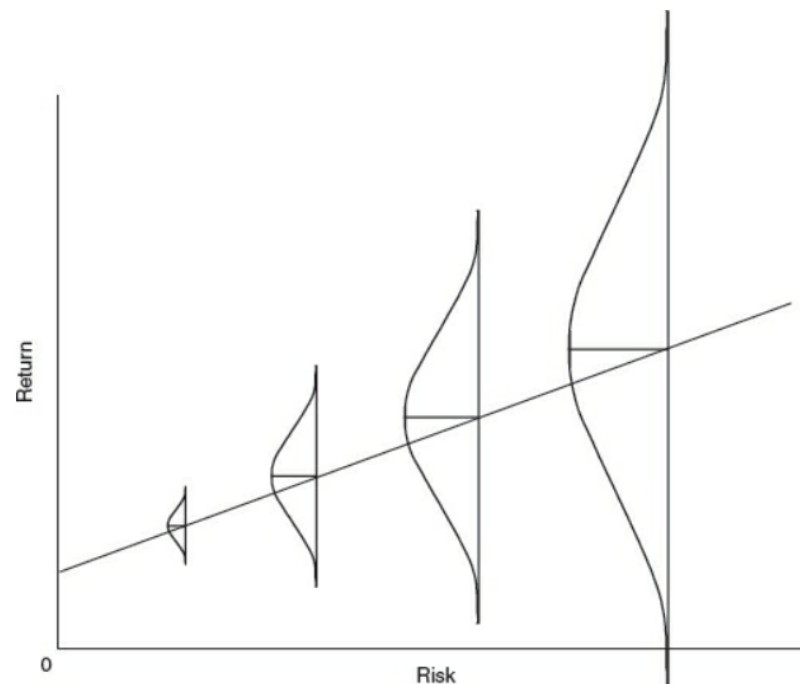
Dealing with Risk

Taking on Risk is Risky

Taking on more risk doesn't guarantee a higher return

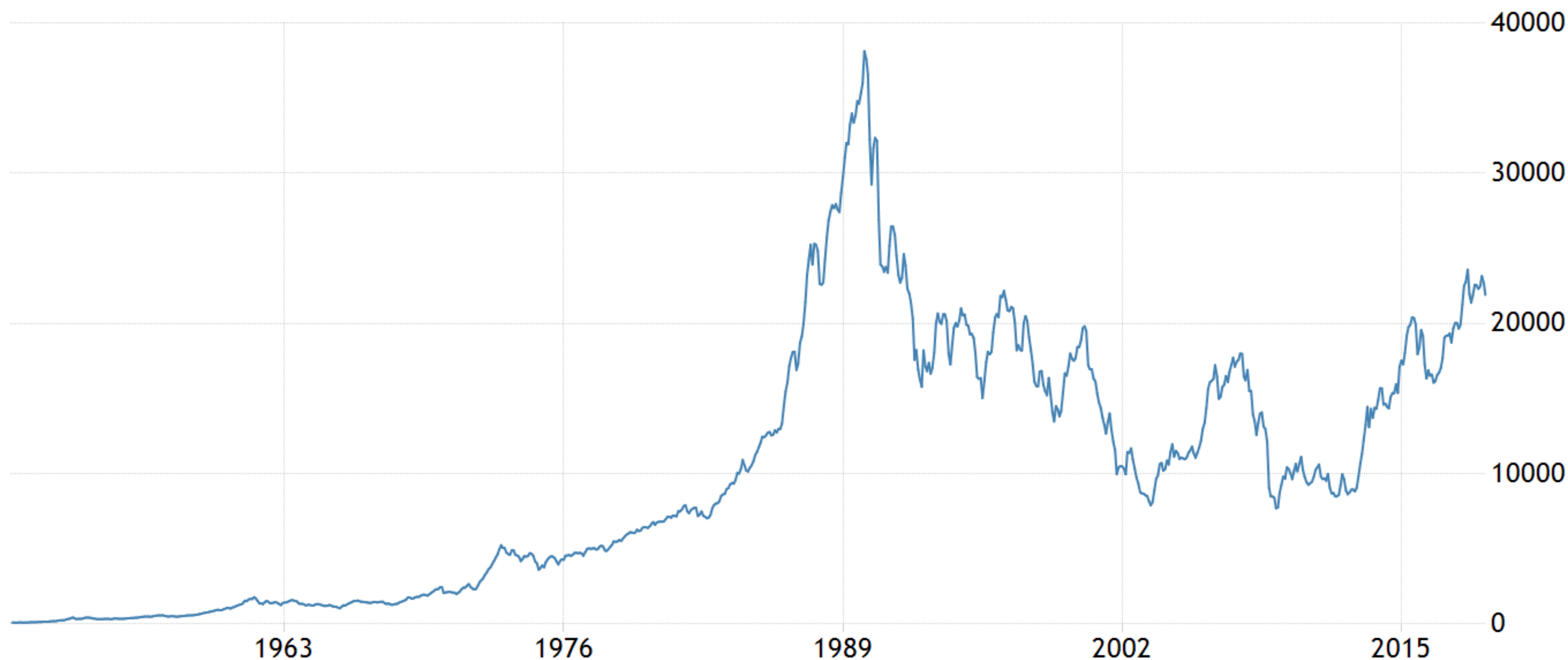
Especially in good times, ***far too many people can be overheard saying, "Riskier investments provide higher returns. If you want to make more money, the answer is to take more risk."*** *But riskier investments absolutely cannot be counted on to deliver higher returns. Why not? It's simple:* ***if riskier investments reliably produced higher returns, they wouldn't be riskier!*** *The correct formulation is that in order to attract capital, riskier investments have to offer the prospect of higher returns, or higher promised returns, or higher expected returns.* ***But there's absolutely nothing to say those higher prospective returns have to materialize.***

- Howard Marks



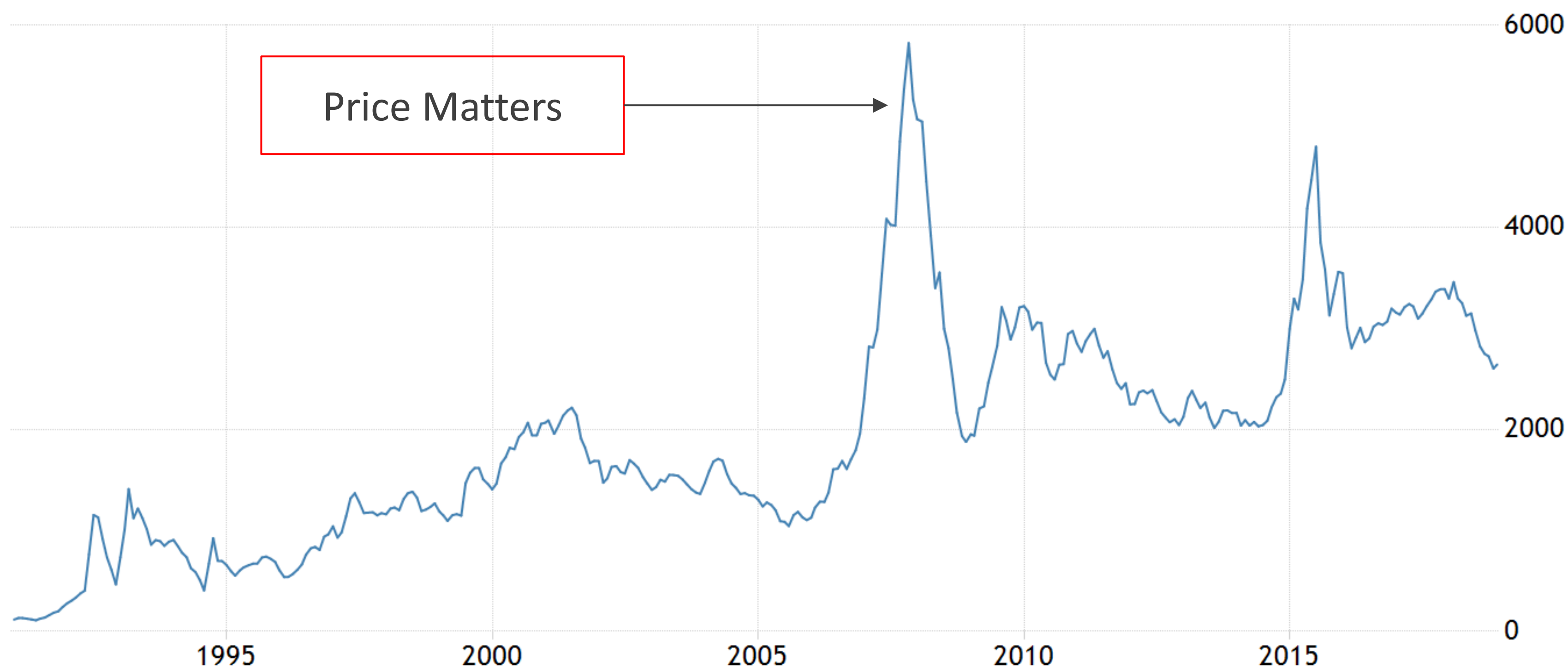
Sources: The Most Important Thing Illuminated

Example – Nikkei 225



Taking on additional risk doesn't guarantee you a higher return

Example – Shanghai Composite



Taking on additional risk doesn't guarantee you a higher return
(even if you invest in the economy of an upcoming superpower)

Uncertainty

Uncertainty is the range of possible outcomes which could occur

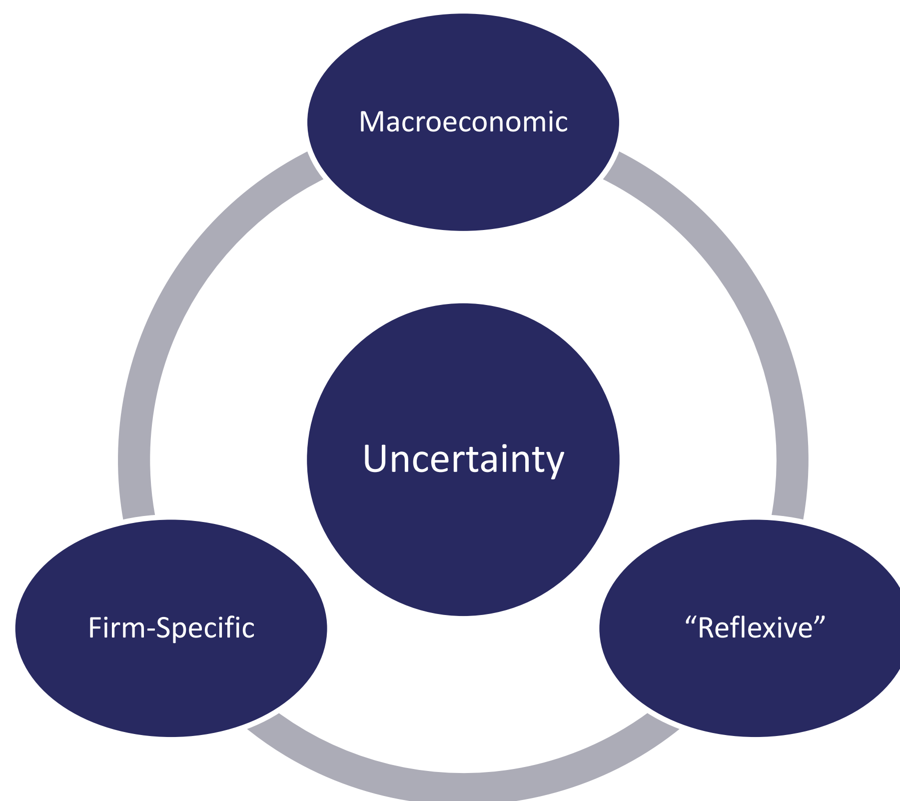
Characteristics

Uncertainty is an **endogenous property**:

> Depends on the properties of the security in which we're investing and the macroeconomic environment
> Can't be controlled by investors

Three main types of uncertainty:

> Macroeconomic
> Firm-Specific
> "Reflexive"



Three Types of Uncertainty

Source	Questions
I. Macroeconomic Uncertainty > Uncertainty about the future macroeconomic environment > The direct effect of macroeconomic changes on the security > Primary risk is from rising interest rates or risk premiums	How uncertain am I about the macroeconomic future? How much potential is there for discount rates to rise?
II. Firm-Specific Uncertainty > Uncertainty about the strength of the firm's core business > Uncertainty about the industry in which the firm operates > Uncertainty surrounding the firm's performance in a recession	How uncertain am I about the company's future? How will the company fare in a macroeconomic environment which is poor for equities?
III. "Reflexive" Uncertainty > Second-order consequences (due to behavior modification) of firm-specific and macroeconomic uncertainty > What actions the firm can/will take in the future depends on the firm's circumstances in the future (which are uncertain)	How will the company have to modify its behavior if things don't go as expected? What would the consequences of these modifications be for the company?

Risk

Risk is the chance of loss we assume when entering an investment

Characteristics

Risk is an **exogenous property:**

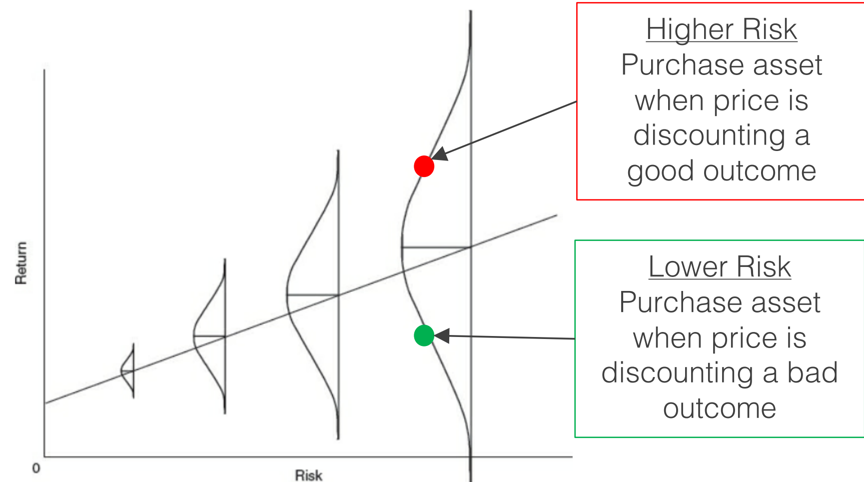
- Depends on not just endogenous properties of the security (uncertainty) but also the circumstances under which we purchase the security
- Can be controlled (to a certain extent) by investors

Three Sources of Risk

Sources of Risk – Price

The cheaper we purchase an asset for, the lower the chance of capital loss

- There will always be a range of possible outcomes with any given investment
- We can decrease risk by…
  - minimizing the percentage of those outcomes which will result in capital loss and
  - minimizing the size of the expected capital loss in the event that loss does occur
- Both of these goals can be achieved by buying assets when prices are cheap



Whereas the theorist thinks return and risk are two separate things, albeit correlated, the value investor thinks of high risk and low prospective return as nothing but two sides of the same coin, both stemming primarily from high prices.

- Howard Marks

Sources of Risk – Time Horizon

The risk we assume in purchasing a security depends on the time horizon of our investment

Short Time Horizon

If our time horizon is short, we care much more about short-term volatility and are generally taking on more risk as a result

When would we have a short time horizon?

- Buying a low-quality business that we think is too cheap
  - E.g. Leapfrog
- Shorting a company
  - E.g. Ackman and Herbalife
- Using excessive leverage
  - E.g. Long Term Capital Management

Long Time Horizon

If our time horizon is long, we can largely ignore short-term volatility and are generally taking on less risk as a result

When would we have a long time horizon?

- Buying high-quality businesses that we expect will be able to compound returns over time
  - E.g. Facebook

Catalysts

Catalysts present one way of dealing with the risk of having a short time horizon

> "**Value investors are always on the lookout for catalysts**. While buying assets at a discount from underlying value is the defining characteristic of value investing, the partial or total realization of underlying value through a catalyst is an important means of generating profits. Furthermore, **the presence of a catalyst serves to reduce risk. If the gap between price and underlying value is likely to be closed quickly, the probability of losing money due to market fluctuations or adverse business developments is reduced**. In the **absence of a catalyst**, however, **underlying value could erode**; conversely, **the gap between price and value could widen with the vagaries of the market**. Owning **securities with catalysts** for value realization is therefore an important way for investors to **reduce the risk within their portfolios**, augmenting the margin of safety achieved by investing at a discount from underlying value."

> Seth Klarman

Examples of Catalysts

Spinoffs	Asset/Business sales	M&A	Index Deletion/Addition
Shareholder Activism	Liquidation	Management Change	Operational Improvements
Regulatory/Tax Changes	New Product	Macro Changes	……

Takeaways

As value investors, we care about the risk we assume when purchasing an asset, not the uncertainty associated with the asset

Risk is likely to be **lowest** when…

1. The **uncertainty** associated with the asset is **low**
2. The **price** of the asset is **cheap**
3. The asset can be **comfortably held for an extended period of time**
   - Or, if the asset can't be held for a long period of time, we have a **strong catalyst for value realization**

The "Perversity" of Risk

Opportunities will be most attractive when you believe risk is low and other investors believe risk is high

There are few things as risky as the widespread belief that there's no risk*, because it's only when investors are suitably risk-averse that prospective returns will incorporate appropriate risk premiums.*

I'm very happy with the phrase "the perversity of risk." ***When investors feel risk is high, their actions serve to reduce risk. But when investors believe risk is low, they create dangerous conditions.***

- Howard Marks

Understanding this "paradox"

Risk increases when people believe it is low and decreases when people believe it is high

This paradox arises because…

> Most investors think quality (uncertainty), as opposed to price, is the key determinant of whether an investment is risky
  - When things are going well, everything naturally looks less risky
> We focus on risk as a whole, which incorporates both quality (in the form of uncertainty) and price

Sources: The Most Important Thing Illuminated – Howard Marks

Risk is Unobservable

Reality is far more vicious than Russian roulette. First, it delivers the fatal bullet rather infrequently, like a revolver that would have hundreds, even thousands of chambers instead of six. After a few dozen tries, one forgets about the existence of a bullet, under a numbing false sense of security. … Second, unlike a well-defined precise game like Russian roulette, where the risks are visible to anyone capable of multiplying and dividing by six, one does not observe the barrel of reality. … ***One is thus capable of unwittingly playing Russian roulette—and calling it by some alternative "low risk" name.***

- Nassim Nicholas Taleb

Here's the key to understanding risk: it's largely a matter of opinion. It's hard to be definitive about risk, even after the fact. *You can see that one investor lost less than another in bad times and conclude that that investor took less risk. Or you can note that one investment declined more than another in a given environment and thus say it was riskier. Are these statements necessarily accurate?*

- Howard Marks

Sources: Fooled by Randomness, The Most Important Thing Illuminated

Risk is Unobservable

How can we evaluate the quality of our investments when we can never directly observe how much risk we're taking on?

Risk is by its very nature connected to the potential for different outcomes to occur, yet we can only observe the single outcome that does occur

- This is a serious problem because it means we can never actually be sure that an investment we made was a good idea; we can only ever observe a *lack of evidence* that our investment was a bad idea
- The only solution to this problem is to build experience and measure the magnitude and consistency of our returns over time

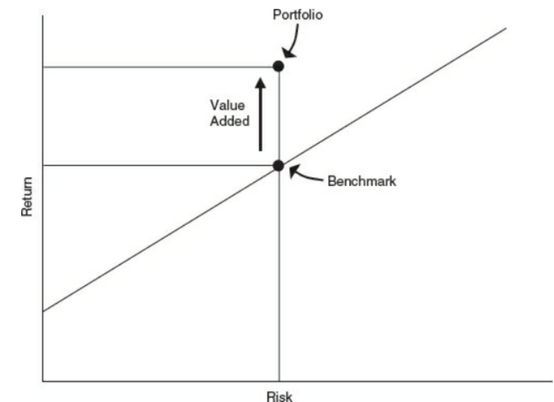
Risk Tolerance

Not tolerating excess/uncompensated risk is central to successful investing

Risk tolerance is antithetical to successful investing. *When people aren't afraid of risk, they'll accept risk without being compensated for doing so … and risk compensation will disappear.*

- Howard Marks

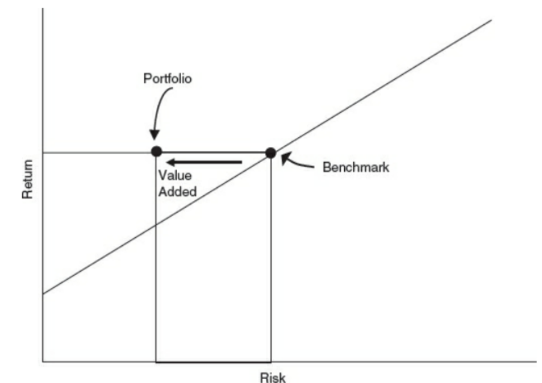
Superior investment performance through achievement of excess returns



I will tell you how to become rich. Close the doors. ***Be fearful when others are greedy. Be greedy when others are fearful.***

- Warren Buffett

Superior investment performance through superior risk management



Sources: The Most Important Thing Illuminated

Investment Checklist

The Investment Process

Sourcing Ideas

Preliminary Research

In-depth Research

- Industry & Company Research

Valuation & Modelling

Investment Presentation

Only have 24 hours?

High

Priority

Low

#	Task	Source
1	Read 2-3 most recent 10K's and 10Q's	Bamsec
2	Read 4 most recent Earnings Call Transcripts	Bamsec
3	Check if the company is pitched during any investment conferences and read/watch the presentation	Google
4	Read most recent initiating coverage reports*	Thomson One
5	Read investor presentations	Company's website[1]
6	Analyze financial performance during past recessions	Bamsec/Yahoo Finance
7	Read short-selling reports* & bearish equity research reports	Thomson One Google
8	Read proxy statements to analyze management's incentives	Bamsec
9	Repeat Task 1 & 3 for most direct competitor(s)	Bamsec/Thomson One

* If applicable
1 Investor Relations section of the company's website

Create an Investment Checklist

Having an idea of what you are (and aren't) looking for in an investment can make finding good ideas much easier

- Sample Checklist that John Huber (Saber Capital) uses
  - Business I understand
  - High ROIC
  - Durability (Predictability of Cash Flows)
  - Shareholder-friendly management (Consider capital allocation and compensation)
  - Margin of Safety (Value)
- Stay flexible!
  - Some investors like quality businesses that compound over decades, but others would rather find the cheapest companies possible—you will only find where your comfort zone is by reading and investing

Ways to Find Value in the Market

Three Basic Sources of Advantages when Investing

1. Information Advantage
   - **Proliferation of information** has **made this** more **challenging**
2. Analytical Advantage
   - **Think** about companies **differently** than others do
   - Apple is a commodity company with margins that will erode versus it is a consumer brand with a defensible position
3. Time Arbitrage
   - **TBC's largest advantage** given we have a permanent capital base
   - Having a 3-5+ year horizon when most people have a shorter-term view

"**Value investing requires a great deal of hard work**, unusually strict discipline, and a long-term investment horizon. **Few are willing and able to devote sufficient time and effort** to become value investors, and **only a fraction of those have the proper mind-set to succeed**" — Seth Klarman