

Active Value Investing



Making Money in *This* Market and *This* Economy

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Three Ways To Achieve Superior Long Term Returns



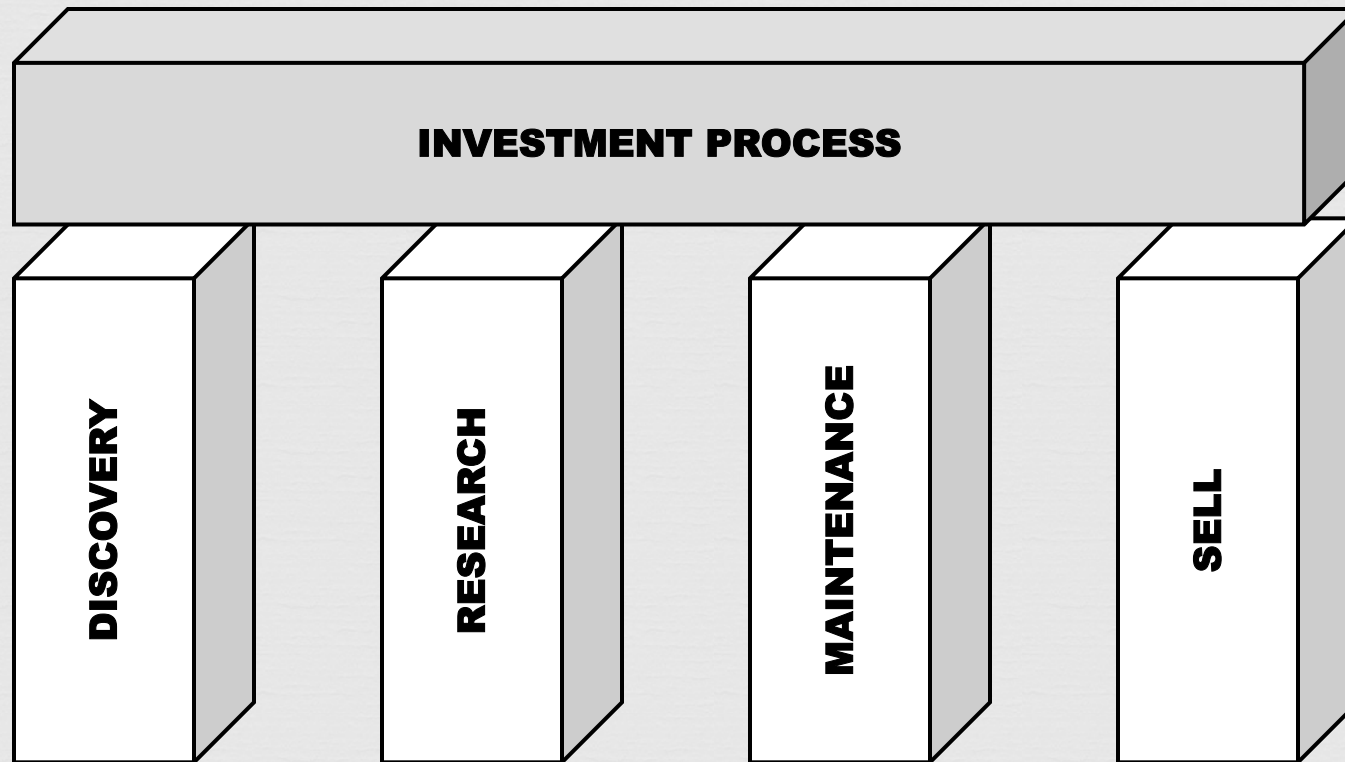
1. *Informational advantage – unless you are analyzing microcaps, “better information” usually means insider information and will land you in jail.*
2. *Analytical advantage – being able to analyze information better, you can build better models.*
3. *Behavioral advantage – be more rational than average market participant*

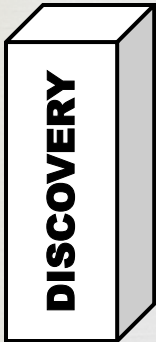
See Russell J. Fuller “Behavioral Finance and Sources of Alpha”

**Investment Process Should
Incorporate Both Analytical and
Behavioral Aspects**



Pillars of Investment Process





Process



- ❧ *Screens* – 52 week lows, insider buying, magic formula (high return on capital + low P/E), etc...
- ❧ *Watch lists* – often when we do analysis we find companies we like but that are too expensive (no margin of safety), we determine what price valuation we want to own them at and put them on a watch list and wait.

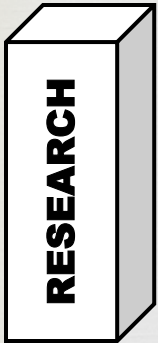
Actively seek to identify great businesses, value them and put them on a watch list. Do analysis when things are going well. Psychologically better prepared to buy when things go bad and it is just the matter of time before they do.
- ❧ *Steal* - study holdings of other value and growth investors we respect. (Growth investors usually spend more time focusing on quality and growth of the business, a quality and growth business that temporarily stumbles will meet our value (margin of safety criteria).



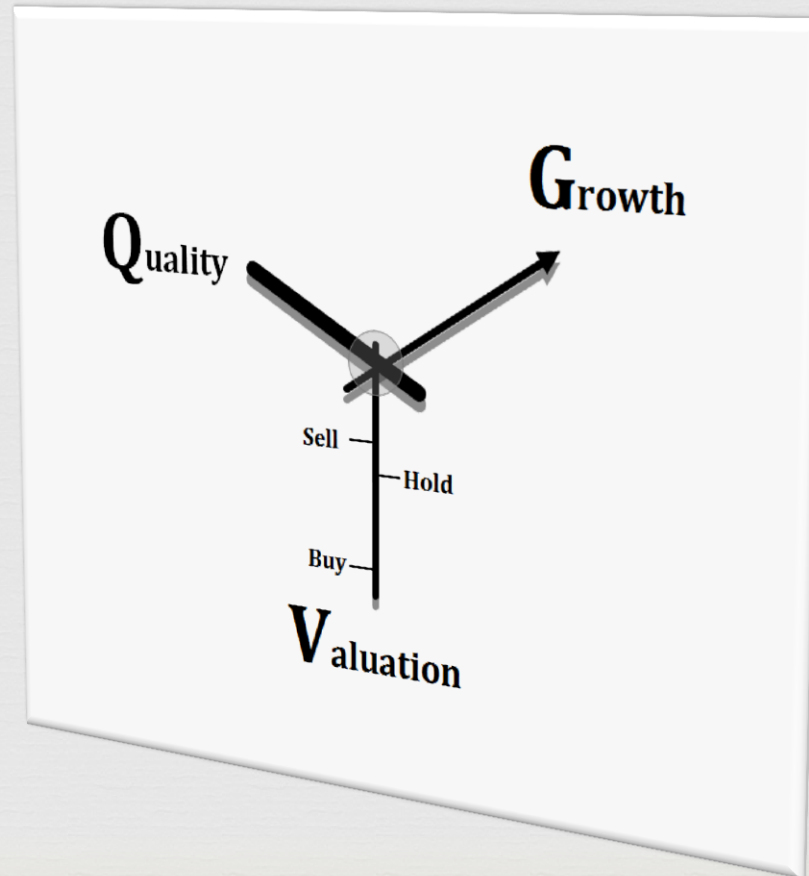
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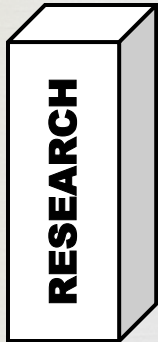


- ❧ *Map the market and the world – follow ETFs of different industries and countries. For instance if utility ETF declines, we look at utility stocks for opportunities.*
- ❧ *Network - we talk to a few dozen value investors on a constant basis. Sharing goes both ways.*
- ❧ *Read, read, read... members of Value Investor Club, SumZero, blogs, newsletters, twitter (wonderful if you “follow” the right people).*
- ❧ *Attend conferences – we found attending conference so useful we created our own VALUEx Vail*

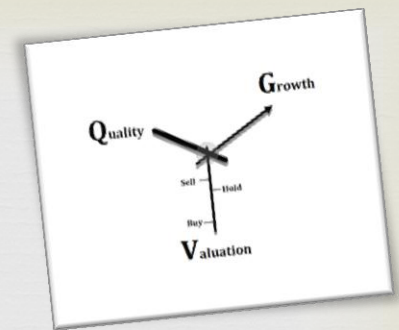


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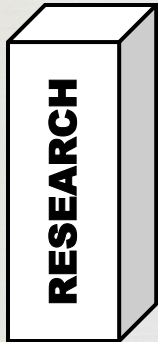




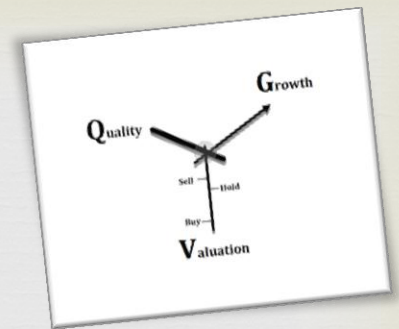
Quality



- ☞ *Sustainable Competitive Advantages – a deep moat around a business*
- ☞ *Predictable Earnings – propelled by recurring revenues*
- ☞ *High Return on Capital - far exceeding the cost of capital, scorecard for value creation*
- ☞ *Significant Free Cash Flows – lessens reliance on external financing, source of dividends, share buybacks, great business with high return on capital usually*
- ☞ *Management – we want honest, competent, long-term oriented, not just good at running business but also good capital allocators.*
- ☞ *Strong Balance Sheets – lean towards companies that underutilize debt.*
- ☞ *(Free cash flows + high return on capital = internal financing of growth = little debt)*



Growth



$$\boxed{\text{Earnings Growth}} + \boxed{\text{Dividends}} = \boxed{\text{Growth}}$$

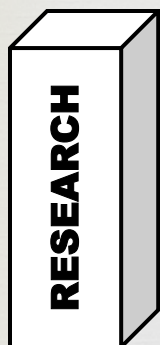
This dimension doesn't just encapsulate earnings and free cash flows growth but it also counts dividends. Dividends are important for two reasons:

❧ *Quantitative* – historically, over 100 plus years, 1/2 returns for stocks came from dividends.

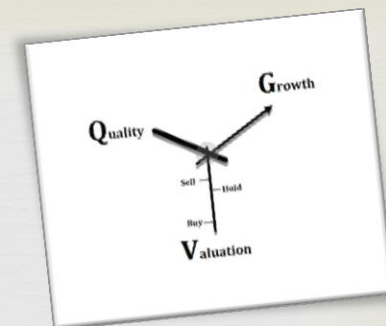
In sideways markets dividends constitute a larger (over 90%) portion of total return.

*In theory, there is no difference between theory and practice. But, in practice, there is.
- Yogi Berra / Jan L. A. van de Snepscheut*

❧ *Qualitative* - is as important, creates another fixed cost (not unlike a rent expense) for a company thus management has to be more frugal and also it limits management's ability to do stupid things with cash flows.

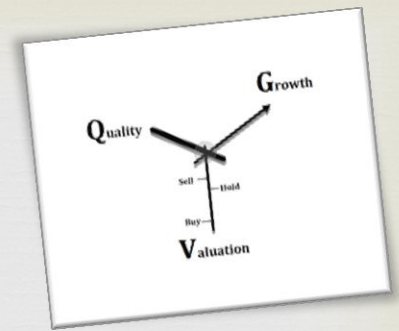


Valuation



- ❧ *We want to buy the company at a significant discount to their fair value - this is a given. Increase margin of safety in sideways markets. Instead of looking for 70 cent \$1, 40-50 cent \$1.*
- ❧ *No model is perfect, all have limitations. We look at several valuation models: sum of parts; absolute P/E, relative P/E, replacement cost, discounted cash flows - this one is very important as it puts in the shoes of investor not speculator.*
- ❧ *In the sideways market environment – declining P/E is your enemy, relative valuation models are dangerous and should be used with caution, absolute valuation models should carry more weight.*

QVG All Together



Quality, Valuation, Growth framework is important for these reasons:

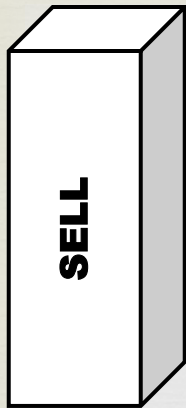
- ☞ Systematizes analytical process - to some degree it serves as a checklist*
- ☞ Helps to understand what is an ideal company.*
- ☞ Paramount in understanding on what we should and should not compromise. Ideally, we want to own companies that ace all QVG dimensions, and though once in a blue moon we'll get an opportunity to own a few of those stocks, it is unlikely that we'll ever have a chance to have a portfolio of them. It is important to know what compromises we are willing to make within and between QVG dimensions. It also helps us to walk away from stocks if we believe we are making too many compromises.*

Process



- ❧ *This is the least exciting part of the investment process, but knowledge is cumulative and thus as you own/follow you will learn a lot more about the businesses. We don't just listen or follow the stocks we own, we follow competitors as well.*
- ❧ *One caveat to the “knowledge is cumulative” argument: it is only cumulative if you can remember and recall. Recalling becomes difficult, because our memory gets overloaded with data. We (like everyone else) look at hundreds of companies, listen to hundreds of conference calls, read hundreds of Ks and Qs, etc. To help us recall, we write down our thesis, take notes of conversations we have with management, record our thoughts from conference calls, etc. (we are big fans of Evernote software).*
- ❧ *Constantly try to debunk your thesis; look for the “other side” arguments.*

*You can observe a lot by just watching.
- Yogi Berra*



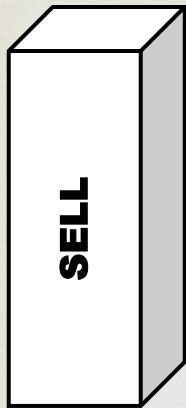
Process



Sell process is as important as the buy process but usually more psychologically difficult. In sideways markets “buy and hold” is not dead, but in the coma waiting for next secular bull market. Selling should be kicked into higher gear. There are three reasons why we sell an investment:

*I made my money by selling too soon
- Bernard Baruch*

- 1. **It made you money.** Difficult because you feel a sense of loyalty after all it made you money, you feel vested into a company, got to know the management, listened to countless presentations and conference calls etc. The best way to deal with this attachment is to set target valuation/price at the time when you buy the stock, at that point you are more rational about what the company is worth.*



Process



*When the facts change, I change my mind. What do you do?
- John Maynard Keynes*

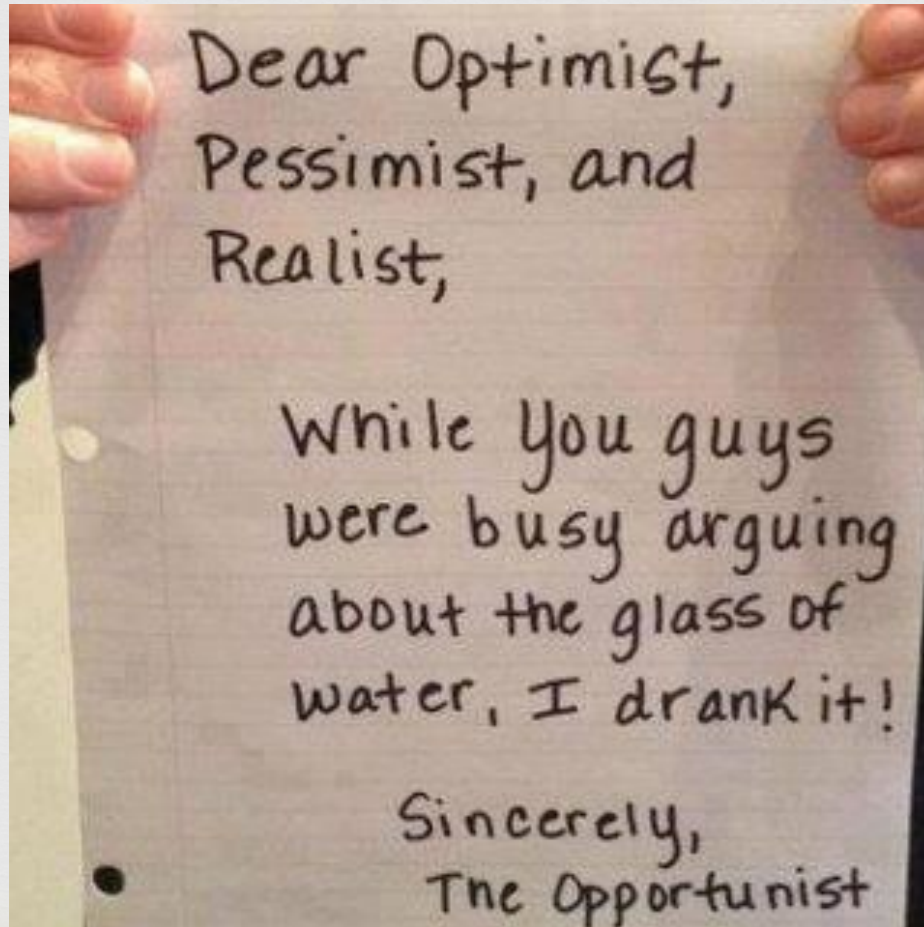
- 2. **Things changed.** It is even more important and more psychologically difficult. To maintain rationality when it comes to selling, do a detailed write up at the time of purchase of why you are buying a stock, spell out your assumptions. When things go bad, and they will, revisit your assumptions and ask yourself a question - if I did not own the stock would I buy it what I know now?*
- 3. **Better opportunities.** Stocks in our portfolio should compete with other stocks (and other asset classes). If we see a better opportunity (especially in similar industry) – lower risk / higher reward, we sell and buy something else. To ease psychological pain – quantify risk and reward for existing position and new position.*

Additional Adjustments



- ❧ ***Pain arbitrage** – have a longer time horizon than competition. Hedge funds have time horizon of months, mutual funds of a few quarters. Often opportunities presented when stock is expected to do nothing for a few quarters or year. This is the only free lunch.*
- ❧ ***Diversification** – in theory sounds great, but often leads to over-diversification, too many stocks breed indifference. It is a balance between owning too few that you cannot recover from a few stocks blowing up and too many so you grow indifferent. We find 20 to 30 stock portfolio strikes the right balance – every decision matters but we can recover from being wrong on a few stocks.*
- ❧ ***Focus** – paraphrasing Steve Jobs – it is not about the companies we choose to analyze it is about the ones we choose not to analyze. There is only so much time in the day you cannot be in expert in everything.*
- ❧

❧ *Opportunistic* – do nothing if there is nothing to buy.
Wait for unique opportunities.



Thank You!



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